

VARIABLE LIFE INSURANCE MODEL REGULATION

Table of Contents

| | |
|-------------|------------------------------------------------------------------|
| Section 1. | Authority |
| Section 2. | Definitions |
| Section 3. | Qualification of Insurer to Issue Variable Life Insurance |
| Section 4. | Insurance Policy Requirements |
| Section 5. | Reserve Liabilities for Variable Life Insurance |
| Section 6. | Separate Accounts |
| Section 7. | Information Furnished to Applicants |
| Section 8. | Applications |
| Section 9. | Reports to Policyholders |
| Section 10. | Foreign Companies |
| Section 11. | Qualifications of Agents for the Sale of Variable Life Insurance |
| Section 12. | Separability |

Section 1. Authority

The following regulations applicable to variable life insurance policies are promulgated under the authority of Section [insert applicable section] of the Insurance Laws of [insert state], and are effective [insert date].

Section 2. Definitions

As used in this regulation:

- A. “Affiliate” of an insurer means a person, directly or indirectly, controlling, controlled by, or under common control with the insurer; a person who regularly furnishes investment advice to the insurer with respect to its separate accounts for which a specific fee or commission is charged; or any director, officer, partner or employee of the insurer, controlling or controlled person, or person providing investment advice or any member of the immediate family of such person.
- B. “Agent” means a person, corporation, partnership or other legal entity that is licensed by this state as a life insurance agent.
- C. “Assumed investment rate” means the rate of investment return that would be required to be credited to a variable life insurance policy, after deduction of charges for taxes, investment expenses and mortality and expense guarantees to maintain the variable death benefit equal at all times to the amount of death benefit, other than incidental insurance benefits, which would be payable under the plan of insurance if the death benefit did not vary according to the investment experience of the separate account.
- D. “Benefit base” means the amount to which the net investment return is applied.
- E. “Commissioner” means the insurance commissioner of this state.

Editor’s Note: Insert the title of the chief insurance regulatory official whenever the term “commissioner” appears.

- F. “Control” (including the terms “controlling,” “controlled by” and “under common control with”) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract other than a commercial contract for goods or non-management services, or otherwise, unless the power is the result of an official position with or corporate office held by the person. Control shall be presumed to exist if a person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing more than ten percent (10%) of the voting securities of any other person. This presumption may be rebutted by a showing made to the satisfaction of the commissioner that control does not exist in fact. The commissioner may determine, after furnishing to all persons in interest notice and opportunity to be heard and making specific findings of fact to support such determination, that control exists in fact, notwithstanding the absence of a presumption to that effect.

- G. “Flexible premium policy” means any variable life insurance policy other than a scheduled premium policy as specified in Subsection O of this section.
- H. “General account” means all assets of the insurer other than assets in separate accounts established pursuant to Section [insert applicable section] of the insurance laws of this state or pursuant to the corresponding section of the insurance laws of the state of domicile of a foreign or alien insurer, whether or not for variable life insurance.
- I. “Incidental insurance benefit” means all insurance benefits in a variable life insurance policy, other than the variable death benefit and the minimum death benefit, including but not limited to, accidental death and dismemberment benefits, disability benefits, guaranteed insurability options, family income or term riders.
- J. “May” is permissive.
- K. “Minimum death benefit” means the amount of the guaranteed death benefit, other than incidental insurance benefits, payable under a variable life insurance policy regardless of the investment performance of the separate account.
- L. “Net investment return” means the rate of investment return in a separate account to be applied to the benefit base.
- M. “Person” means an individual, corporation, partnership, association, trust or fund.
- N. “Policy processing day” means the day on which charges authorized in the policy are deducted from the policy’s cash value.
- O. “Scheduled premium policy” means a variable life insurance policy under which both the amount and timing of premium payments are fixed by the insurer.
- P. “Separate account” means a separate account established pursuant to Section [insert section] of the insurance laws of this state or pursuant to the corresponding section of the insurance laws of the state of domicile of a foreign or alien insurer.
- Q. “Shall” is mandatory.
- R. “Variable death benefit” means the amount of the death benefit, other than incidental insurance benefits, payable under a variable life insurance policy dependent on the investment performance of the separate account, which the insurer would have to pay in the absence of any minimum death benefit.
- S. “Variable life insurance policy” means an individual policy that provides for life insurance the amount or duration of which varies according to the investment experience of any separate account or accounts established and maintained by the insurer as to the policy, pursuant to Section [insert applicable section] of the insurance laws of this state or pursuant to the corresponding section of the insurance laws of the state of domicile of a foreign or alien insurer.

