Chapter 7

The Funding Vehicle

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§ 7:1 Regulation Under the Investment Company Act

The vast majority of variable products are offered through a two-tier structure comparable to that used by master-feeder funds.[1] Specifically, an open-end investment management company sells its shares to one or more insurance company separate accounts that are registered under the Investment Company Act of 1940 (the "Investment Company Act") as unit investment trusts. Typically, these underlying funds are not affiliated with the separate accounts to which their shares are sold. In effect, this represents a delegation of the portfolio management function by the participating insurance companies to the underlying mutual funds.

In many respects, underlying mutual funds resemble retail mutual funds that are sold directly to the public. Indeed, the usual practice is for fund sponsors to create an underlying mutual fund by "cloning" it from an existing retail fund.[2] That is, the "clone" insurance products fund often will have the same investment objective, investment policies, investment adviser, and portfolio manager as the retail fund. This approach offers a number of advantages, including administrative efficiencies, expedited Securities and Exchange Commission (SEC) review,[3] and the ability to tout the past performance of the

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1. Like a master-feeder fund, an insurance company separate account investing in an underlying mutual fund generally relies on section 12(d)(1)(E) of the Investment Company Act of 1940 (the "Investment Company Act") to avoid section 12(d)(1)'s usual restrictions on the "layering" of investment companies. Section 12(d)(1)(E) imposes several conditions, including the requirement that the security of the underlying mutual fund be "the only investment security" held by the separate account. Because of this requirement, a separate account typically divides into "sub-accounts," each of which invests exclusively in either a single underlying fund or in a single series of an underlying fund. Note that under section 12(d)(1)(G) of the Investment Company Act, a single sub-account could invest in *more than one underlying fund or series* if the separate account and the funds/series all are part of the same "group of investment companies" and certain other conditions are met.
2. Like retail funds, insurance underlying funds register both the issuing investment company and the shares it issues on Form N-1A.
3. Ordinarily, the SEC staff would selectively review an underlying fund's initial registration statement on Form N-1A based on its similarity to a retail fund's existing registration statement. *See* Division of Investment Management Industry Comment Letter to Variable Insurance Registrants (Nov. 7, 1996) (stating that "[t]he Office of Insurance Products generally will accord selective review to a Form N-1A registration statement for an underlying fund based on prior review of a similar filing by the Division's Office of Disclosure and Review").

retail fund.[4] In general, underlying mutual funds are subject to the same panoply of regulations under the Investment Company Act and the Securities Act of 1933 (the "Securities Act"). However, there are differences, which this chapter explores.

§ 7:2 Unique Federal Tax Status of Underlying Mutual Funds

As discussed more extensively in chapter 4, Internal Revenue Code section 817(h) provides essentially that a variable annuity or variable life policy preserves tax deferral only if the underlying assets are "adequately diversified." Stated differently, a holder of a variable insurance contract is subject to current taxation if his or her contract is *not* adequately diversified under section 817(h). As discussed in chapter 4, there are two basic diversification tests, the alternative safe harbor test and the general diversification test.

Variable annuities and variable life policies that invest in underlying mutual funds generally meet this diversification requirement by qualifying for the "look through" rule of Treasury Regulation 1.817-5(f). If a variable contract qualifies under this rule, it may "look through" to the assets held by the underlying fund for purposes of meeting the diversification requirements. That is, the variable contract may treat its interest in the underlying fund not as a single investment, but rather as a pro rata holding of the fund's portfolio securities.

To qualify for "look through" treatment, all the beneficial interests in the underlying fund must be held by one or more segregated asset accounts of one or more insurance companies, and public access to the fund must be available exclusively through the purchase of a variable

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4. For a number of years, the SEC staff permitted a variable insurance registrant to set out in its prospectus the past performance of the retail fund counterpart, provided that such substitute performance factored in all of the expenses of the separate account. *See* Division of Investment Management Industry Comment Letter to Variable Insurance Registrants (Nov. 12, 1993). The SEC staff currently requires that such performance be set out only in the registration statement of the applicable underlying fund. In 1997, the Division permitted such "clone fund" performance to also be depicted in Rule 482 advertisements and supplemental sales literature. ITT Hartford Mutual Funds, SEC No-Action Letter (Feb. 7, 1997) (newly created retail mutual fund was permitted to advertise the past performance of an existing, and similarly managed, insurance products fund). Despite the SEC's position, FINRA continues to prohibit such "clone fund" performance in broker-dealer advertisements and sales literature. In File No. SR-NASD-98-11, FINRA proposed that variable product sales materials be allowed to include "clone fund" and other related performance information. That proposal was withdrawn in 2004. *See* section 19:5.1[A][2].

contract, subject to certain exceptions.[5] Under Treasury Regulations and an IRS Revenue Ruling, look through treatment is preserved even if the underlying mutual fund sells its shares to a variety of qualified retirement plans, including section 401(a) plans, section 403(b) plans, section 403(b) custodial accounts, and section 457 deferred compensation plans.[6] The IRS also has allowed an underlying fund's shares to be held by the fund's adviser if held in connection with the creation or management of the fund and if there is no intent to sell to the public.

As with retail mutual funds, diversification testing is done on a quarterly basis. In summary, insurance underlying funds have additional diversification requirements of which to be mindful.

§ 7:3 Mixed and Shared Funding

An underlying mutual fund that wishes to sell its shares to a variety of variable annuity and variable life insurance separate accounts needs to consider whether to apply for, and obtain, an exemptive order from the SEC. These exemptive orders are referred to as "mixed and shared" funding orders. Mixed funding exists where an underlying fund sells its shares to both variable annuity and variable life insurance separate accounts of the same insurance company or affiliated insurance companies. Shared funding exists where separate accounts of unaffiliated insurance companies invest in the same underlying mutual fund. Many underlying funds sell their shares to both insurance company separate accounts and *retirement plans,* and have received a form of mixed/shared funding order permitting them to do so.

Historically, a new underlying fund needed to obtain a mixed/shared funding order before selling its shares. The need for those orders derived largely from the fact that Rule 6e-3(T) under the Investment Company Act (which provides flexible premium variable life insurance issuers with a number of exemptions) explicitly permits mixed funding, but not shared funding.[7] However, in IM Guidance Update 2014-10, the SEC's Division of Investment Management observed that the exemptions granted by a mixed/shared funding

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5. *See* G. Pehrson, *Current Tax Law Issues Relating to Insurance Products*, appearing in course materials for 1995 ALI-ABA Conference on Life Insurance Company Products.
6. *See id.*
7. *See* Separate Accounts Funding Flexible Premium Variable Life Insurance Contracts, Investment Company Act Release No. 15,651 (Mar. 30, 1987), in which the SEC indicated that because "[t]oo few applications have been received to have raised and explored all of the issues inherent in these arrangements," Rule 6e-3(T) was not drafted to allow for shared funding. Note, however, that shared funding that involved only variable annuity separate accounts would not be prohibited by Rule 6e-3(T) because that rule pertains only to variable life insurance.

order are relied upon very infrequently. Thus, the Division announced that an underlying fund (a) is not required to obtain a mixed/shared funding order prior to offering its shares, and (b) that has previously obtained a mixed/shared funding order, need not comply with the terms and conditions of that order if the exemptions granted by the order are not being relied upon by any person. Finally, the Division indicated that if the exemptions afforded by a mixed/shared funding order are not needed, underlying funds should consider amending the participation agreements they have with insurers and/or retirement plans, to eliminate references to the mixed/shared funding conditions.

