

The SEC's Variable Contract Summary Prospectus and Disclosure Enhancement Proposals—Synopsis and Areas for Industry Comment

By W. Thomas Conner, Nathaniel Segal and Emily T. Rubino

November 2018

I. Overview of the Summary Prospectus Proposal

In a long-awaited development, the Securities and Exchange Commission (SEC or Commission), on October 30, 2018, issued a proposal consisting of new rules and registration form amendments that would permit insurance companies to provide investors in variable annuity contracts and variable life insurance policies (together, variable contracts) with a more concise, user-friendly disclosure document in the form of a “summary prospectus.” The proposal reflects a lengthy but ultimately successful degree of coordination between the Commission, its staff and industry participants to address the unique disclosure challenges posed by variable contracts.

The proposal reflects certain attributes of the mutual fund summary prospectus that has been widely and successfully implemented over the past decade. The proposal also reflects generally what the SEC has come to understand as a strong preference by investors for “layered disclosure.” Despite the SEC’s success in adopting layered disclosure through a summary prospectus for mutual funds, in developing a variable contract summary prospectus the SEC has been challenged by the unique “volume, format and content of disclosures” regarding variable contracts. This has made it difficult for many investors to find and understand the key information they need to make an informed investment decision.

In addition to variable contract complexity and the inherent length of variable contract prospectuses (often 150 pages and more), perhaps the most vexing challenge to the SEC and industry participants has been that the benefits and guarantees offered by variable annuity contracts (and, to some extent, variable life insurance policies) constantly evolve to reflect changing market conditions and investor concerns about funding their retirement. The latest generation of benefits and guarantees is offered to new investors only, so they require different information than existing contract owners who have already purchased a contract. These existing contract owners, however, need to have ongoing access to information about the specific prior generations of benefits and guarantees offered at the time they bought their contract as well as an understanding of whatever changes may have been made to their contract and the underlying funds offered within the contract.

The SEC addressed this conundrum by proposing the use of two versions of “summary prospectuses.

- ***Initial Summary Prospectus.*** The “initial summary prospectus” is intended to help investors make informed investment decisions regarding variable contracts. The initial summary prospectus would modernize disclosures by using a layered disclosure approach designed to provide investors with key information relating to a contract’s terms, benefits, and risks in a concise and more reader-friendly presentation, with access to more detailed information available online and electronically or in paper format on request.

The summary prospectus rule would also permit insurers to satisfy their prospectus delivery obligations under the federal securities laws for a variable contract by sending or giving a summary prospectus to investors and making the statutory prospectus available online. The proposal would require the insurance company issuing the contract (or the financial intermediary distributing the variable contract) to send the variable contract statutory prospectus and other materials to the investor in paper or electronic format upon request. The SEC also proposed amendments to the registration forms for variable contracts to update and enhance the disclosures to investors in these contracts and to implement the proposed summary prospectus framework.

- ***Updating Summary Prospectus.*** The second version of the summary prospectus would permit insurance companies to provide existing contract owners annually with updated information in the form of an “updating summary prospectus.” This document would provide a brief description of important changes to the contract as well as a subset of the information in the initial summary prospectus. The updating summary prospectus incorporates the notion that the combination of the availability of the statutory prospectus, which describes all of the current and prior generations of riders, together with the section in the updating summary prospectus that describes any changes that have been made to benefits and guarantees, updated underlying fund information and other “key information” should provide complete information to all contract owners without having to repeat disclosure about all of the various generations of riders in the updating summary prospectus.

II. Areas for Potential Industry Comment

We expect that many of the aspects of the proposal will be strongly supported by the industry. Industry participants will be studying the proposal, which is quite lengthy, for some time, but our initial reaction to the proposal leads us to believe that several aspects of the proposal are particularly noteworthy and may generate significant industry comment.

Underlying Fund Prospectus Delivery

The Commission has interpreted applicable sections of the federal securities laws to require the delivery of an underlying fund prospectus to any variable contract investor that allocates his or her purchase payments to that fund, including on any exchange of contract value. The Commission noted in the proposing release its understanding that since variable contracts generally offer exchange privileges permitting an investor to reallocate his or her investment from one underlying fund to another, prospectuses for all underlying funds offered under a contract typically are delivered to investors to avoid the administrative burden of tracking whether an investor has already received the current prospectus. Because the identity of investors is known by the insurance company and

not the underlying fund, delivery of prospectuses for underlying funds is typically effected by the insurance company rather than the underlying fund.

The proposal would consider an insurance company to have met its prospectus delivery obligations for underlying fund prospectuses associated with a variable contract if the insurance company uses an initial summary prospectus, and the initial summary prospectus, underlying fund prospectuses and fund summary prospectuses are posted online. This aspect of the proposal was not widely expected; in fact, while some commentators on the Commission's recent adoption of rules permitting mutual funds to deliver shareholder reports by making them available online urged the Commission to permit a similar approach for variable contract prospectuses, to our knowledge the industry has not widely advocated for a similar approach to underlying fund prospectuses.