Section 3. Qualification of Insurer to Issue Variable Life Insurance

The following requirements are applicable to all insurers either seeking authority to issue variable life insurance in this state or having authority to issue variable life insurance in this state.

- A. **Licensing and Approval to do Business in This State.** An insurer shall not deliver or issue for delivery in this state any variable life insurance policies unless:
 - (1) The insurer is licensed or organized to do a life insurance business in this state;

- (2) The insurer has obtained the written approval of the commissioner for the issuance of variable life insurance policies in this state. The commissioner shall grant written approval only after the commissioner has found that:
- (a) The plan of operation for the issuance of variable life insurance policies is not unsound;
 - (b) The general character, reputation and experience of the management and those persons or firms proposed to supply consulting, investment, administrative or custodial services to the insurer are such as to reasonably assure competent operation of the variable life insurance business of the insurer in this state; and
 - (c) The present and foreseeable future financial condition of the insurer and its method of operation in connection with the issuance of such policies is not likely to render its operation hazardous to the public or its policyholders in this state. The commissioner shall consider, among other things:
 - (i) The history of operation and financial condition of the insurer;
 - (ii) The qualifications, fitness, character, responsibility, reputation and experience of the officers and directors and other management of the insurer and those persons or firms proposed to supply consulting, investment, administrative or custodial services to the insurer;
 - (iii) The applicable law and regulations under which the insurer is authorized in its state of domicile to issue variable life insurance policies. The state of entry of an alien insurer shall be deemed its state of domicile for this purpose; and
 - (iv) If the insurer is a subsidiary of, or is affiliated by common management or ownership with another company, its relationship to such other company and the degree to which the requesting insurer, as well as the other company, meets these standards.

B. Filing for Approval to do Business in This State. The commissioner may, at his discretion, require that an insurer, before it delivers or issues for delivery any variable life insurance policy in this state, file with the department the following information for the consideration of the commissioner in making the determination required by Subsection A(2) of this section:

- (1) Copies of and a general description of the variable life insurance policies it intends to issue;
- (2) A general description of the methods of operation of the variable life insurance business of the insurer, including methods of distribution of policies and the names of those persons or firms proposed to supply consulting, investment, administrative, custodial or distribution services to the insurer;
- (3) With respect to any separate account maintained by an insurer for a variable life insurance policy, a statement of the investment policy the issuer intends to follow for the investment of the assets held in the separate account and a statement of procedures for changing the investment policy. The statement of investment policy shall include a description of the investment objectives intended for the separate account;
- (4) A description of any investment advisory services contemplated as required by Section 6H;
- (5) A copy of the statutes and regulations of the state of domicile of the insurer under which it is authorized to issue variable life insurance policies;
- (6) Biographical data with respect to officers and directors of the insurer on the National Association of Insurance commissioners Uniform Biographical Data Form; and

- (7) A statement of the insurer's actuary describing the mortality and expense risks which the insurer will bear under the policy.
- C. Standards of Suitability. Every insurer seeking approval to enter into the variable life insurance business in this state shall establish and maintain a written statement specifying the standards of suitability to be used by the insurer. The standards of suitability shall specify that no recommendation shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of the policy is not unsuitable for the applicant on the basis of information furnished after reasonable inquiry of the applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or the agent making the recommendation.
- D. Use of Sales Materials. An insurer authorized to transact variable life insurance business in this state shall not use any sales material, advertising material or descriptive literature or other materials of any kind in connection with its variable life insurance business in this state which is false, misleading, deceptive or inaccurate. Variable life insurance sales material, advertising material and descriptive literature shall be subject to the additional requirements of [insert citation to the state life insurance advertising rules].
- E. Requirements Applicable to Contractual Services. Any material contract between an insurer and suppliers of consulting, investment, administrative, sales, marketing, custodial or other services with respect to variable life insurance operations shall be in writing and provide that the supplier of such services shall furnish the commissioner with any information or reports in connection with the services which the commissioner may request in order to ascertain whether the variable life insurance operations of the insurer are being conducted in a manner consistent with these regulations, and any other applicable law or regulations.
- F. Reports to the Commissioner.
- (1) An insurer authorized to transact the business of variable life insurance in this state shall submit to the commissioner, in addition to any other materials that may be required by this regulation or any other applicable laws or regulations:
- (a) An annual statement of the business of its separate account or accounts in such forms as may be prescribed by the National Association of Insurance Commissioners; and
 - (b) Prior to the use in this state any information furnished to applicants as provided for in Section 7; and
 - (c) Prior to the use in this state the form of any of the reports to policyholders as provided for in Section 9; and
 - (d) Such additional information concerning its variable life insurance operations or its separate accounts as the commissioner shall deem necessary.
- (2) Any material submitted to the commissioner under this section shall be disapproved if it is found to be false, misleading, deceptive or inaccurate in any material respect and, if previously distributed, the commissioner shall require the distribution of amended material.
- G. Authority of Commissioner to Disapprove. Any material required to be filed with and approved by the commissioner shall be subject to disapproval if at any time it is found by him or her not to comply with the standards established in this regulation.