The premise underlying mixed/shared funding is one that has appeared elsewhere in SEC precedents. Specifically, the concept is that additional protections are required to guard against the conflicts of interest that may arise when discrete classes of shareholders invest in the same fund. This concern figured prominently in the hundreds of SEC multi-class exemptive orders that preceded Rule 18f-3 under the Investment Company Act.[8] As in the current mixed/shared funding orders, the multi-class orders required the fund's board of directors to monitor for conflicts among the different share classes and take remedial action if an irreconcilable conflict developed.[9] It is noteworthy that the board monitoring requirement of the multi-class orders was not incorporated into Rule 18f-3. In lieu of multiple board reviews, which the SEC indicated might involve "more ritual than

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8. Rule 18f-3 under the Investment Company Act permits open-end management companies to issue more than one class of voting stock without obtaining an exemptive order. *See* Class Voting on Distribution Plans, Investment Company Act Release No. 20,915 (Feb. 23, 1995) (adopting Rule 18f-3).

9. *E.g.*, Lincoln Renaissance Fund, Inc., Investment Company Act Release Nos. 19,991 (Dec. 30, 1993) (notice) and 20,034 (Jan. 25, 1994) (order). As was typical for multi-class orders, the *Lincoln Renaissance* order contained the following condition:

> On an ongoing basis, the directors of a Fund, pursuant to their fiduciary responsibilities under the Act and otherwise, will monitor the Fund for the existence of any material conflicts between the interests of the various classes of shares offered by the Fund. The directors, including a majority of the independent directors, shall take such action as is reasonably necessary to eliminate any such conflicts that may develop. The Investment Adviser and the Distributor will be responsible for reporting any potential or existing conflicts to the boards of directors. If a conflict arises, the Investment Adviser and the Distributor at their own cost will remedy such conflict up to and including, if necessary, establishing new registered management investment companies.

substance," the SEC required the fund's board to make a single finding.[10]

The concern with conflicts of interest also appears in the regulation of master-feeder funds. For example, a feeder fund shareholder faces the risk that a change to the master fund's investment objective will be approved by the other feeder funds investing in the master, but not approved by his or her fund. In such a scenario, the nonconforming feeder fund could choose to redeem all its master fund shares and reinvest in a more suitable master fund. To address this concern, the SEC requires clear disclosure in the feeder fund's prospectus as to this possibility.[11] A fund engaged in mixed/shared funding must not only disclose the attendant risks in its prospectus,[12] but also might need to obtain an SEC order. In sum, despite the similarities between multi-class arrangements and master-feeder funds on the one hand, and mixed/shared funding on the other, the latter is subject to somewhat different regulation.

The SEC's Division of Investment Management, acting by delegated authority, has issued a considerable number of mixed/shared funding orders. Not surprisingly, the representations and conditions in those orders have become somewhat standardized.

To its credit, the SEC staff has granted expansive class relief in recent exemptive orders, such that a fund complex typically should have to obtain only one mixed/shared funding order. It is possible that the SEC ultimately will codify these orders in the form of an exemptive rule. In the meantime, the typical conditions in mixed/shared funding orders in a nutshell include the following:

- A majority of the board of directors of the fund will consist of persons who are not "interested persons" of the fund, as defined by section 2(a)(19) of the Investment Company Act and the rules thereunder; and
- The board will monitor the fund for the existence of any material, irreconcilable conflict between and among the interests of the owners of all variable life and variable annuity contracts, and determine what action, if any, should be taken in response to such conflicts; and
- Participating insurance companies (on their own behalf, as well as by virtue of any investment of general account assets in the

10. *See* Investment Company Act Release No. 19,955 at n.48 and accompanying text (Dec. 15, 1993) (proposing Rule 18f-3).
11. Item 12(c)(4) of Form N-1A requires a feeder fund that has the ability to change the master fund in which it invests to briefly describe the consequences of no longer investing in the master fund. *See also* Feb. 22, 1993, Generic Comment Letter to investment company registrants.
12. *See* Nov. 8, 1990, Generic Comment Letter to Variable Insurance Registrants.

fund), and the adviser/subadviser to the fund (with respect to any seed money invested in the fund by the adviser/subadviser) must report any potential or existing conflicts to the board. Each such participant in the fund is responsible for assisting the board in carrying out the board's responsibilities, by providing the board with all information reasonably necessary for the board to consider any issues raised. This responsibility includes, but is not limited to, an obligation by each participating insurance company to inform the board whenever variable contract owner voting instructions are disregarded. The responsibility to report such information and conflicts, and to assist the board, must be a contractual obligation of all participating insurance companies under their participation agreement with the fund, and these responsibilities must be carried out with a view only to the interests of the variable contract owners; and

- If it is determined by a majority of the board, or a majority of the disinterested directors, that a material irreconcilable conflict exists, then the relevant participant in the fund must, at its expense and to the extent reasonably practicable (as determined by a majority of the disinterested directors), take whatever steps are necessary to remedy or eliminate the material irreconcilable conflict, up to and including: (a) withdrawing the assets allocable to some or all of their separate accounts from the fund and reinvesting such assets in a different investment vehicle, including another fund; (b) in the case of a participating insurance company, submitting the question as to whether such segregation should be implemented to a vote of all affected variable contract owners and, as appropriate, segregating the assets of any appropriate group that votes in favor of such segregation, or offering to the affected contract owners the option of making such a change; and (c) establishing a new registered management investment company or managed separate account; and
- The determination by the board of the existence of a material irreconcilable conflict and its implications must be made known in writing promptly to all participants in the fund; and
- Participating insurance companies must provide pass-through voting privileges to all variable contract owners whose contracts are issued through registered separate accounts for as long as the SEC continues to interpret the Investment Company Act as requiring such pass-through voting privileges. As to variable contracts issued through separate accounts that are not registered as investment companies under the Investment Company Act, pass-through voting privileges will be extended to owners of such contracts to the extent granted by the participating insurance company. Accordingly, such participating insurance

companies, where applicable, must vote the shares of the fund held in their separate accounts in a manner consistent with voting instructions timely received from variable contract owners. Participating insurance companies must be responsible for assuring that each of their separate accounts investing in the fund calculates voting privileges in a manner consistent with all other participating insurance companies investing in the fund. The obligation to calculate voting privileges as provided in the SEC order must be a contractual obligation of all participating insurance companies under their participation agreement with the fund. Each participating insurance company must vote shares of the fund held in its separate accounts for which no timely voting instructions are received, as well as shares held in its general account, in the same proportion as those shares for which voting instructions are received; and

- As long as the SEC continues to interpret the Investment Company Act as requiring that pass-through voting privileges be provided to variable contract owners, a fund adviser/subadviser or any general account must vote its respective shares of the fund in the same proportion as all votes cast on behalf of all variable contract owners having voting rights; provided, however, that such an adviser/subadviser or general account must vote its shares in such other manner as may be required by the SEC or its staff; and
- The fund must comply with all provisions of the Investment Company Act requiring voting by shareholders (which, for these purposes, must be the persons having a voting interest in its shares), and, in particular, the fund must either provide for annual meetings (except to the extent that the SEC may interpret section 16 of the Investment Company Act not to require such meetings) or comply with section 16(c) of the Investment Company Act; and
- The fund will make its shares available to the separate accounts at or about the time it accepts any seed capital from its adviser/subadviser or from the general account of a participating insurance company; and
- The fund must have notified, or will notify, all participants in the fund that disclosure regarding potential risks of mixed and shared funding may be appropriate in separate account prospectuses. The fund must disclose, in its prospectus, that: (a) shares of the fund may be offered to both variable annuity and variable life separate accounts; (b) due to differences in tax treatment and other considerations, the interests of various variable contract owners participating in the fund may conflict; and (c) the

fund's board must monitor events in order to identify the existence of any material irreconcilable conflicts and to determine what action, if any, should be taken in response to any such conflicts; and

