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Clear, Concise Disclosures For Variable Contracts In Sight

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On Oct. 30, 2018, the U.S. Securities and Exchange Commission proposed rule changes designed to improve disclosure for investors about variable annuities and variable life insurance contracts (collectively, variable contracts). Following a disclosure framework that has long been in place for retail funds, the present proposal would permit a variable contract to use a summary prospectus, in accordance with proposed Rule 498A under the Securities Act of 1933.[1]

The SEC proposal is designed to provide investors with more user-friendly, layered disclosures — efforts that investors likely will welcome. Improving the retail investor experience is a key priority for the SEC's Division of Investment Management.[2] The public comment period for the rule changes will remain open through Feb. 15, 2019.

Background

A variable contract is a contract between a contract holder and an insurance company that "provides investors with exposure to the securities markets while also offering certain insurance protections, such as protection against market losses, protection against outliving their assets, or assurances that their beneficiaries will receive a certain amount upon death."[3] Variable contracts are part of the retirement and investment plans of many Americans.

Virtually all variable contracts are issued through a two-tiered structure. The top tier consists of an insurance company "separate account." This account is a segregated investment account established under state insurance law that holds variable annuity assets and liabilities separate and apart from the assets and liabilities of an insurance company's general account. Each separate account is organized as a management investment company or a unit investment trust (UIT) registered under the Investment Company Act of 1940 and is divided into subaccounts. The bottom tier of the two-tiered structure consists of certain investment options, typically mutual funds, and each subaccount is invested exclusively in a particular investment option. A beneficial interest in the insurance company's separate account is a security.[4]

Section 5(b)(2) of the Securities Act generally makes it unlawful to sell a security “unless accompanied or preceded” by a prospectus that meets the requirements of Section 10(a) of the act. Each initial purchase and additional purchase payment under a variable contract is considered a “sale” of an interest in an insurer’s separate account, where the sale must be accompanied or preceded by a current prospectus.[5]

An insurer or the financial intermediary distributing the variable contract must deliver the variable contract prospectus no later than upon issuance of the contract to comply with the requirements of Section 5(b)(2). However, many insurers provide the variable contract prospectus to potential investors, as part of the application package. In addition, most issuers send the new prospectus to all contract holders annually when the product prospectus is updated.

Section 5(b)(2), in effect, also requires delivery of an underlying mutual fund prospectus to an investor in a variable contract who has allocated his or her purchase payments to that fund.[6] Most investors receive summary prospectuses for the underlying fund at the same time they receive the statutory prospectus for the variable contract or contemporaneous with the confirmation for such product purchase payments. Variable contracts generally offer exchange privileges permitting a contractholder to reallocate all or a portion of his or her investment from one fund to another. Therefore, many insurance companies deliver prospectuses for all underlying funds to simplify the administrative task of tracking current prospectus deliveries to contract holders. However, other insurers have systems in place to permit them to deliver current prospectuses to only those contract holders who have invested in particular funds.[7]

Option to Use Variable Contract Summary Prospectus

Proposed Rule 498A would provide that, for a variable contract, the use of a summary prospectus would satisfy the Section 5(b)(2) delivery obligation under certain conditions.[8] The rule would permit the use of two distinct types of variable contract summary prospectuses:

1. Initial summary prospectuses — for variable contracts currently offered to new investors.
2. Updating summary prospectuses — for existing contract holders.

Initial Summary Prospectuses

The initial summary prospectus would include certain key information about the contract’s most important features, benefits and risks, presented in a standardized order. The proposed rule requires that the document only describe a single contract that the registrant currently offers for sale. However, the document may describe more than one class of a currently offered contract.[9]

The following table outlines the information in the proposed initial summary prospectus. The table and the proposed rule reference specific disclosure items in the various variable contract SEC registration forms.[10]

Outline of the Initial Summary Prospectus				
	Heading in Initial Summary Prospectus	*Proposed Item of Form N-3*	*Proposed Item of Form N-4*	*Proposed Item of Form N-6*
Cover Page	Identifying Information	–	–	–
	Legends	–	–	–
	EDGAR Contract Identifier	–	–	–
	Table of Contents (optional)	–	–	–
Content	Overview of the [Variable Annuity/Life Insurance] Contract	2	2	2
	Important Information You Should Consider About the [Contract]	3	3	3
	Standard Death Benefit	11(a)	10(a)	10(a)
	Other Benefits Available Under the Contract	12(a)	11(a)	11(a)
	Buying the Contract	13(a)	12(a)	9(a)-9(e)
	How Your Contract Can Lapse	–	–	14
	Surrendering Your Contract or Making Withdrawals: Accessing the Money in Your Contract	14(a)	13(a)	12(a)
	Additional Information About Fees	4	4	4
	Appendix: Portfolio Companies Available Under the Contract	19 or 20[11]	18	18

An initial summary prospectus must contain the rule-required information, and "only [that] information."[12] This condition is required for the document to be deemed a prospectus that is permitted under Section 10(b) of the Securities Act for purposes of Section 5(b)(1) of the act.[13]

The proposed initial summary prospectus requires information to be disclosed in a specific sequenced and standardized format with clear and concise information. These enhancements over the current statutory prospectus are designed to produce a more reader-friendly document allowing investors to better compare the key features of each product to others. Some of the key features in the proposed initial summary prospectus include, but are not limited to, fees and expense information such as surrender charges, administrative fees and insurance-related charges; death benefits; withdrawal options; loans; conflicts; and taxes. The proposed initial summary prospectus will also include information about the purposes for each product and the general timeline structure for each product, such as the accumulation and distribution phases for variable annuities.

