SEC PROPOSES SUMMARY PROSPECTUS RULE FOR VARIABLE ANNUITY AND VARIABLE LIFE INSURANCE CONTRACTS

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U.S. Investment Management Alert

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EXECUTIVE SUMMARY

In a significant step toward improving variable insurance product ("VIP") disclosure, the U.S. Securities and Exchange Commission ("SEC"), on October 30, 2018, proposed a new rule (the "Summary Prospectus Rule") long advocated by the insurance industry that would allow VIP issuers to use a summary prospectus to satisfy prospectus delivery obligations under Section 5 of the Securities Act of 1933 (the "Proposal").[1] The Proposal includes the following components, which are discussed in more detail in this Client Alert:

- *Option to Use Summary Prospectus* — New Rule 498A would permit the use of two types of summary prospectuses describing the VIP: (1) an "initial summary prospectus" delivered in hard copy, or electronically if an investor elects, to new investors that would include certain key information about the VIP; and (2) an "updating summary prospectus" delivered in hard copy, or electronically if an investor elects, to existing investors that would include a summary of any VIP changes, as applicable, since the last update as well as certain information from the initial summary prospectus.
- *Internet Availability of Statutory Prospectus and Other Information* — In order to use a VIP summary prospectus, new Rule 498A would require the related statutory prospectus and statement of additional information to be publicly accessible, free of charge, at a website address specified on or, in the case of an electronic copy, hyperlinked in the cover page of the summary prospectus, and a hard copy made available by request at no cost.
- *Optional Delivery Method for Portfolio Company Prospectuses* — An important aspect of the Proposal provides an optional method for satisfying prospectus delivery obligations for the underlying portfolio company investment options, under which the VIP issuer would include certain key information about these portfolio companies in an appendix to the VIP summary prospectus and would make the portfolio companies' summary and statutory prospectuses available online at the website address specified on or, in the case of an electronic copy, hyperlinked in the VIP summary prospectus, and a hard copy made available by request at no cost.
- *VIPs No Longer Actively Sold to New Investors* — For VIPs no longer actively sold to new investors (referred to by the SEC as "Discontinued Contracts"), the SEC noted that many issuers rely on SEC staff no-action letters permitting issuers to cease filing updates to the VIP registration statements and

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delivering updated prospectuses and other information to existing investors under certain circumstances. With respect to such Discontinued Contracts, the SEC proposes to effectively "grandfather" contracts relying on the existing no-action relief as of the effective date of a final Summary Prospectus Rule, subject to continued compliance with the no-action letters. For all other Discontinued Contracts, issuers would be required to file post-effective amendments to update their registration statements and provide updated prospectuses in reliance on the new Summary Prospectus Rule framework. The SEC also discussed, and requested comment on, alternative approaches to address Discontinued Contracts.

- *Form Amendments; XBRL; Other Amendments* — The SEC also proposed to update and enhance certain disclosure requirements for VIPs under Forms N-3, N-4, and N-6 and would require VIP registrants to use the Inline XBRL format for filing certain information. In addition, the proposal includes certain technical and conforming amendments to implement the proposed summary prospectus regime, and to update or rescind other rules and forms applicable to VIPs.

The approach reflected in the Summary Prospectus Rule is similar to that taken in the mutual fund summary prospectus rule, but includes several key differences that reflect the unique nature of VIPs. Overall, the Summary Prospectus Rule aims to facilitate comparability among insurance products and reflects significant industry input received over several years. If adopted, the proposed changes should result in investors receiving information in a more digestible manner and would reduce issuer costs.

The public comment period expires on February 15, 2019. We would be pleased to assist you in evaluating the Proposal and submitting comments.

NEW OPTION TO USE VIP SUMMARY PROSPECTUSES

The Summary Prospectus Rule would permit, but not require, use of two types of summary prospectuses for VIPs to satisfy prospectus delivery obligations under Section 5(b)(2) of the 1933 Act: (1) an "initial summary prospectus" to be provided in connection with sales of VIPs to new investors; and (2) an "updating summary prospectus" to be provided to investors who are existing contract owners. Use of summary prospectuses would be conditioned on, among other things, providing the statutory prospectus and other materials online, and on sending such materials to investors in paper or electronically upon request.

Importantly, as with mutual fund summary prospectuses, the Summary Prospectus Rule would, subject to certain conditions, permit issuers of VIPs to incorporate by reference into both the initial summary prospectuses, as well as updating summary prospectuses, information contained in the statutory prospectus, statement of additional information "SAI" and, in the case of variable annuity separate accounts registered as management companies, shareholder reports. Permitting incorporation by reference is an essential aspect in facilitating summary prospectus use as it allows issuers to include the additional information and disclosure contained in offering documents such as the statutory prospectus and SAI, which may protect issuers from liability relating to the omission of information.