- If and to the extent Rule 6e-2 and Rule 6e-3(T) under the Investment Company Act are amended, or proposed Rule 6e-3 under the Investment Company Act is adopted, to provide exemptive relief from any provision of the Investment Company Act, or the rules thereunder, with respect to mixed or shared funding, on terms and conditions materially different from any exemptions granted in the exemptive order, then the fund and the participating insurance companies, as appropriate, must take such steps as may be necessary to comply with Rules 6e-2 or 6e-3(T), as amended, or Rule 6e-3, to the extent such rules are applicable; and
- Each participant in the fund, at least annually, must submit to the board such reports, materials, or data as the board reasonably may request so that the directors may fully carry out the obligations imposed upon the board by the conditions contained in the exemptive order. Such reports, materials, and data must be submitted more frequently if deemed appropriate by the board. The obligations of the participants in the fund to provide these reports, materials, and data to the board, when it so reasonably requests, must be a contractual obligation of all participants under their participation agreement with the fund; and
- All reports of potential or existing conflicts received by the board, and all board action with regard to determining the existence of a conflict, notifying participants of a conflict, and determining whether any proposed action adequately remedies a conflict, will be properly recorded in the minutes of the board or other appropriate records, and such minutes or other records must be made available to the SEC upon request.[13]

In addition to these conditions, the SEC's Division of Investment Management has imposed extra conditions if retirement plans invest in the underlying fund. The "retirement plan" orders, for example, have required a plan to sign a participation agreement with the underlying fund if it owns 10% or more of the fund's assets. Commentators have observed that the SEC staff has not always been

13. *See, e.g.*, Arden Series Trust et al., Investment Company Act Release Nos. 30,745 (Oct. 17, 2013) (notice) and 30,781 (Nov. 12, 2013) (order).

consistent in the conditions it has imposed on retirement plans and unregistered separate accounts.[14]

§ 7:4 Rule 12b-1 Plans

Until 1996, the SEC staff essentially prohibited underlying mutual funds from imposing fees pursuant to Rule 12b-1 under the Investment Company Act.[15] The SEC staff observed that insurance companies already were charging for distribution costs through the mortality and expense risk charge imposed at the separate account level. Thus, the staff was concerned that a 12b-1 fee would represent a duplicative charge for distribution costs.[16]

In a May 30, 1996, letter issued to the American Council of Life Insurance and others ("May 30 Letter"), the SEC staff changed its position. (Editor's Note: The May 30 Letter can be found in the Appendix to Part II.) The May 30 Letter emphasizes that just like retail mutual funds, underlying funds are permitted to adopt and implement 12b-1 plans so long as they comply with Rule 12b-1's conditions. On the other hand, the May 30 Letter also noted that the unique nature of underlying funds dictates certain unique requirements for their 12b-1 plans. These requirements include the following:

- In determining whether a proposed 12b-1 plan will benefit the underlying fund and its shareholders, the fund's directors must view the "shareholders" as the holders of the variable contracts, rather than the separate account.

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14. *See* Gary O. Cohen, Mutual Funds Selling to Life Insurance Company Separate Accounts and Qualified Plans: Recent Developments Regarding SEC "Mixed, Shared and Plan Funding" Conditions. This outline, which was presented at the March 25–28, 1996, Mutual Funds and Investment Management Conference, provides a comprehensive analysis of mixed/shared funding regulation.

15. A few funds adopted 12b-1 plans prior to 1996 but deferred implementing them on account of the SEC staff's antipathy toward such plans. *See* Gary O. Cohen, *Advertising of Variable Insurance Products: Certain Developments and Related Matters Regarding Supplemental Sales Literature and Prospectuses, in* ALI-ABA Conference on Life Insurance Company Products Course Materials (Oct. 1994).

16. The SEC staff also raised issues under section 17(e) of the Investment Company Act with respect to an underlying fund's proposal to charge a 12b-1 fee. Section 17(e) issues could theoretically arise in several ways. For example, a separate account investing in an underlying fund could be an affiliate of the fund under section 2(a)(3) of the Investment Company Act on account of 5% ownership. The insurance company then would be an affiliate of an affiliate of the underlying fund, and thus, its receipt of compensation for distributing shares of the fund arguably would raise issues under section 17(e).

- Variable contract owners, rather than the participating separate accounts, would vote on the 12b-1 plan.[17]
- The separate account prospectus must fully disclose the 12b-1 fee.

The May 30 Letter was a positive development for the investment company industry. With an ever-increasing number of underlying funds available, insurance companies' costs of keeping their sales force properly educated about those funds have similarly increased. Rule 12b-1 fees received from underlying funds help to offset these costs of marketing underlying funds' shares.[18]

In addition to a 12b-1 fee, an underlying fund may pay an insurance company that invests in the fund through its separate account a fee for administrative services that the insurance company provides. These administrative services include keeping records of each contract holder's indirect investment in the underlying fund, answering contract holders' inquiries about the underlying fund, and similar duties. Typically, such administrative fees are equal to a percentage of the fund's assets that are attributable to the separate account's investment in the fund, and are memorialized either in the participation agreement or in a separate administrative services agreement that accompanies the participation agreement. How such fees are regulated depends on the nature of the services provided by the insurance company. Fees paid by the underlying fund could be deemed "service fees" under FINRA Rule 2830, which are defined as "payments by an investment company for personal service and/or the maintenance of shareholder accounts." On the other hand, FINRA, in Notice to

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17. Such a shareholder vote can be avoided (unless and until the plan is amended materially) if the 12b-1 plan is adopted before the fund's shares are sold publicly. The SEC staff used to require mutual funds to hold a shareholders' meeting to approve the 12b-1 plan and other matters that were put in place at the outset by the fund's investment adviser. That requirement was eliminated in 1992. *See* Feb. 22, 1993, Generic Comment Letter to mutual fund registrants.

18. Note that in Investment Company Act Release No. 29,367 (July 21, 2010), the SEC has proposed to rescind Rule 12b-1 and substitute a new regulatory framework to address how fund assets may be used to finance distribution costs. Under the new paradigm, new Rule 12b-2 would permit funds to deduct a fee of up to the NASD service fee limit (*i.e.*, 25 basis points) from fund assets to pay for distribution activities, without being subject to the limitations on sales loads set forth in proposed amendments to Rule 6c-10. As proposed to be amended, Rule 6c-10 would permit funds to deduct asset-based distribution fees in excess of the amount permitted under Rule 12b-2 (*i.e.*, 25 basis points annually), provided that the excess amount is considered an "ongoing sales charge" subject to certain sales charge restrictions and an automatic conversion feature. There has been no further SEC action on the proposal.

Members 93-12, has clarified that its definition of service fees does not encompass, among other things, charges for maintenance of records and the like. Thus, to the extent that the insurer's duties under its administrative arrangement with the underlying fund are those of a sub–transfer agent, it would appear that fees paid in that capacity would be outside of NASD Rule 2830's definition of "service fees."

§ 7:5 Participation Agreements

For the majority of variable insurance products, the issuing separate account invests in an underlying fund. Thus, each business day the insurance company (on behalf of the separate account) submits purchase and redemption orders to the fund. In addition to this daily transaction activity, there are a number of other activities in which the insurance company and underlying fund must cooperate. For example, a separate account is obligated to transmit to variable contract policyholders the annual and semi-annual reports produced by the underlying fund.[19] To clarify their respective duties, the sponsoring insurance company, the underlying fund, and its distributor enter into a "participation agreement." This section identifies the key issues that typically are addressed in a participation agreement.

§ 7:5.1 Purchases and Redemptions

The underlying fund agrees to sell its shares to the separate account at net asset value, but may reserve the right to terminate share sales. In addition, participation agreements provide that good order receipt of a purchase or redemption by the separate account is deemed to be good order receipt by the underlying fund. Thus, for example, if a variable annuity holder submits a purchase to the insurance company on business day 1, he purchases shares of the underlying fund at business day 1's price—even though the insurance company does not present that purchase order to the fund until business day 2.[20] Finally,

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19. Rule 30e-2 under the Investment Company Act imposes this obligation on trust accounts.