Updating Summary Prospectuses

Today, contract holders are typically sent an updated current variable contract statutory prospectus each year. The updating summary prospectus would include only a brief description of certain changes to the variable contract that occurred during the prior year, and some of the information required to be in the initial summary prospectus. Certain key information about underlying fund investment options would be provided in both the initial summary prospectus and updating summary prospectus.

The following table outlines the information required in the updating summary prospectus, along with references to the SEC registration statement forms.

Outline of the Updating Summary Prospectus				
	Heading in Updating Summary Prospectus	*Proposed Item of Form N-3*	*Proposed Item of Form N-4*	*Proposed Item of Form N-6*
Cover Page	Identifying Information	–	–	–
	Legends	–	–	–
	EDGAR Contract Identifier	–	–	–
	Table of Contents (optional)	–	–	–
Content	Updated Information About Your Contract	–	–	–
	Important Information You Should Consider About the [Contract]	3	3	3
	Appendix: Portfolio Companies Available Under the Contract	19 or 20[14]	18	18

Similar to the proposed initial summary prospectus, the proposed updating summary prospectus must disclose information in a specific sequenced and standardized format. The updating summary prospectus will focus heavily on key changes to the variable contract. The most likely key changes would be those related to fees and expenses, death benefits, guaranteed benefit riders, other investor benefits under the contract, and changes in portfolio options.

Optional Method for Underlying Fund Prospectus Delivery

Proposed Rule 498A would provide an optional method for satisfying underlying mutual fund prospectus delivery obligations.[15] Fund summary and statutory prospectuses would be available online at the website address specified on or hyperlinked in the variable contract summary prospectus. Only certain key information about the funds would be included in the variable contract's summary prospectus. Investors also would be able to request and receive those documents in paper or electronically. This new option for satisfying fund prospectus delivery requirements only would be available for funds available as investment options through variable contracts that use summary prospectuses. Online availability of mutual fund prospectuses would significantly reduce a fund's printing and mailing costs.

The initial summary prospectus and updating summary prospectus would include an appendix with summary information regarding funds currently offered under the variable contract.[16] If one or more funds vary by contract benefits, the issuer would be required to include another appendix indicating which funds were available with each of those benefits.[17] Each appendix would include a legend stating that fund summary and statutory prospectuses are available on a specific internet site for variable contracts registered on Forms N-4 and N-6. For variable contracts that use Form N-3, the legend would direct investors to the cover page of the initial summary prospectus, which includes information on investment options.

The following table summarizes the various requirements under the current and the proposed prospectus/summary prospectus delivery requirements.[18] Again, use of a summary prospectus would be voluntary.

Information Available to Variable Contract Investors		
	CURRENT PROSPECTUS DELIVERY REGIME[19]	OPTIONAL PROPOSED SUMMARY PROSPECTUS REGIME
Contract Statutory Prospectus	Delivered to all investors	Required to be available online and delivered (in paper or electronic format) upon request
Contract SAI	Available upon request	Required to be available online and delivered (in paper or electronic format) upon request
Contract Part C Information	Not delivered to investors or required to be available online, but is filed with registration statement (available on EDGAR)	Not delivered to investors or required to be available online, but is filed with registration statement (available on EDGAR)
Initial Summary Prospectus	N/A	Delivered to new investors
Updating Summary Prospectus	N/A	Delivered to existing investors
Underlying Fund Prospectuses	Delivered to all investors	Delivered to investors, or, if the new option to satisfy fund prospectus delivery is relied-upon, required to be available online and delivered (in paper or electronic format) upon request[20]

Conclusion

Reader-friendly, clear and concise disclosures are important to an investor's understanding of a product and a key regulatory goal of the SEC. The long-anticipated proposals to improve disclosures related to variable contracts is a move toward meeting these objectives. The ease and use of the documents, and the flexibility to utilize technological advances to distribute these documents, should go a long way in enhancing the investment experience for retail investors.

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[1] Rule 498A under the Securities Act of 1933 (hereinafter Proposed Rule 498A).

[2] See Testimony on "Oversight of the SEC's Division of Investment Management," Before the U.S. House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities and Investment, Dahlia Blass, Director, Division of Investment Management (Sept. 26, 2018).

[3] Release 33-10569.

[4] See Prudential Ins. Co. v. SEC, 326 F.2d 383, 388 (3d Cir. 1964).

[5] Insurance company separate accounts use the following SEC registration forms, which include prospectus requirements: Form N-3 for separate accounts that are variable annuities structured as management companies; Form N-4 for separate accounts that are variable annuities structured as UITs; and Form N-6 for separate accounts that are variable life insurance contracts.

[6] See Release 33-10569.

[7] Release 33-10569.

[8] Proposed Rule 498A(f).

[9] Proposed Rule 498A(b)(1).

[10] Release 33-10569.

[11] Variable contracts that use Form N-3 may omit this appendix and provide the more detailed disclosures about the investment options offered under the Contract. Release 33-10569.

[12] Proposed Rule 498A(b)(5).

[13] Proposed Rule 498A(c).

[14] A Variable contract registered on Form N-3 could omit this appendix and instead provide the more detailed disclosures about the investment options offered under the contract. Release 33-10569.

[15] Proposed Rule 498A(j)(1).

[16] Proposed Rule 498A(b)(5)(ix).

[17] Instructions to Items in Form N-3, Form N-4 and Form N-6.

[18] Release 33-10569.

[19] This column assumes that the particular variable contract is not providing alternative disclosures to investors in lieu of the statutory prospectus. Release 33-10569.

[20] Additionally, summary information about underlying funds would be available in the initial summary prospectus and updating summary prospectus. Release 33-10569.