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Initial Summary Prospectus

Under the Summary Prospectus Rule, an initial summary prospectus may describe only a single contract[2] that the registrant currently offers for sale, and would be required to include certain information, and only that information, in the same order, and under the relevant corresponding headings, as the proposed rule specifies, including the following:

- A cover page including certain identifying information (such as the name of the insurance company, the separate account registrant, and the contract), legends with identifying information about the VIP and certain general information that applies to all VIPs, and a hyperlink where additional information about the contract may be found;
- An optional table of contents;
- An overview of the contract, providing an introduction to the contract, how it works, and its primary features (including death benefits, withdrawal options, loan provisions, and any available optional benefits);
- A table with a standardized format, order, and headings outlining key information ("Key Information Table") about the contract, including fees and expenses; risks; restrictions or limitations, principally in regards to investment options or benefits; taxes; and conflicts of interest;
- A discussion of the standard death benefit available under the contract and how it operates;
- A table summarizing other benefits available under the contract, including each benefit's name and purpose, whether the benefit is standard or optional, associated fees, and limitations or restrictions;
- A description of the procedures for purchasing the contract, including the minimum initial and subsequent payments required, and limitations or restrictions on payments;
- For variable life insurance policies, a description of when and under what circumstances the contract will lapse, any lapse options, the effect of the lapse, and under what circumstances a contract may be reinstated;
- A discussion of how investors may access their money through surrender or withdrawal, including any limits on the ability to surrender, how proceeds are calculated, and when they are payable;
- The full fee table (including the expense example in the case of variable annuity contracts) that also would appear in the statutory prospectus detailing all of the expenses incurred when an investor buys, sells, or owns the contract; and
- An appendix (discussed in more detail below) describing the portfolio companies currently available as investment options under the contract.[3]

Updating Summary Prospectus

Under current industry practice, insurance companies typically send the updated VIP statutory prospectus to existing contract owners each year to satisfy prospectus delivery obligations in connection with additional

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purchase payments or premium payments that may be received, or the reallocation of contract value that may be made, in the coming year. Under the Summary Prospectus Rule, this obligation could be satisfied with respect to existing investors by providing an "updating summary prospectus" rather than a full statutory prospectus. An updating summary prospectus would discuss any material changes that have occurred with the contract during the past year, as well as certain of the information required in the initial summary prospectus, including the following:

- A cover page including certain identifying information and legends similar to the initial summary prospectus and a hyperlink where additional information may be found;
- An optional table of contents;
- A brief description of any changes to the contract with respect to the fee table, the standard death benefit, other benefits available under the contract, portfolio companies available under the contract, and other changes that the registrant wishes to disclose, since the most recent updating summary prospectus or statutory prospectus was sent to investors;
- A Key Information Table with the disclosure required in the initial summary prospectus; and
- An appendix (discussed in more detail below) with the portfolio company disclosure required in the initial summary prospectus.[4]

In describing any changes to the contract, issuers should "provide enough detail to allow investors to understand the change and how it will affect them."[5] However, this need not be extensive, as Appendix B to the Proposing Release, which provides a hypothetical updating summary prospectus, succinctly lists contract changes in bullet form.[6]

Importantly, the updating summary prospectus must contain the information required by the rule in the specific order outlined in the rule. In addition, unlike for an initial summary prospectus which must describe only one contract, the Summary Prospectus Rule would permit the updating summary prospectus to describe one or more contracts covered in the statutory prospectus to which the updating summary prospectus relates. However, a registrant may only use an updating summary prospectus if that registrant uses an initial summary prospectus for each currently offered contract described under the current statutory prospectus to which the updating summary prospectus relates.

Appendix of Portfolio Companies

The appendix of portfolio companies required under the Summary Prospectus Rule would include a legend: (1) stating that the portfolio companies listed are currently available under the VIP and are subject to change; (2) providing a hyperlink to a landing page, a telephone number, and an email address that investors may use to obtain a copy of a portfolio company's summary and statutory prospectus; and (3) stating that the portfolio company expense information provided does not reflect contract charges, that performance would be lower if these charges were included, and that past performance does not indicate future performance. The appendix would then identify each portfolio company available as an investment option in a table indicating each portfolio

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company's type or investment objective; name; investment adviser or sub-adviser; expense ratio; and average annual total returns for the past 1-year, 5-year, and 10-year periods. Additionally, if the portfolio companies that are available vary based on benefit options selected, the appendix also would include a separate table identifying the portfolio companies available under each benefit.