20. This practice was sanctioned by the SEC staff in the New York Life Fund, Inc., SEC No-Action Letter (May 6, 1971). In Investment Company Act Release No. 26,288 (Dec. 11, 2003), the SEC proposed amendments to Rule 22c-1, under which an order to purchase or redeem shares (or units) would receive the current day's price only if the investment company, its designated transfer agent, or a registered securities clearing agency receives the order by the time that the investment company establishes for calculating its net asset value. These amendments are intended to eliminate "late trading" of investment company securities by fund intermediaries (that is, the scenario in which an intermediary has been designated as a pricing agent of the investment company, the intermediary receives an order *after* the investment company's NAV determination time on a given day, yet the

to assure the separate account that the fund's assets can be counted for purposes of the "adequate diversification" requirement of Internal Revenue Code section 817(h), the underlying fund typically agrees to sell its shares to separate accounts and certain qualified retirement plans and to refrain from selling its shares to the general public.

§ 7:5.2 Prospectuses and Sales Literature

Because investors must receive a prospectus for each of the separate account and the fund, the fund often agrees to provide the insurance company with as many fund prospectuses as it needs. The insurance company may agree to pay for these prospectuses. With respect to sales literature, the participation agreement usually stipulates that the insurance company's broker-dealer not use sales literature mentioning the fund absent prior approval by the fund. The fund typically makes a comparable promise with respect to sales literature that it prepares mentioning the variable contracts.

§ 7:5.3 Mixed and Shared Funding Provisions

As discussed earlier in this chapter, the conditions to an underlying fund's mixed/shared funding exemptive order create a mechanism whereby conflicts are reported to the fund's board of directors. These conditions explicitly require that the various parties' obligations to identify and resolve conflicts be memorialized in the participation agreement. Thus, the participation agreement will provide that

(1) the participating insurance company must determine voting rights in a manner that is consistent with the methodology used by the other participating insurance companies;

(2) the participating insurance company must report to the board of the underlying fund concerning any potential or existing conflicts that arise, and provide the board with information related thereto; and

(3) the participating insurance company will resolve material irreconcilable conflicts at its own expense.

§ 7:5.4 Other Typical Provisions

Each party usually indemnifies the other against liability for materially inaccurate registration statements and sales literature, and for

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intermediary improperly characterizes the order as having been received by it prior to that NAV determination time). The proposed rule includes a "conduit fund" exception, under which a trust account could continue to serve as pricing agent of the underlying funds.

various other liabilities. The participation agreement may clarify that because the insurance company's broker-dealer has contact with the customer, it is responsible for determining suitability as to both the insurance and investment components of the variable insurance product.[21] Finally, like any other contract, the participation agreement typically will contain provisions as to choice of law, exclusion of oral statements, execution of the agreement in counterparts, and other matters.

§ 7:6 Substitution of Underlying Funds Held by UIT Accounts

Section 26(c) of the Investment Company Act makes it unlawful for any depositor or trustee of a registered unit investment trust (UIT) holding the security of a single issuer to substitute another security for such security unless the SEC has approved the substitution in advance. The section further directs the SEC to issue an exemptive order approving a substitution if the evidence establishes that the substitution is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Investment Company Act.[22] The SEC views each sub-account of a UIT separate account that invests in shares of a single series of an underlying fund as being subject to section 26(c). Thus, a depositor would be prohibited by section 26(c) from substituting another series' shares within that sub-account.

Section 26(c) was intended to protect investors' expectation that the UIT's holdings will be static and not be altered unilaterally by the UIT's sponsor.[23] Consistent with that philosophy, the SEC staff on a number of occasions has permitted UIT sponsors to engage in

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21. In Notice to Members 96-86, NASD Regulation Reminds Members and Associated Persons That Sales of Variable Contracts Are Subject to NASD Suitability Requirements (Dec. 1996), FINRA clarified that for a variable insurance product, a suitability analysis requires an assessment of both the insurance element and the investment element of the product. *See also* Regulatory Notice 07-53 (announcing FINRA Rule 2821).

22. This standard for granting an exemptive order is similar to that in section 6(c), the general grant of exemptive authority under the Investment Company Act. Unlike section 6(c), however, section 26(c) does not require an applicant to demonstrate that the proposed exemption is "necessary or appropriate in the public interest."

23. Section 26(c) [formerly designated as section 26(b)] was enacted as part of the Investment Company Act Amendments of 1970. The section's legislative history states:

> The proposed amendment recognizes that in the case of a unit investment trust holding the securities of a single issuer notification to shareholders does not provide adequate protection since the only relief available to the shareholders, if dissatisfied, would be to

substitutions without an exemptive order where variable contract holders previously approved the substitution.[24] The staff's implicit reasoning in those no-action letters is that it need not act on behalf of contract owners to review a section 26(c) application if contract owners have received full disclosure and an opportunity to vote through the proxy process.

§ 7:6.1 Section 26(c) Applications

Absent no-action relief, a substitution can proceed only after receiving an order under section 26(c) from the SEC. In general, the orders issued by the SEC staff have adhered to a fairly standard set of conditions designed to assure that contract owners would be at least as well off after the substitution. In these orders, applicants typically represented the following:

- the investment objectives and policies of the fund to be substituted ("New Fund") are substantially similar to those of the fund being replaced ("Old Fund");
- the New Fund's fees are less than or equal to those of the Old Fund;[25]

> redeem their shares. A shareholder who redeems and reinvests the proceeds in another unit investment trust or in an open-end company would under most circumstances be subject to a new sales load. The proposed amendment would close this gap in shareholder protection by providing for Commission approval of the substitution.

1970 U.S.C.C.A.N. 4936 (quoting S. REP. NO. 91-184).

24. *See, e.g.*, Nw. Nat'l Life Ins. Co. et al., SEC No-Action Letter (Apr. 10, 1995); Generic Comment Letter (Nov. 15, 1991); Bankers Sec. Life Ins. Soc'y, SEC No-Action Letter (July 11, 1991); Conn. Gen. Life Ins. Co., SEC No-Action Letter (Oct. 3, 1985). Key conditions to this line of no-action letters included, among other things, that: (a) contract holders had approved the proposed substitution, and (b) the depositor voted shares as to which no voting instructions were received as well as shares that it owned in the same proportion as the votes of the variable contract owners. *See also* Janus Aspen Series (Apr. 10, 2008), in which the SEC staff provided no-action assurance under section 26(c), where two underlying funds, unaffiliated with the insurer, merged in reliance on Rule 17a-8, but *without* a shareholder vote. In Janus Aspen Series, the staff's response noted, among other things, that (a) the surviving fund has no fundamental investment policy that differed from a fundamental policy of the merging fund, (b) no advisory contract of the surviving fund was materially different than an advisory contract of the merging fund, (c) directors of the merging fund who were outside directors *and* elected by shareholders constituted a majority of the outside directors of the surviving fund, and (d) 12b-1 fees of the surviving fund were no higher than those of merging fund.

25. If the New Fund's fees are higher than those of the Old Fund, the SEC staff typically will require the New Fund to cap its expenses for two years after

- the cost of the substitution will be borne by the insurance company or the New Fund's investment adviser, rather than by the variable contract owners;
- variable contract owners' account values and contractual rights will not change on account of the substitution;[26]
- the substitution will not create tax consequences for variable contract owners;
- variable contract owners who are dissatisfied may be allowed to transfer money out of the sub-account corresponding to the New Fund without charge (and without the transfer being counted as such) for a brief period after the substitution (for example, thirty days);[27]
- either before or after the substitution, affected contract owners are mailed a notice that describes the substitution;
- an amended prospectus (or sticker) is delivered to contract owners;

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the substitution, so that its expenses are less than or equal to those of the Old Fund. *See, e.g.*, Allianz Life Ins. Co. of N. Am. et al., Investment Company Act Release Nos. 28,369 (Aug. 28, 2008) (notice) and 28,384 (Sept. 19, 2008) (order).