Section 4. Insurance Policy Requirements

- A. **Policy Qualification.** The commissioner shall not approve any variable life insurance form filed pursuant to this regulation unless it conforms to the requirements of this section.
- B. **Filing of Variable Life Insurance Policies.** All variable life insurance policies, and all riders, endorsements, applications and other documents that are to be attached to be made a part of the policy and which relate to the variable nature of the policy, shall be filed with the commissioner and approved by him or her prior to delivery or issuance for delivery in this state.
 - (1) The procedures and requirements for filing and approval shall be, to the extent appropriate and not inconsistent with this regulation, the same as those otherwise applicable to other life insurance policies.
 - (2) The commissioner may approve variable life insurance policies and related forms with provisions the commissioner deems to be not less favorable to the policyholder and the beneficiary than those required by this regulation.
- C. **Mandatory Policy Benefit and Design Requirements.** Variable life insurance policies delivered or issued for delivery in this state shall comply with the following minimum requirements.
 - (1) Mortality and expense risks shall be borne by the insurer. The mortality and expense charges shall be subject to the maximums stated in the contract.
 - (2) For scheduled premium policies, a minimum death benefit shall be provided in an amount at least equal to the initial face amount of the policy so long as premiums are duly paid (subject to the provisions of Subsection E of this section);
 - (3) The policy shall reflect the investment experience of one or more separate accounts established and maintained by the insurer. The insurer shall demonstrate that the reflection of investment experience in the variable life insurance policy is actuarially sound.
 - (4) Each variable life insurance policy shall be credited with the full amount of the net investment return applied to the benefit base.
 - (5) Any changes in variable death benefits of each variable life insurance policy shall be determined at least annually.
 - (6) The cash value of each variable life insurance policy shall be determined at least monthly. The method of computation of cash values and other nonforfeiture benefits, as described either in the policy or in a statement filed with the commissioner of the state in which the policy is delivered, or issued for delivery, shall be in accordance with actuarial procedures that recognize the variable nature of the policy. The method of computation shall be such that, if the net investment return credited to the policy at all times from the date of issue should be equal to the assumed investment rate with premiums and benefits determined accordingly under the terms of the policy, then the resulting cash values to the minimum values required by Section [insert applicable section of the standard nonforfeiture law of this state] for a general account policy with such premiums and benefits. The assumed investment rate shall not exceed the maximum interest rate permitted under the Standard Nonforfeiture Law of this state. If the policy does not contain an assumed investment rate this demonstration shall be based on the maximum interest rate permitted under the Standard Nonforfeiture Law. The method of computation may disregard incidental minimum guarantees as to the dollar amounts payable. Incidental minimum guarantees include, for example, but are not limited to, a guarantee that the amount payable at death or maturity shall be least equal to the amount that otherwise would have been payable if the net investment return credited to the policy at all times from the date of issue had been equal to the assumed investment rate.

