Committee of Annuity Insurers
Sutherland Asbill & Brennan LLP
January 16, 2013

NAIC SEC Considerations (E) Subgroup:

Presentation on Federal Securities Laws and Insurance Company Receiverships

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Overview

- Overview of Federal Securities Laws and Insurance Products
  - Registered variable products
  - Registered fixed products
  - Exemptions and exclusions from SEC registration
- The Role of the Securities and Exchange Commission ("SEC") in Prior Insurance Company Receiverships
- Potential Limits on What a Receiver Can or Cannot Do With Regard to Registered Insurance Products
- Ongoing Securities Act of 1933 (the "1933 Act") and Investment Company Act of 1940 (the "1940 Act") Issues

Federal Securities Laws and Variable Insurance Products

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- The SEC:
  - Not a solvency regulator for insurance companies
  - Not a receiver
- Registered Variable Products in Insulated Separate Accounts
  - The Variable Annuity contract ("VA") or Variable Life Insurance policy ("VLI") is a security that must be registered under the 1933 Act
    - **1933 Act** – <u>Disclosure</u>. Unless exempted, a financial product that is a security must be registered with the SEC on a registration statement in accordance with the provisions of the 1933 Act – and must be offered to the public by means of a prospectus that is filed as part of the registration statement

Registered Variable Annuities and Variable Life

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- Registered Variable Products in Insulated Separate Accounts
  - The Separate Account is an “investment company” that must be registered with the SEC under the 1940 Act
    - **1940 Act** – Regulation. Investment companies, with some exceptions, must register with the SEC. Operations of the investment company must comply with the provisions of the Investment Company Act of 1940
  - Register VA on Form N-4; VLI on Form N-6

Registered Variable Annuities and Variable Life

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- Two kinds of insulated Separate Accounts are used to fund VA and VLI products
  - Managed Separate Account – original VA and VLI funding vehicle
    - Separate Account is a “management” investment company (same as mutual funds)
    - Has an investment adviser that manages the assets per the 1940 Act and a board of directors
    - Originally had only one bucket of securities
  - Unit Investment Trust (“UIT”)
    - Registered with the SEC on Form N-4
    - Insurance company acts as “depositor” for the UIT
    - No board of directors

Registered Variable Annuities and Variable Life

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- 1933 Act
  - In order to sell a registered VA/VLI, the insurance company must file a “registration statement” with the SEC
    - Registration statement includes a “Prospectus” that describes the material terms of the offering and information about the insurer, the separate account and distribution arrangements
    - Audited financial statements for the Separate Account and the insurance company are included in the SEC filing
    - Top officers and directors must sign the registration statement and can be personally liable for fraud in the registration statement
    - SEC reviews the disclosure in the registration statement
    - Security must be sold using the current prospectus
    - Registration statement must be refiled with the SEC at least annually

Registered Variable Annuities and Variable Life

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- ## 1933 Act (cont'd)
  - SEC and purchasers can bring injunctive and enforcement actions against company, officers and directors for violating the federal securities laws (Section 20 of 1933 Act)
  - Willful violations can lead to imprisonment and fines (Section 24 of 1933 Act)
  - Civil class action and SEC enforcement actions can be brought against the company, its directors, its officers who sign the registration statement, the principal underwriter, and those who "expertize" the registration statement if:
    - Prospectus contains materially misleading statements or
    - Prospectus fails to state a material fact (Section 11 of 1933 Act)
  - "Controlling Persons" and "aiders & abettors" also liable (Section 15 of 1933 Act)

Registered Variable Annuities and Variable Life

- 1940 Act and UIT Separate Accounts
  - Daily Valuation of Units of the Separate Account
    - Pass-through performance of underlying mutual funds in which the Separate Account invests
    - Forward pricing
    - Deduct insurance charge from daily unit value
  - Daily Redeemability
    - Units must be redeemable at daily price
    - Payout within seven days
    - Highly liquid and transparent
  - Separate Account Insulation
  - Audited GAAP financial statements for the Separate Account
  - Detailed record keeping requirements