26. *See, e.g.*, Pacific Life Ins. Co., et al., Investment Company Act Release Nos. 30,744 (Oct. 17, 2013) (notice) and 30,777 (order). The *Pacific Life* order involved variable annuity separate contracts with living benefit riders. In an acknowledgment of the importance of such riders to variable annuity contracts, applicants represented that the "Proposed Substitution will not adversely affect existing Contract Owners who elected optional living benefit riders and allocated Contract value to Subaccounts investing in the Replaced Portfolio since the Replacement Portfolio is an allowable Investment Option for use with such riders."

27. *See* MetLife Ins. Co. of Conn., et al., Investment Company Act Release No. 29,190 (Mar. 25, 2010) (notice), in which Applicants represented that:

> within five business days after the proposed substitutions are completed, Contract owners will be sent a written notice informing them that the substitutions were carried out and that they may make one transfer of all Contract value or cash value under a Contract invested in any one of the sub-accounts on the date of the notice to one or more other sub-accounts available under their Contract at no cost and without regard to the usual limit on the frequency of transfers from the variable account options to the fixed account options. The notice will also reiterate that (other than with respect to "market timing" activity) the Insurance Company will not exercise any rights reserved by it under the Contracts to impose additional restrictions on transfers or to impose any charges on transfers until at least 30 days after the proposed substitutions.

- the New Fund may be larger (thus generating economies of scale) than the Old Fund, and may have a superior performance history;[28] and
- where the insurer received portfolio securities of the Old Fund in lieu of cash (that is, an "in-kind" redemption), and used those portfolio securities to purchase shares of a New Fund advised by an affiliate, Applicants have sought and obtained relief under section 17 of the Investment Company Act.[29]

The SEC staff also appears to be wary of a substitution through which the insurance company will directly or indirectly reap some benefit. Evidence for this sentiment includes the following:

- orders in which Applicants represented that the decision to substitute was not motivated by any financial consideration paid, or to be paid, to Applicants or its affiliates by the New Fund and its affiliates;[30]
- where the New Fund has a "manager-of-managers" SEC exemptive order,[31] and the Old Fund does not, the SEC staff is likely to insist that the New Fund not rely on that order (such as

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28. *See, e.g.*, ING Life Ins. and Annuity Co., Investment Company Act Release Nos. 27,253 (Feb. 28, 2006) (notice) and 27,275 (Mar. 28, 2006) (order); Merrill Lynch Life Ins. Co., Investment Company Act Release Nos. 23,776 (Apr. 8, 1999) (notice) and 23,819 (Apr. 30, 1999) (order); Citicorp Life Ins. Co., Investment Company Act Release Nos. 22,567 (Mar. 14, 1997) (notice) and 22,614 (Apr. 10, 1997) (order).
29. *See, e.g.*, Allianz Life Ins. Co. of N. Am., Investment Company Act Release Nos. 28,369 (Aug. 28, 2008) (notice) and 28,384 (Sept. 19, 2008) (order); The Penn Mutual Life Ins. Co., Investment Company Act Release Nos. 28,328 (July 2, 2008) (notice) and 28,342 (July 25, 2008) (order).
30. *E.g.*, AIG SunAmerica Life Assurance Co., Investment Company Act Release Nos. 26,257 (Nov. 18, 2003) (notice) and 26,293 (Dec. 15, 2003) (order).
31. The adviser to a fund subject to such an exemptive order may, under specified conditions, change subadvisers, or materially amend a subadvisory agreement, without obtaining a shareholder vote. This line of exemptive orders is generally consistent with no-action letters that allow certain restructurings of subadvisory arrangements without a shareholder vote. *See, e.g.*, INVESCO, SEC No-Action Letter (Aug. 5, 1997), in which the adviser was permitted to change the portion of the advisory fee that it paid to the subadviser without obtaining a shareholder vote. In Investment Company Act Release No. 26,230 (Oct. 23, 2003), the SEC proposed Rule 15a-5, which would essentially codify those exemptive orders. There has been no further SEC action on proposed Rule 15a-5.

by firing a subadviser) unless shareholders have approved the "manager-of-managers" structure;[32]

- orders in which the insurer specifically represented that it would not receive benefits from the New Fund (or its adviser or affiliates) that exceeded the benefits that the insurer derived from the Old Fund;[33]
- a no-action letter, in which the SEC staff's response highlighted the staff's aversion to substitutions that are motivated by the prospect of financial benefit to the insurer. Specifically, *AIG Life Insurance Company* (August 16, 2001) concerned a scenario in which a Merrill Lynch-affiliated underlying fund liquidated, and for contract owners who did not (after notice from the insurer) express a preference as to where their account value should be reinvested, the insurer sought to allocate account value by default to a Merrill Lynch-affiliated money market fund. The insurer questioned whether section 26(c) governed this situation, given that the liquidation of the underlying fund was not instigated by it. The SEC staff granted no-action assurance under certain conditions. Nonetheless, the staff cautioned that "[w]e do not agree with your assertion that section 26(c) is premised on the existence of a voluntary affirmative act by the depositor that results in one security replacing another. In the

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32. *See, e.g.*, The Variable Annuity Life Ins. Co., Investment Company Act Release Nos. 24,714 (Oct. 26, 2000) (notice) and 24,742 (Nov. 17, 2000) (order), in which shareholders were to vote on both the New Fund's "manager-of-managers" structure as well as its higher management fees.

33. *E.g.*, United Investors Life Ins. Co., et al., Investment Company Act Release Nos. 25,313 (Dec. 7, 2001) (notice) and 25,351 (Dec. 31, 2001) (order), in which applicants represented that:

> United Investors does not currently receive (and will not receive for three years from the date of the Commission order requested herein) any direct or indirect benefit from AIM Capital Appreciation Fund or AIM Advisors, Inc., or any of its affiliates, that would exceed the amount that United Investors has received from the Discovery Fund or Strong Capital Management Inc., or any of its affiliates, including without limitation Rule 12b-1 fees, shareholder service or administrative or other service fees, revenue sharing or other arrangements, either with specific reference to the AIM Capital Appreciation Fund or as part of an overall business arrangement.

See also Ameritas Life Ins. Corp., et al., Investment Company Act Release Nos. 30,764 (Oct. 25, 2013) (notice) and 30,787 (Nov. 15, 2013) (order) (making a comparable representation regarding the receipt of revenue sharing and the like by the applicant insurers during the three-year period after the substitution).

staff's view, a substitution may involve the abuses that section 26(c) was designed to protect against, regardless of whether the reallocation is undertaken entirely on the depositor's own initiative or in response to circumstances, such as the liquidation of an unaffiliated underlying fund, that the depositor did not initiate. For example, absent the requirements of section 26(c), upon the liquidation of an unaffiliated fund, an insurer could reallocate the proceeds to an affiliated fund with higher expenses, *potentially enriching itself at the expense of contract owners affected by the liquidation*"[34] (emphasis added).