- (7) The computation of values required for each variable life insurance policy may be based upon such reasonable and necessary approximations as are acceptable to the commissioner.
- D. Mandatory Policy Provisions. Every variable life insurance policy filed for approval in this state shall contain at least the following:
- (1) The cover page or pages corresponding to the cover page of each policy shall contain:
 - (a) A prominent statement in either contrasting color or in bold-faced type that the amount or duration of death benefit may be variable or fixed under specified conditions;
 - (b) A prominent statement in either contrasting color or in bold-faced type that cash values may increase or decrease in accordance with the experience of the separate account subject to any specified minimum guarantees;
 - (c) A statement describing any minimum death benefit required pursuant to Subsection C (2) of this section;
 - (d) The method, or a reference to the policy provision which describes the method, for determining the amount of insurance payable at death;
 - (e) To the extent permitted by state law, a captioned provision that the policyholder may return the variable life insurance policy within ten (10) days of receipt of the policy by the policyholder and receive a refund equal to the sum of the difference between the premiums paid including any policy fees or other charges and the amounts allocated to any separate accounts under the policy and the value of the amounts allocated to any separate accounts under the policy, on the date the returned policy is received by the insurer or its agent. Until such time as state law authorizes the return of payments as calculated in the preceding sentence, the amount of the refund shall be the total of all premium payments for such policy.
 - (f) Such other items as are currently required for fixed benefit life insurance policies and which are not inconsistent with this regulation.
 - (2)
 - (a) For scheduled premium policies, a provision for a grace period of not less than thirty-one (31) days from the premium due date which shall provide that when the premium is paid within the grace period, policy values will be the same, except for the deduction of any overdue premium, as if the premium were paid on or before the due date.
 - (b) For flexible premium policies, a provision for a grace period beginning on the policy processing day when the total charges authorized by the policy that are necessary to keep the policy in force until the next policy processing day exceed the amounts available under the policy to pay such charges in accordance with the terms of the policy. The grace period shall end on a date not less than sixty-one (61) days after the mailing date of the Report to Policyholders required by Section 9C.
 - (c) The death benefit payable during the grace period will equal the death benefit in effect immediately prior to such period less any overdue charges. If the policy processing days occur monthly, the insurer may require the payment of not more than three (3) times the charges that were due on the policy processing day on which the amounts available under the policy were insufficient to pay all charges authorized by the policy that are necessary to keep the policy in force until the next policy processing day.

- (3) For scheduled premium policies, a provision that the policy will be reinstated at any time within two (2) years from the date of default upon the written application of the insured and evidence of insurability, including good health, satisfactory to the insurer, unless the cash surrender value has been paid or the period of extended insurance has expired, upon the payment of any outstanding indebtedness arising subsequent to the end of the grace period following the date of default together with accrued interest thereon to the date of reinstatement and payment of an amount not exceeding the greater of:
 - (a) All overdue premiums with interest at a rate not exceeding [insert number] percent per annum compounded annually and any indebtedness in effect at the end of the grace period following the date of default with interest at a rate not exceeding [insert number] percent per annum compounded annually; or
 - (b) 110 percent of the increase in cash value resulting from reinstatement plus all overdue premiums for incidental insurance benefits with interest at a rate not exceeding [insert number] percent per annum compounded annually.
- (4) A full description of the benefit base and of the method of calculation and application of any factors used to adjust variable benefits under the policy;
- (5) A provision designating the separate account to be used and stating that:
 - (a) The assets of the separate account shall be available to cover the liabilities of the general account of the insurer only to the extent that the assets of the separate account exceed the liabilities of the separate account arising under the variable life insurance policies supported by the separate account.
 - (b) The assets of the separate account shall be valued at least as often as any policy benefits vary but at least monthly.
- (6) A provision specifying what documents constitute the entire insurance contract under state law;
- (7) A designation of the officers who are empowered to make an agreement or representation on behalf of the insurer and an indication that statements by the insured, or on his or her behalf, shall be considered as representations and not warranties;
- (8) An identification of the owner of the insurance contract;
- (9) A provision setting forth conditions or requirements as to the designation, or change of designation, of a beneficiary and a provision for disbursement of benefits in the absence of a beneficiary designation;
- (10) A statement of any conditions or requirements concerning the assignment of the policy;
- (11) A description of any adjustments in policy values to be made in the event of misstatement of age or sex of the insured;
- (12) A provision that the policy shall be incontestable by the insurer after it has been in force for two (2) years during the lifetime of the insured. However, any increase in the amount of the policy's death benefits subsequent to the policy issue date, which occurred upon a new application or request of the owner and was subject to satisfactory proof of the insured's insurability, shall be incontestable after the increase has been in force, during the lifetime of the insured, for two (2) years from the date of issue of increase;
- (13) A provision stating that the investment policy of the separate account shall not be changed without the approval of the insurance commissioner of the state of domicile of the insurer, and that the approval process is on file with the commissioner of this state;