Registered Variable Annuities and Variable Life

- 1940 Act and UIT Separate Accounts (cont'd)
  - Registration Statement Required
    - Combined with 1933 Act Registration Statement
  - Chief Compliance Officer (CCO) Must Be Appointed
    - Separate Account must have written compliance policies and procedures
    - CCO must conduct annual review and prepare annual report of adequacy of compliance policies and procedures
  - SEC Enforcement Powers
    - SEC has authority to enforce 1940 Act through investigations, subpoenas, injunctions, penalties (Section 42 of 1940 Act)

Registered Variable Annuities and Variable Life

- SEC Enforcement Powers (cont'd)
  - Contract that violates the 1940 Act is unenforceable (Section 47 of 1940 Act)
  - "Controlling Person" and "aiders and abettors" and indirect violations (causing another person to violate) are also covered (Section 48 of the 1940 Act)

Registered Fixed Insurance Products

- Registered Fixed and Fixed Indexed Annuities: 1933 Act Registration Only
  - Outside the Section 3(a)(8) exclusion/ Rule 151 because these products expose the contract owner to investment risk
  - The Insurance Company must register these securities under the 1933 Act on Form S-1 or S-3
    - Extensive disclosure about the product, the insurance company and its officers and directors
    - Anti-fraud liability
  - May or may not be funded through an unregistered Separate Account
    - Separate Account's investment experience does not pass-through directly into contract value
    - Separate Account may or may not be insulated
      - Separate Account insulation varies according to state law
      - Separate Account insulation, alone, does not trigger 1940 Act registration
  - May have registered fixed and registered variable annuity in same product

Exemptions and Exclusions from 1933 Act and 1940 Act Registration

- 1933 Act and 1940 Act provide for the exemption of certain securities from SEC registration
  - Certain variable products sold in the pension market
  - COLI/BOLI
  - Subject to the anti-fraud provisions of the federal securities laws
- Private placement VA and VLI products
  - Sold to institutions and high net worth individuals
  - No registration statements is filed with the SEC
  - Not offered using a prospectus
  - Subject to the anti-fraud provisions of the federal securities law
- Exclusion for fixed annuities and life insurance from federal securities laws (Section 3(a)(8), Rule 151, Harkin Amendment)
- Combination Contracts: Partly registered, partly excluded

The SEC's Role in Prior Receiverships

- The SEC has generally not interceded in insurance company receiverships
  - State notices and opinion letters and receivership orders have generally recognized the insulation of registered Separate Accounts and redeemability requirements
    - Mutual Benefit Life Insurance Company (July 1991)
    - Monarch Life Insurance Company (May 1991)
  - The SEC probably would view a General Account guarantee of a Separate Account product as part of the registered Separate Account "security"
  - The SEC has a broad arsenal of legal remedies under the 1933 and 1940 Acts to protect the insulation of registered Separate Account products

Potential Limits on What a Receiver Can and Cannot Do

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- Receiver stands in the shoes of the insurance company and becomes the “control person” of the insurance company managing registered insurance products
- If the product is a registered VA/VLI, receiver should comply with requirements of the 1940 Act
  - Daily valuation of Separate Account assets
  - Redeemability of Separate Account assets as required by the 1940 Act
    - SEC can issue orders suspending redemption
  - Preserve Separate Account insulation
- If product is registered under the 1933 Act, the receiver must maintain the registration statements
- Receiver’s potential 1933 Act and 1940 Act liability

Ongoing 1933 Act and 1940 Act Considerations

- Receiver's role in:
  - Ongoing "evergreening" of prospectuses
    - Send prospectus to current investors each year
    - Deliver underlying fund documents for Variable Contracts
  - Filing updated registration statements
    - Auditor opinions and consents
  - Filing disclosure about receivership
  - Filing disclosure about contract changes
    - Restricting premiums
    - Distribution changes
    - Interest rate changes
    - Redeemability
- Possible liability under 1933 Act Sections 11 and 12 (through Section 15), 1934 Act Section 10(b)-5 and 1940 Act Section 34

Questions?