§ 7:7 Mutual Fund Redemption Fees

In 2003, the New York Attorney General's Office, the SEC, and other regulators brought enforcement actions against a number of major mutual fund complexes for "late trading" and market timing. "Late trading" can come in a variety of forms. For example, a favored investor may place an order with the fund prior to the fund's transaction cut-off time, but then be given a period of time after the cut-off to either affirm the order or disavow the order, depending on how the market moved. Market timing similarly can occur in a number of ways, but in general refers to frequent mutual fund trades occurring within a short time period. In addition to its enforcement actions, the SEC acted quickly to propose rules designed to combat these trading abuses. Reacting to the fact that several of the trading improprieties had been effected through intermediaries, the SEC proposed amendments to Rule 22c-1 to limit the kinds of entities that can serve

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34. The AIG letter cited in the text sets forth a procedure for handling the liquidation of an unaffiliated fund without seeking an SEC section 26(c) order. In particular, the staff stated that it would not take enforcement action if AIG, without obtaining an SEC order, allocated monies received upon liquidation of a portfolio to the subaccount that invests in a money market fund. The staff relied on a number of representations, including the absence of affiliation between the insurance company and the Old Fund, and certain notices to contract owners and opportunities to select alternative investments. In Am. Enters. Life Ins. Co., SEC No-Action Letter (Apr. 30, 2002), the staff took a no-action position in similar circumstances where the money market fund to which the liquidation proceeds would be allocated was affiliated with the insurance company. The staff continued to note the importance of the lack of affiliation between the Old Fund and the insurance company. *See also* AIG Life Ins. Co., SEC No-Action Letter (Nov. 6, 2001) (granting no-action for substitution replacing a class of fund shares with higher total expenses with a class of shares of the same fund with lower total expenses).

as agent of the fund for pricing purposes.[35] In addition, the SEC proposed,[36] and ultimately adopted,[37] Rule 22c-2 under the Investment Company Act.

Rule 22c-2 gives mutual funds an additional tool with which to combat market timing by permitting the imposition of a redemption fee of up to 2%. Because market timers often profit by exploiting only small price differences, a redemption fee, it is theorized, would eliminate the profitability of many of their trades. To the extent that a market timer proceeded with a trade nonetheless, the redemption fee imposed is required to be paid to the fund, thus compensating other shareholders for the costs associated with rapid trading.

The basic requirements of Rule 22c-2 are as follows:

- The board of directors of the fund, including underlying funds, decides
  - (i) whether to impose a redemption fee,
  - (ii) the amount of the fee (not to exceed 2%), and
  - (iii) the minimum holding period required to avoid a redemption fee (the period must be at least seven calendar days).
- To enable funds to effectively police market timing, funds must enter into written agreements with all intermediaries through which fund shares are sold. The rule includes as intermediaries entities such as broker-dealers and insurance company separate accounts. Under these written agreements, intermediaries must furnish the fund with information that will allow a fund to monitor trading and identify individual shareholders who are engaging in impermissible market timing. Thus, for example, the intermediary must identify individual shareholders according to their taxpayer identification number (TIN). Based on its review of this trading data, a fund may ask an intermediary to restrict or prohibit further trading by a particular shareholder, and the rule obligates intermediaries to enforce that request by the fund. Thus, an underlying fund could direct an insurer to restrict trading by a particular variable annuity contract holder.

As adopted, Rule 22c-2 had a compliance date of October 16, 2006. However, there was substantial controversy associated with the rule, particularly as it applied to variable products. In light of this controversy, and the host of interpretive issues that were unanswered by the adopting release, the SEC proposed amendments to Rule 22c-2 in

35. Investment Company Act Release No. 26,288 (Dec. 11, 2003).
36. Investment Company Act Release No. 26,375 (Mar. 2, 2004).
37. Investment Company Act Release No. 26,782 (Mar. 11, 2005).

February 2006.[38] The proposed amendments dealt primarily with intermediaries. For example, the proposed amendments sought to clarify how a fund addresses multiple intermediaries, such as where an underlying fund sells to a separate account (intermediary #1) that in turn sells a variable product to a participant-directed retirement plan (intermediary #2). The release adopting the proposed amendments[39] clarified that a fund must enter into a shareholder information agreement only with "first-tier intermediaries" (that is, financial intermediaries that submit their orders directly to the fund, its principal underwriter, transfer agent, or a registered clearing agency). That does not mean, however, that second-tier (or third-tier) intermediaries are immune from monitoring. Under the final rule, a fund may identify specific contract holders, and ask the first-tier intermediary to determine whether or not those contract holders are themselves financial intermediaries. If they are, the fund then may ask the first-tier intermediary to seek to obtain underlying transaction details from the second-tier intermediary. If the second-tier intermediary refuses, the fund may ask the first-tier intermediary to refuse the second-tier intermediary's purchases and transfers in fund shares. The information-sharing aspect of the rule became effective on October 16, 2007, although funds were required to enter into shareholder information agreements with their first-tier intermediaries no later than April 16, 2007.

There are several issues under Rule 22c-2 that could be problematic for variable product issuers:

- *In-Force Contract Issue.* With respect to their in-force contracts, insurers would be obligated to collect redemption fees from transgressing contract holders and/or to restrict the trading of such contract holders. Yet it is unlikely that these existing contracts have contractual provisions that vest the insurer with the authority to take those actions. Insurers therefore may face actions for breach of contract and possibly sanctions by state insurance regulators. The SEC's response to this concern has been to state in the releases that a redemption fee is not a fee under the insurance contract, but instead is merely a fee imposed by the underlying fund. Whether the SEC's statement will be dispositive in all forums is unclear.
- *Administrative Difficulties.* It is not uncommon for a separate account to invest in forty to fifty underlying funds from perhaps a dozen fund complexes. If several of these funds adopted redemption fees in different amounts that are triggered by

38. Investment Company Act Release No. 27,255 (Feb. 28, 2006).
39. Investment Company Act Release No. 27,504 (Sept. 27, 2006).

different holding periods, the administrative difficulties could be substantial.

- *Trading Restrictions.* As discussed above, an insurer may face contractual issues in seeking to restrict trading under in-force contracts that lack any provision for redemption fees. Restricting trading raises other issues as well. For example, the fact that a variable contract holder has been placed in restricted status by the underlying fund would not appear to affect the insurer's obligation to price in accordance with Rule 22c-1. Thus, if a contract holder who was recently placed in a restricted status submits a purchase order, must the insurer price the order in the desired allocation option in accordance with Rule 22c-1, or should the order be rejected as being not-in-good order?

§ 7:8 Rule 22e-3: Exemption for Liquidation of Money Market Funds

Rule 22e-3 under the Investment Company Act permits money market funds relying on Rule 2a-7, including money market funds underlying variable product separate accounts, to suspend redemptions if the fund's board (including a majority of directors who are not interested persons of the fund) irrevocably has approved the liquidation of the fund, and certain other conditions are met. Rule 22e-3 is intended to reduce the vulnerability of investors to the harmful effects of a run on the fund, and minimize the potential for disruption to the securities markets. The SEC adopted the rule in response to the difficulties of certain money market funds during the 2008 financial crisis, which experienced material deviations between the share value as calculated under the amortized cost method, and that determined based on the market value of the fund's securities. The board of a money market fund facing such a deviation might conclude that suspending the right of redemption, and liquidating the fund, is necessary to avoid harm to existing shareholders (for example, paying unjustifiably large redemption proceeds, based on amortized cost, to those who redeem out early). If the board reaches that conclusion, it may rely on Rule 22e-3 to suspend redemptions and adopt a plan of liquidation. Rule 22e-3 extends relief not only to the underlying money market fund, but also to a registered investment company (such as a registered separate account) that, in reliance on section 12(d)(1)(E) of the Investment Company Act, invests in the fund. Each of the money market fund and the separate account must notify the SEC's Division of Investment Management of its reliance on Rule 22e-3. Other considerations for variable product issuers include the following:

