

SECURITIES AND EXCHANGE COMMISSION

Release No. IC-34199 / February 23, 2021

Commission Statement on Insurance Product Fund Substitution Applications

AGENCY: Securities and Exchange Commission.

ACTION: Commission statement.

SUMMARY: The Commission is issuing a statement regarding applications for orders approving the substitution of certain securities pursuant to section 26(c) of the Investment Company Act of 1940, as amended, (the “Act”) (and related orders of exemption pursuant to section 17(b) of the Act from section 17(a) of the Act). The statement sets forth the Commission’s position that the substitution by an insurance company of registered open-end investment companies used as investment options for variable life insurance policies or variable annuity contracts will not provide a basis for enforcement action under section 26(c) of the Act (and section 17(a) of the Act for in-kind substitutions) if the insurance company does not obtain an order under section 26(c) (and section 17(b)) so long as the terms and conditions of the proposed substitution are substantially similar to those approved by a prior order for a substitution under section 26(c) (and section 17(b)) obtained by the insurance company since January 1, 2004.

DATES: The Commission’s statement is effective upon publication in the Federal Register.

FOR FURTHER INFORMATION CONTACT: Jennifer O. Palmer, Senior Counsel, David J. Marcinkus, Branch Chief, Nadya B. Roytblat, Assistant Chief Counsel, or Daniele Marchesani, Assistant Chief Counsel, at (202) 551-6825 (Chief Counsel’s Office, Division of Investment Management).

BACKGROUND:

Variable insurance contracts (variable annuities and variable life insurance policies) are issued by insurance companies and typically have a two-tier structure. The top tier is a separate account of the insurance company, registered under the Act as a unit investment trust (“UIT”). The separate account, in turn, has subaccounts that invest in numerous (sometimes hundreds of) underlying mutual funds (open-end investment companies registered under the Act) and exchange-traded funds (collectively, “Investment Options”). Contract holders typically allocate their assets across these various Investment Options available through the separate account. Under the contracts, the insurance company typically reserves the right, subject to compliance with applicable laws, to substitute Investment Options with other Investment Options after appropriate notice. The contracts also typically permit the insurance company to limit the manner in which a contract owner may allocate purchase payments to the subaccounts that invest in an Investment Option.¹ Insurance companies have offered separate account UITs with numerous Investment Options with the expectation and understanding that they would have the ability to make changes among the Investment Options in appropriate circumstances.

Section 26(c) of the Act prohibits a depositor or trustee of a UIT that invests in the securities of a single issuer from substituting the securities of another issuer without the approval of the Commission.² Section 26(c) provides that such approval shall be granted by order of the

¹ In addition to registering with the Commission as an investment company under the Act, each separate account registers its securities under the Securities Act of 1933. In doing so, each separate account files a registration statement with the Commission that includes a prospectus describing the Contracts offered by the separate account and a copy of the form of such contracts.

² Section 26(c) states: “It shall be unlawful for any depositor or trustee of a registered unit investment trust holding the security of a single issuer to substitute another security for such security unless the Commission shall have approved such substitution. The Commission shall issue an order approving such substitution if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.” 15 U.S.C. 80a-26(c).

Commission 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 Act. Congress' concern underlying section 26(c) related to the lack of recourse and potentially additional fees experienced by investors in a single-security UIT in the case of a substitution.³ Legislative history suggests that when Congress enacted the substitution order requirement in section 26(c) in 1970, it intended to limit the requirement to those UITs whose investors' economic exposure was limited to the single underlying security being substituted.⁴

In the past four decades, nearly 200 substitution applications under section 26(c) by insurance companies sponsoring variable annuity and variable life insurance products that offer multiple Investment Options have been approved by the Commission.⁵ In so doing, the

³ In amending section 26 to require Commission approval of substitutions, Congress stated: "The proposed amendment recognizes that in the case of the unit investment trust holding the securities of a single issuer notification to shareholders does not provide adequate protection since the only relief available to shareholders, if dissatisfied, would be to 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. The [Commission] would be required to issue an order approving the substitution if it finds the substitution consistent with the protection of investors and the purposes fairly intended by the policy and provisions of the Act." S. Rep. No. 184, 91st Cong., 1st Sess. 41 (1969), reprinted in 1970 U.S.C.C.A.N. 4897, 4936 ("Senate Report").