EASING THE PROSPECTUS DELIVERY REQUIREMENTS THROUGH "LAYERED" DISCLOSURE

Online Availability of VIP Disclosure Documents

The Summary Prospectus Rule also would change how prospectus delivery requirements may be satisfied. VIP issuers currently are required to provide not only the prospectus and (upon request) the SAI for the VIP, but also the prospectus for each portfolio company to which an investor has allocated value under the contract.

Under the Summary Prospectus Rule, an issuer could satisfy its prospectus delivery obligations by providing investors with a contract summary prospectus and making the contract statutory prospectus available online and in paper or electronically by request. This process reflects a "layered" disclosure approach in which investors would receive the most pertinent information through the initial or updating summary prospectus and would be able to access the statutory prospectus or SAI online or by requesting a paper copy for further information. The Summary Prospectus Rule's conditions relating to online accessibility are similar to mutual funds and require that:

- A current version of each document remains on the website provided to investors for at least 90 days following the time of the "carrying or delivery" of the contract security;
- Any documents posted online be "human readable" (i.e., text appears legible and is not cut off);
- The documents be linked such that a user can move between an electronic version of the table of contents and a particular section of the document and also between sections of the contract summary prospectus and related sections of the contract statutory prospectus and SAI;
- Investors be able to view the definition of any special terms used in the summary prospectus by hovering over or selecting the term, or by moving between the special term and its respective glossary definition; and
- Investors accessing the online documents be able to permanently retain such documents free of charge in an electronic format.

In addition, a contract summary prospectus may not be bound together with any other materials except for summary and statutory prospectuses of portfolio companies, provided that the portfolio companies are available to the investor to whom the materials are sent or given and the materials include a table of contents identifying each portfolio company prospectus included and the page on which it may be found.

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New Delivery Option for Portfolio Company Prospectuses

As noted above, the Proposal includes a new delivery option for portfolio company prospectuses under which issuers sending a contract summary prospectus would not be required to provide investors with prospectuses of portfolio companies simultaneously with the VIP prospectus. Rather, under the Proposal, the VIP issuer would include certain key information about the portfolio companies available under the contract in an appendix to the contract's summary prospectus, and would make the summary and statutory prospectuses for the portfolio companies available online at the website address specified on or hyperlinked in the VIP summary prospectus. In particular, this approach would satisfy prospectus delivery obligations if: (1) an initial summary prospectus is used for each currently offered VIP described under the related registration statement; (2) a summary prospectus is used for the portfolio company; and (3) the portfolio company's current summary prospectus, statutory prospectus, SAI, and most recent shareholder reports are posted online under similar posting requirements for the VIP's summary prospectuses and other documents. These documents would be subject to similar online formatting and accessibility requirements as mutual fund summary prospectuses under Rule 498, but the Proposal would require the documents to be posted at the same website address as the VIP materials that appear online.

VIPS NO LONGER ACTIVELY SOLD TO NEW INVESTORS

The SEC staff has provided no-action relief to issuers of Discontinued Contracts under which such issuers are permitted to cease filing updates to the VIP registration statements and delivering updated prospectuses to existing investors under certain circumstances, including delivery of certain alternative disclosures.[7] In general, the relief under these no-action letters is only available if: (1) there are no material changes to the contract; (2) investors are provided with certain alternative disclosures, including offering documents relating to the portfolio companies, transaction confirmations, updated audited financial statements within 120 days after the close of the fiscal year, and a statement of the number of units and values in the investor's account; (3) the registrant files periodic reports with the SEC; and (4) no new contracts are offered to the public. The Proposal includes various alternative approaches for Discontinued Contracts, which seek to incorporate use of updating summary prospectuses for such contracts in certain circumstances.

The SEC's primary proposal with respect to Discontinued Contracts would effectively “grandfather” contracts relying on the existing no-action relief as of the effective date of a final summary prospectus rule, subject to compliance with the SEC staff no-action letters. For all other contracts (*i.e.*, those not relying on the no-action relief at the effective date), issuers would be required to file post-effective amendments to update their registration statements and provide updated prospectuses under current regulatory requirements, but could use the summary prospectus framework, relying on the streamlined disclosures in the updating summary prospectus for such contracts.

However, the SEC also discussed, and requested comment on, two alternative approaches to address Discontinued Contracts. An issuer could rely on the relief under these alternative approaches only if the contract

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is no longer offered to new purchasers, there are fewer than 5,000 investors, and there are no material changes to the contract.