- *Unregistered Separate Accounts*. The exemption afforded by Rule 22e-3(b) extends only to registered investment companies that invest in underlying money market funds. This leaves unanswered how a separate account that is unregistered (for example, in reliance on section 3(c)(11) of the Investment Company Act because it sells only to certain qualified plans) would accommodate a registered underlying fund's decision to suspend redemptions. Under the Investment Company Act, one would point out that (a) in general, separate accounts that are unregistered in reliance on one of the exclusions in section 3(c) of the Investment Company Act are not investment companies in the first instance, and (b) more specifically, the prohibition on suspending redemptions under section 22(e) applies only to registered investment companies. Nonetheless, issues as to the authority of the unregistered separate account to suspend redemptions might arise under the participation agreement with the fund and/or the insurance contract issued by the sponsoring insurer.
- *Prospectus Disclosure*. For registered variable products, it is advisable to include prospectus disclosure that alerts investors to the fact that if an underlying money market fund suspends the right of redemption in reliance on Rule 22e-3, the separate account accordingly will suspend transfers and withdrawals (including death benefits) from the money market sub-account until the money market fund is liquidated.[40]
- *2014 Amendments to Rule 2a-7.* As indicated, Rule 22e-3, as adopted originally, permitted a money market fund to permanently suspend redemptions and liquidate if the fund's board determined that the deviation between the fund's amortized cost price per share and its market-based NAV per share could result in material dilution or unfair results to investors. In 2014, the SEC adopted significant rule amendments for money market funds that, among other things, amended Rule 22e-3. The 2014 amendments to Rule 2a-7 and various other rules are too extensive to describe in detail here. However, in brief, amended Rule 2a-7 divides money market funds into three types: Retail, Institutional, and Government. One of the most important rule changes was to no longer allow Institutional Prime money market funds to value their shares at $1 per share

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40. In Investment Company Act Release No. 29,132 (Feb. 23, 2010), the Release adopting Rule 22e-3, the Commission stated that "[a] fund that intends to be able to rely on rule 22e-3 may also need to update its prospectus to disclose the circumstances under which it may suspend redemptions." *Id.* at n.378.

(that is, the "floating NAV" requirement). Another major reform was the introduction of liquidity fees and gates, which are intended as tools a fund can employ to make the fund less vulnerable to heavy redemptions in times of market stress. If the money fund's liquid assets fall below a specified level (that is, less than 30% of the fund's assets are in weekly liquid assets), then the fund's Board *may*, but is not obligated to, impose fees and/or gates. A liquidity fee can be up to 2% of the amount withdrawn and is paid by the investor making the withdrawal. Under a "gate," redemptions can be suspended for up to ten business days during any rolling ninety-day period. Liquidity fees and gates apply only to Institutional Prime Funds and Retail Funds, not Government money funds.

As part of the 2014 money market fund amendments, the SEC also amended Rule 22e-3 to permit (but not require) the permanent suspension of redemptions and liquidation of a money market fund if the fund's level of "weekly liquid assets" falls below 10% of its total assets.

The 2014 money market fund amendments generated several issues for variable insurance products investing in money market funds. For example, a gate imposed by an underlying money market fund in effect would trigger the same redemption suspension for the subaccount investing in the money fund.

Insurers viewed such a scenario as problematic, because variable insurance products are redeemable securities and also may have explicit contractual provisions guaranteeing the ability to redeem. In response to a request by the Committee of Annuity Insurers, in 2015 the Division of Investment Management issued a series of Frequently Asked Questions (FAQs) that, among other things, addressed certain underlying fund issues.[41] In particular, FAQ 22 made clear that insurance companies, as a matter of law, can pass through any liquidity fee imposed by an underlying money market fund. As the Division of Investment Management stated, "the staff believes that liquidity fees (like redemption fees) are not subject to any limitations that may be contained in the variable contract. Paragraph (c)(2)(iv) of Rule 2a-7 allows the insurance company to administer a liquidity fee imposed by the fund, by applying the fund's liquidity fee to contract owners, without violating section 27(i) of the 1940 Act." Likewise, insurance companies, as a matter of law, can impose a gate on

41. *See* SEC, DIVISION OF INVESTMENT MANAGEMENT, 2014 MONEY MARKET FUND REFORM FREQUENTLY ASKED QUESTIONS (last updated Apr. 29, 2015), *available at* www.sec.gov/divisions/investment/guidance/2014-money-market-fund-reform-frequently-asked-questions.shtml.

subaccount transactions in response to a gate instituted by an underlying money market fund. In FAQ 23, the Division of Investment Management stated, "In the staff's view, if an underlying money market fund imposes a redemption gate, then for a separate account sub-account that has all of its assets invested in that fund, the fund's suspension of redemptions would in effect likely create an emergency for the sub-account for purposes of relevant contractual provisions."

§ 7:9 Special Exemptions for Underlying Funds

In certain rules under the Investment Company Act, the SEC has afforded exemptions to underlying funds.[42] These exemptions include:

- *Exemption from $100,000 Initial Net Worth Requirement.* To assure that registered investment companies have sufficient financial solvency, section 14(a) of the Investment Company Act requires such companies to have a net worth of at least $100,000 before making a public offering. Rule 14a-2 under the Investment Company Act exempts from this requirement a registered underlying fund that has as its "promoter" an insurance company meeting certain financial requirements.[43]
- *No 24f-2 Fees for Shares Sold to Registered Separate Accounts.* Under section 24(f) of the Investment Company Act and Rule 24f-2 thereunder, a mutual fund or UIT registers an indefinite number of shares and pays Securities Act registration fees each year based on the sales and redemptions that occurred in the prior year. An underlying fund pays no 24f-2 fees with respect to shares sold to registered separate accounts whose securities (for example, variable annuities) are subject to Rule 24f-2 fees.[44] On the other hand, an underlying fund *would* have to pay 24f-2 fees

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42. Note also that Rules 15a-3, 16a-1, and 32a-2 provide certain exemptions to newly created variable annuity separate accounts that are organized as open-end investment management companies. For example, Rule 15a-3 permits the adviser to such a managed separate account to serve without shareholder approval for up to one year after the effective date of the account's registration statement. Comparable exemptions exist for variable life insurance accounts in Rules 6e-2 and 6e-3(T).

43. "Promoter" is defined in section 2(a)(30) of the Investment Company Act as a person who, acting alone or in concert with other persons, is initiating or directing, or has within one year initiated or directed, the organization of the company. Rules 6e-2(b)(15) and 6e-3(T)(b)(15) each provide a similar exemption for certain underlying funds that the insurer has established. Because each of those rules, and Rule 14a-2, require that the underlying funds have been established by a life insurer, the rules would not exempt underlying funds that were organized by non-insurers.

44. *See* Investment Company Act Release No. 22,815 (Sept. 10, 1997) (adopting amendments to Rule 24f-2) and Instruction C(3) to Form 24f-2. That

with respect to shares sold to an exempt separate account that paid no Securities Act fees on its shares.[45] This SEC position acknowledges that in these two-tier arrangements, only one set of Rule 24f-2 fees should be paid.[46]

- *Different Prospectus Requirements.* For the most part, an underlying fund is subject to the same registration statement disclosure requirements that apply to retail mutual funds. Both underlying funds and retail mutual funds follow Form N-1A to register under the Investment Company Act and the Securities Act.

In 1998, the SEC enacted sweeping changes to Form N-1A, the SEC registration form used by open-end investment management companies.[47] One purpose of those amendments was to focus prospectus disclosure on those items that will be most pertinent to an investment decision. Consistent with that goal, the SEC now permits an underlying fund to tailor its prospectus by, among other things, omitting from its prospectus certain disclosures concerning shareholder information and distribution arrangements.[48] The SEC originally permitted an underlying fund that offered its shares exclusively to one or more separate accounts to omit from its prospectus the fee table required by Item 3 of Form N-1A. The rationale behind this position was that contract owners would be presented with both separate account and fund charges in the prospectus for the variable product—thus obviating the need to repeat fund fee information in the fund prospectus that they will receive. In the release adopting Form N-6,[49]

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instruction states that the aggregate sale price of securities sold to a UIT that offers interests that are registered under the Securities Act and on which a registration fee has been or will be paid to the SEC, may be excluded from the aggregate sale price of securities reported on Form 24f-2.