⁴ In 1966, the Commission recommended requiring Commission approval for any proposed substitution, regardless of the number of underlying issuers. *See* Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. 337 (1966) (stating "the Commission recommends that section 26 be amended to require that proposed substitutions may not occur without Commission approval"). Congress, however, amended section 26 with reference to single-security UITs only. At the time Congress enacted section 26(c), most UITs invested all of their assets in a single security and issued "periodic payment plan certificates," which in return for fixed monthly payments over a period of years provided the purchaser with an interest in, but not direct ownership of, an underlying investment company's shares. These single-security UITs "serve[d] merely as a mechanism for buying investment company shares on an installment payment basis." *Id.* at 38. Although UITs holding a variety of securities were popular in the early 1930s, by the time section 26(c) was enacted, their importance had dwindled. Both types of UITs seldom made changes to their underlying securities and were viewed as fixed portfolios. *See id.* at 38. In 1982, in response to a commenter, the Commission stated in a release that it had determined not to reexamine at that time its position that section 26(c) of the Act requires Commission approval for a substitution of securities in any subaccount of a registered separate account. *See* Inv. Co. Act Rel. No. 12678 (Sep. 21, 1982) at 5.

⁵ A number of such orders also included relief pursuant to section 17(b) of the Act from section 17(a)(1) and (2) of the Act to the extent necessary to permit the substitutions to be carried out by redeeming shares issued by each

Commission has come to require terms and conditions that focus on key investor protections designed to address the concerns expressed in the legislative history of Section 26(c). These conditions include, among others, disclosure notifying affected contract owners at least 30 days in advance of the substitution; a requirement that each substitute fund have substantially similar investment objectives, principal investment strategies, and principal risks to the fund it is replacing; and a cap on total operating expenses of the substitute fund, such that they will not exceed those of the fund it is replacing for at least two years. The terms and conditions of substitution applications approved by the Commission under section 26(c) have been substantially similar to one another for at least the past 17 years.⁶

COMMISSION STATEMENT:

Based on the Commission's administrative experience with substitution orders, we are stating our position that the substitution by an insurance company of registered open-end investment companies used as Investment Options for variable life insurance policies or variable annuity contracts will not provide a basis for an enforcement action if the insurance company does not obtain an order from the Commission under section 26(c) (and section 17(b) for certain substitutions) so long as the terms and conditions of the proposed substitution are substantially similar to those approved by a prior order for a substitution pursuant to section 26(c) obtained by

target fund in-kind and using the securities distributed as redemption proceeds to purchase shares issued by the applicable destination funds, at the respective net asset values of the funds. Section 17(a)(1) of the Act, in relevant part, prohibits any affiliated person of a registered investment company, or an affiliated person of such person, acting as principal, knowingly from selling any security or other property to such registered investment company. Section 17(a)(2) of the Act, in relevant part, prohibits any affiliated person of a registered investment company, or an affiliated person of such person, acting as principal, knowingly from purchasing any security or other property from such registered investment company. "Affiliated person" is defined in section 2(a)(3) of the Act.

⁶ Pursuant to the Congressional Review Act, the Office of Information and Regulatory Affairs has designated this policy statement as not a "major rule," as defined by 5 U.S.C. 804(2). See 5 U.S.C. 801 *et seq.*

the insurance company since January 1, 2004.⁷

When making the sort of substitution discussed in this Commission statement, the insurance company should submit correspondence accompanying its disclosure of the upcoming substitution made via a prospectus supplement filed with the Commission pursuant to Rule 497 under the 1933 Act. Such correspondence should: (1) indicate that the substitution is of the type discussed in this Commission statement; (2) identify the prior order with terms and conditions substantially similar to those in the substitution; (3) confirm that the substitution is consistent with the terms and conditions of the identified prior order; and (4) explain why each existing fund and corresponding replacement fund are substantially similar, including a comparison of the investment objectives, strategies and risks of each existing fund and its corresponding replacement fund.

Any insurance company that has not obtained an order under section 26(c) for a substitution since January 1, 2004 will need to apply for one, and any insurance company that prefers to receive such an order is able to continue to apply for one.⁸ We believe that this approach would continue to preserve the investor protections that have been afforded as part of the review of substitutions under section 26(c), while allowing for a more efficient process of substitutions in the variable insurance products context. We also believe that this approach would lessen the regulatory burden associated with insurance company substitutions, while

⁷ Our position also extends to any related relief under section 17(b) of the Act from section 17(a) that the insurance company might have received to conduct the substitutions in-kind.

⁸ An insurance company that has not obtained such an order since January 1, 2004, but may have acquired another insurance company that did, may not rely on the acquiree's order under the Commission's position; an insurance company that had obtained such an order and also may have acquired another insurance company that also had obtained such an order, must look exclusively to the terms and conditions of the acquiror's order for purposes of the Commission's position.

remaining consistent with previous Substitution Orders that were designed to address the concerns reflected in the legislative history of section 26(c) of the Act.

By the Commission.

J. Matthew DeLesDernier
Assistant Secretary