Under the first alternative approach, registrants of Discontinued Contracts would not need to comply with certain updating and delivery requirements, provided that: (1) investors receive an annual notice of certain material information that would otherwise be included in the updating summary prospectus; (2) financial statements provided to investors under the alternative disclosure permitted under the SEC staff no-action letters are filed with the SEC, posted to the issuer's website and delivered to an investor upon request; (3) registrants may use the optional portfolio company prospectus delivery method permitted under the Summary Prospectus Rule; and (4) investors would continue to receive shareholder reports and proxy materials for portfolio companies.

The second alternative approach would: (1) permit registrants to rely on a modified version of the Summary Prospectus Rule requiring that investors receive an annual notice including the information required by the annual notice required under the first alternative approach above, make the contract statutory prospectus and SAI available online, and use the delivery requirements of the Summary Prospectus Rule; (2) require that separate account and depositor financials be filed with the SEC and permit issuers to incorporate these documents by reference into the registration statement, even if they are filed after the registration statement's effective date (known as forward incorporation by reference); and (3) require that investors continue to receive shareholder reports and proxy materials for portfolio companies.

PROPOSED AMENDMENTS TO UPDATE AND HARMONIZE FORMS N-3, N-4, AND N-6; XBRL; OTHER AMENDMENTS

Form Amendments

The SEC also proposed amendments (the “Amendments”) to Form N-3, Form N-4 and Form N-6 (the “Forms”)[8] designed not only to incorporate the new summary prospectus disclosure, but to reflect changes within the variable insurance industry since the adoption of each form and to make disclosure more consistent among registrants. The Amendments also seek to enhance consistency among the Forms. The Proposing Release notes that Form N-6, adopted in 2002, is the most recently adopted of the Forms. As such, many of the Amendments seek to align the disclosure requirements of Forms N-3 and N-4 more closely with Form N-6.

XBRL

The SEC also proposed amendments that would require VIP registrants to file certain information in “Inline XBRL” format, similar to the requirements for mutual funds and exchange-traded funds. Inline XBRL format is designed to facilitate review and comparison of data. This tagging requirement primarily would apply to: (1) the Key Information Table; (2) the Fee Table; (3) the section on the Principal Risks of Investing in the Contract; (4) the

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section on Other Benefits Available Under the Contract; and (5) the Investment Options Available Under the Contract.

Other Amendments

The Proposal also includes proposed amendments to the rules applicable to VIPs, as well as the rescission of other rules and forms, to update the regulatory framework for VIPs, including changes stemming from the enactment of the National Securities Markets Improvement Act of 1996 ("NSMIA"). Certain proposed amendments would, consistent with the statutory amendments resulting from NSMIA, replace numerical limits on fees and charges currently included in rules governing VIPs with a requirement that the charges be reasonable in the aggregate. Other proposed amendments would rescind Form N-1 and also rules requiring notices relating to refund and withdrawal rights of periodic payment plan certificate holders.

CONCLUSION

The proposed Summary Prospectus Rule represents the most significant regulatory disclosure overhaul of VIPs in recent years. Many of the changes promote simplicity, seeking to make the contracts easier for investors to understand and compare. The streamlined process and cost savings to issuers under the Summary Prospectus Rule will likely be viewed as a welcome change by the variable insurance industry. The SEC also has requested input on a variety of significant questions and other matters, both in connection with the summary prospectus proposal and VIP regulation more generally. As stated earlier, please let us know if we can assist you in evaluating the Proposal or submitting comments.

Notes

[1] SEC Release Nos. 33-10569, 34-84508 and IC-33286 (Oct. 30, 2018), https://www.sec.gov/rules/proposed/2018/33-10569.pdf (the "Proposing Release").
[2] An initial summary prospectus may, however, describe more than one class of a contract. *Id.* at 33.
[3] Proposed Rule 498A(b). The Proposing Release includes an appendix with a hypothetical initial summary prospectus. *See* Proposing [4] Release at Appendix A.
[4] Proposed Rule 498A(c).
[5] Proposing Release at 104. The Proposing Release indicates, for example, that stating merely that a fee has changed in not sufficient. Rather, the updating summary prospectus should disclose that the fee has changed from 1.5% to 1.7%. *Id.*
[6] *See* Proposing Release at Appendix B.
[7] *See, e.g., Great-West Life and Annuity Insurance Company* (Oct. 23, 1990). Many of these no-action letters were limited to circumstances where the number of investors still owning contracts was fewer than 5,000, but there are multiple no-action letters in which the number of contracts owners substantially exceeded that number.
[8] Form N-3 applies to variable annuity separate accounts registered as management companies, Form N-4 applies to variable annuity separate accounts registered as unit investment trusts and Form N-6 applies to variable life insurance separate accounts.

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