45. For example, a separate account that sold group variable annuities only to certain qualified retirement plans would be exempt under section 3(a)(2) of the Securities Act.

46. This position also comports with the SEC's treatment of master funds, which do not pay Securities Act registration fees because they sell their shares privately to the feeder funds.

47. *See* Investment Company Act Release No. 23,064 (Mar. 13, 1998).

48. *See* Gen. Instruction C(3)(d) of Form N-1A. This General Instruction indicates that this type of information may be omitted or modified if these topics are discussed in the prospectus for the variable product itself. In addition, an underlying fund is also given the ability to modify "other disclosure in the prospectus" consistent with offering the fund as a specific investment option for a variable contract. Funds sold to defined contribution plans qualified under sections 401(k), 403(b), or 457 of the Internal Revenue Code also may create such specially tailored prospectuses.

49. Investment Company Act Release No. 25,522 (Apr. 12, 2002). The SEC made this change "because the fee table in the Form N-6 prospectus will

the SEC eliminated this exclusion from the fee table requirement for underlying funds selling their shares to either variable life or variable annuity separate accounts.

§ 7:10 Fund Summary Prospectus

In 2009, the SEC adopted amendments to Form N-1A, Rule 498, and certain other provisions[50] that, among other things:

- *require* fund prospectuses (including underlying fund prospectuses) to include a summary section at the front of the prospectus containing, in *plain English*, key information about the fund, including investment objectives and strategies, risks, costs, and performance; and
- *permit* funds (including underlying funds) to create a prospectus summary (the "Summary") that can be delivered as a stand-alone document for purposes of: (i) offering fund shares, (ii) preceding or accompanying Rule 34b-1 supplemental sales literature, and (iii) prospectus delivery, as required in connection with the sale of fund shares. As a condition of item (iii), the fund must make its full, statutory prospectus and statement of additional information (SAI) available continuously online. The SEC's willingness to allow the statutory prospectus to reside online was predicated largely on its observation that "Internet use among adults is at an all time high with approximately three quarters of Americans having access to the Internet."

The Summary, therefore, represents the latest step in the "layered" disclosure approach that originated when the SEC transitioned from Form N-1 to Form N-1A in 1983.

If an underlying fund chooses to use a Summary, the insurer through which the fund is sold may fulfill its legal obligation to deliver a prospectus by delivering a Summary. Insurers likely will have to amend their participation agreement to accommodate a fund that uses a Summary. For example, insurance companies might seek an increased administrative services fee to compensate for the obligation to deliver both the Summary and the statutory prospectus (if the latter is requested).

Rule 498 raises two other unique issues for insurers—hyperlinking and binding.

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require variable life registrants to disclose the range of expenses for all Portfolio companies offered through a variable life insurance policy, rather than separately stating the fees and charges of each Portfolio company."

50. Investment Company Act Release Nos. 28,064 (Nov. 21, 2007) (proposing release) and 28,584 (Jan. 13, 2009) (adopting release).

- *Hyperlinking.* To facilitate an investor's access to the statutory prospectus and SAI, Rule 498 requires the Summary to identify a website where the investor may obtain the Summary, statutory prospectus, SAI, and certain other documents free of charge.[51] At that website, the Summary, statutory prospectus, and SAI must be hyperlinked so that, for example, an investor reading one section of the Summary can obtain further detail by automatically hyperlinking to the counterpart section of the statutory prospectus (or the pertinent item from the statutory prospectus table of contents). The division of responsibilities between fund and insurer with regard to hyperlinking must be clear. For example, an insurer may wish to consider the advisability of posting a fund Summary on its website where the Summary refers investors to the fund's website for the statutory prospectus and SAI. That is, mere placement of the fund Summary on the insurer's website might lead investors to assume that they can hyperlink to the fund statutory prospectus and SAI from the insurer's website (when that might not be the case).
- *Binding.* Rule 498 permits an insurer to bind the statutory prospectus for its variable product along with fund summaries, fund statutory prospectuses, or a mix of summaries and statutories. However, the Rule on its face appears to prohibit the binding of fund summaries and/or statutories as a separate "book."[52] Because many insurers deliver the fund prospectus separately, when an investor allocates money to the fund, insurers asked the SEC staff to permit delivery of fund summaries in the form of a separate "book." Reportedly, the staff supports that request. On the other hand, the staff has expressed concerns about a fund "book" containing any summary prospectuses and/or statutory prospectuses that are not available to the investor receiving the book (because that would violate the requirement that "all of the funds to which the summary prospectuses and statutory prospectuses that are bound together relate are available to the person to whom such documents are sent or given").

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51. Investment Company Act Release No. 28,584, at text accompanying n.262.
52. This is derived from the Rule's general prohibition against binding a summary with any other materials. *See* Investment Company Act Release No. 28,584, at n.214 and accompanying text.

Further interpretive questions may arise in connection with the widely anticipated variable annuity summary prospectus that is under development at the SEC.

§ 7:11 State Regulation of Underlying Funds

Originally, mutual funds were regulated directly by both federal and state securities regulators. In particular, state securities departments formerly had the authority to comment on fund prospectuses and impose substantive requirements on funds through so-called "merit regulation" laws.

Recognizing that these state laws generally were duplicative of SEC regulation, the federal government preempted these "merit regulation" laws in 1996 by enacting the National Securities Markets Improvement Act of 1996 (NSMIA). In pertinent part, NSMIA provides that:

- no law, rule, regulation, or order, or other administrative action of any state or any political subdivision thereof shall directly or indirectly prohibit, limit, or impose any conditions upon the use of any offering document (for example, a statutory prospectus) that is prepared by or on behalf of an issuer of a "covered security" (for example, securities issued by a registered mutual fund); and
- no law, rule, regulation, or order, or other administrative action of any state or any political subdivision thereof shall directly or indirectly prohibit, limit, or impose conditions, based on the merits of such offering or issuer, upon the offer or sale of a "covered security."

There is no doubt that these provisions preempt state merit regulation of retail mutual funds. As such, states now may only require notice filings of retail mutual funds, and may pursue such funds in the event of fraud or unlawful conduct.

For underlying mutual funds, there also is no doubt that these provisions preempt regulation by state *securities* departments in the same fashion as for retail funds. But states, through their *insurance* departments, might seek to impose merit regulations on underlying funds sponsored by domestic insurers. The literal language of NSMIA—which prohibits direct *or indirect* merit regulation by any "state"—appears to preempt such insurance department regulation as well.

Other sections of NSMIA, and its legislative history, that support this result include the following:

- In describing what state authority is preserved (for example, fraud authority), NSMIA states that "the securities commission (or any agency or office performing like functions) shall retain jurisdiction. . . ." In contrast, the section of NSMIA in which state laws are preempted refers more broadly to any law, rule, regulation, or order or other administrative action of any "state."
- House Report No. 104-622 (June 17, 1996) (accompanying H.R. 3005) states that the prohibition on state regulation "applies both to direct and indirect State action, thus precluding States from exercising indirect authority to regulate the matters preempted by Section 18(a). . . . By extending the prohibition to indirect State action, the Committee specifically intends to prevent *State regulators* from circumventing the provisions of Section 18(a) that expressly prohibit them from requiring the registration of, or otherwise imposing conditions or limitations upon, offerings of covered securities" (emphasis added).
- House Conference Report No. 104-864 (Sept. 28, 1996) states that "[s]ome securities offerings, such as those made by investment companies . . . are inherently national in nature, and are therefore subject only to Federal regulation."

Apart from the clear language of NSMIA, and its legislative history, is the notion of a "level playing field." Underlying funds often are developed as "clones" of retail mutual funds. It would be unfair to subject underlying funds, which ultimately compete with retail funds for investor dollars, to state insurance regulations.