Areas warranting additional analysis and possible industry comment include the following:

- Importantly, this aspect of the proposal, together with the ability to deliver much shorter updating summary prospectuses, could be a game-changer in several important ways, including changing the economics of existing participation agreements between issuing insurance companies and underlying funds as well as the dynamics of 12b-1 and revenue sharing arrangements between insurers and underlying funds.
- Underlying funds may currently satisfy applicable prospectus delivery obligations by coordinating with an insurance company offering the fund as an investment option in its variable contracts to permit delivery of fund summary prospectuses as long as the full fund prospectus is available online. However, coordinating the necessary compliance procedures required by this approach between the insurance company and the underlying fund may present operational and administrative challenges. This has reportedly slowed the widespread adoption of this approach. On the other hand, the proposing release states that the SEC understands that most insurers satisfy their underlying fund prospectus delivery obligation by delivering fund summary prospectuses. In any case, underlying fund sponsors that are not currently using fund summary prospectuses will now have an economic incentive to do so, which may also impact the economics of participation agreement cost sharing structures.
- For underlying funds that are sold to unaffiliated insurance companies (often referred to as "variable insurance trusts" or "VITs") that are not currently using fund summary prospectuses, the decision whether to do so may be complicated by the requirement of the proposed rule permitting satisfaction of delivery requirements for underlying fund prospectuses through online posting, that the insurance company use initial summary prospectuses for the contracts. Thus, one wonders how economical it will be for a fund sponsor to use underlying fund summary prospectuses where all of the insurance companies offering the fund as an investment option are not using contract initial summary prospectuses, and therefore the fund may still have to share some or all of the expenses of printing and mailing full fund prospectuses.

"Discontinued" or "Great-Wested" Contracts

There has been some concern brewing recently in the insurance industry that the Commission would use the adoption of the updating summary prospectus as an opportunity to retract the "Great-West"

line of SEC staff no-action letters. This line of no-action letters permits insurers with less than a specified number of contract owners represented by a particular registration statement, when the contracts are no longer offered for sale but subsequent premiums may be accepted, to provide substitute documents for annual updating or “evergreening” purposes. The substitute documents include underlying fund prospectuses as well as separate account financial statements.

The Commission recognized the cost and other potentially significant ramifications that could result from retracting the Great-West line of letters and potentially requiring updating of hundreds of discontinued and “dormant” registration statements. Accordingly, it did not propose a “hard cut-off” of the ability of insurers with blocks of contracts under 5,000 to operate in accordance with “Great-West” procedures, as some had feared. Instead, the Commission proposed that beginning on the ultimate effective date of any final summary prospectus rules, blocks of business that have been “Great-Wested” can remain in this state, provided there is no material change to the variable contract and investors continue to receive the substitute documents. Importantly, however, no variable contracts may be newly Great-Wested. Consequently, this aspect of the Commission’s proposal would seem to place insurers with blocks of business approaching 5,000 “on notice” of a limited window in which they can reasonably expect to be able to implement Great-West procedures for these contracts.

This could result in an anomalous outcome where Great-Wested contract owners annually receive full fund prospectuses, while non-Great-Wested contract owners would get no underlying fund prospectuses (because of the new rule that would deem online availability of underlying fund prospectuses to satisfy delivery requirements). Notably, the Commission also asked for comment on a variant of this approach, where, after the effective date, Great-Westing would be permitted only if a new set of “updating summary prospectus-lite” rules were adopted. Under these alternative rules, owners of variable contracts that have been Great-Wested would receive an annual notice that includes information comparable to that provided in an updating summary prospectus. In fact, in what would essentially be a variant of just “grandfathering” existing Great-Wested contracts as of the effective date of the final rules, the Commission asked for comment on whether these new rules should apply on a going forward basis or to the entire universe of Great-Wested contracts.

The Commission’s proposed “default” provisions—leaving existing Great-West conditions and procedures essentially in stasis—will likely be the strong preference of companies with larger and older blocks of Great-Wested contracts. This is because the alternative proposals would seem to be cumbersome, if not completely unworkable in certain circumstances. For example, preparing the “updating summary prospectus-lite” notice documents would require a description of, among other things, any material changes to the offering. This means insurers would need to determine what changes to include in the first version of the notice document when changes of varying types had been made to underlying funds or other features of the offering over a period of years while the registration statement has not been updated annually.

III. Collateral Issues of Concern or Potential Comment

Non-Insurance Company Industry Participant Interests. Many insurers “evergreen” existing contract owners by printing and mailing bound books of the contract prospectus and all of the underlying fund prospectuses. These books may run hundreds, if not over a thousand, pages long. While insurers, underlying funds and investors may benefit from the Commission’s proposed layered approach to variable contract disclosure, there are other industry service providers that may react negatively to the proposal. In this regard, the Commission was recently sued by a coalition that

includes financial printers over the Commission's newly adopted rule changing the default option for delivering mutual fund shareholder reports from mail to electronic delivery.

Impact on Non-Variable Contract Lines of Business. Variable contract issuers have increasingly been turning to index-linked and other types of registered fixed annuity contracts to augment or even replace their variable contract business. These products involve different registration and ongoing periodic reporting requirements that have been viewed as more onerous than those for variable contract procedures. Some industry participants have been working with the staff of the Commission to streamline these requirements in various ways. The proposal may shift the relative returns on equity from these two different lines of products and, if nothing else, may add an increased sense of urgency to efforts to streamline the regulatory registration and disclosure requirements for registered index-linked and other fixed insurance contracts.

Variable Life Insurance Policy Summary Prospectus. Industry trade groups first started working on a variable annuity summary prospectus in the mid-1990s. The focus throughout has been on developing a summary prospectus for variable annuities. Notably, however, the proposal also covers variable life insurance contracts. It will be interesting to see whether this aspect of the proposal garners significant interest, given the very different nature of these products and the market for these products generally.

* * *

The public comment period will remain open through February 15, 2019.

The SEC's proposing release is available at:

<https://www.sec.gov/rules/proposed/2018/33-10569.pdf>

If you have any questions, please contact Tom Conner, tconner@vedderprice.com, Nate Segal, nsegal@vedderprice.com or Emily Rubino, erubino@vedderprice.com of Vedder Price's Investment Services group, or any other Vedder Price attorney with whom you have worked.