- (14) A provision that payment of variable death benefits in excess of any minimum death benefits, cash values, policy loans or partial withdrawals (except when used to pay premiums) or partial surrenders may be deferred:
 - (a) For up to six (6) months from the date of request, if the payments are based on policy values which do not depend on the investment performance of the separate account; or
 - (b) Otherwise, for any period during which the New York Stock Exchange is closed for trading (except for normal holiday closing) or when the Securities and Exchange Commission has determined that a state of emergency exists which may make such payment impractical;
 - (15) If settlement options are provided, at least one option shall be provided on a fixed basis only;
 - (16) A description of the basis for computing the cash value and the surrender value under the policy shall be included;
 - (17) Premiums or charges for incidental insurance benefits shall be stated separately;
 - (18) Any other policy provision required by this regulation;
 - (19) Such other items as are currently required for fixed benefit life insurance policies and are not inconsistent with this regulation; and
 - (20) A provision for nonforfeiture insurance benefits. The insurer may establish a reasonable minimum cash value below which any nonforfeiture insurance options will not be available.
- E. Policy Loan Provisions. Every variable life insurance policy, other than term insurance policies and pure endowment policies delivered or issued for delivery in this state shall contain provisions which are not less favorable to the policyholder than a provision for policy loans after the policy has been in force for [insert number] full years which provides the following:
- (1) At least seventy-five percent (75%) of the policy's cash surrender value may be borrowed.
 - (2) The amount borrowed shall bear interest at a rate not to exceed that permitted by state insurance law.
 - (3) Any indebtedness shall be deducted from the proceeds payable on death.
 - (4) Any indebtedness shall be deducted from the cash surrender value upon surrender or in determining any nonforfeiture benefit.
 - (5) For scheduled premium policies, whenever the indebtedness exceeds the cash surrender value, the insurer shall give notice of any intent to cancel the policy if the excess indebtedness is not repaid within thirty-one (31) days after the date of mailing of notice. For flexible premium policies, whenever the total charges authorized by the policy that are necessary to keep the policy in force until the next following policy processing day exceed the amounts available under the policy to pay the charges, a report must be sent to the policyholder containing the information specified by Section 9C.
 - (6) The policy may provide that if, at any time, so long as premiums are duly paid, the variable death benefit is less than it would have been if no loan or withdrawal had ever been made, the policyholder may increase the variable death benefit up to what it would have been if there had been no loan or withdrawal by paying an amount not exceeding 110 percent of the corresponding increase in cash value and by furnishing such evidence of insurability as the insurer may request.

- (7) The policy may specify a reasonable minimum amount that may be borrowed at any time but the minimum shall not apply to any automatic premium loan provision.
 - (8) No policy loan provision is required if the policy is under extended insurance nonforfeiture option.
 - (9) The policy loan provisions shall be constructed so that variable life insurance policyholders who have not exercised such provisions are not disadvantaged by the exercise thereof.
 - (10) Amounts paid to the policyholders upon the exercise of any policy loan provision shall be withdrawn from the separate account and shall be returned to the separate account upon repayment except that a stock insurer may provide the amounts for policy loans from the general account.
- F. Other Policy Provisions. The following provision may in substance be included in a variable life insurance policy or related form delivered or issued for delivery in this state:
- (1) An exclusion for suicide within [insert “two” or other number of years] years of the issue date of the policy; provided, however, that to the extent of the increased death benefits only, the policy may provide an exclusion for suicide within two (2) years of any increase in death benefits which result from an application of the owner subsequent to the policy issue date;
 - (2) Incidental insurance benefits may be offered on a fixed or variable basis;
 - (3) Policies issued on a participating basis shall offer to pay dividend amounts in cash. In addition, such policies may offer the following dividend options:
 - (a) The amount of the dividend may be credited against premium payments;
 - (b) The amount of the dividend may be applied to provide amounts of additional fixed or variable benefit life insurance;
 - (c) The amount of the dividend may be deposited in the general account at a specified minimum rate of interest;
 - (d) The amount of the dividend may be applied to provide paid-up amounts of fixed benefit one-year term insurance;
 - (e) The amount of the dividend may be deposited as a variable deposit in a separate account.
 - (4) A provision allowing the policyholder to elect in writing in the application for the policy or thereafter an automatic premium loan on a basis not less favorable than that required of policy loans under Subsection E of this section, except that a restriction that no more than two (2) consecutive premiums can be paid under this provision may be imposed;
 - (5) A provision allowing the policyholder to make partial withdrawals; and
 - (6) Any other policy provision approved by the commissioner.

Section 5. Reserve Liabilities For Variable Life Insurance

- A. Reserve Liabilities Under Standard Valuation Law. Reserves liabilities for variable life insurance policies shall be established under [insert citation to the standard valuation law] in accordance with actuarial procedures that recognize the variable nature of the benefits provided and any mortality guarantees.

- B. Reserve Liabilities for the Guaranteed Minimum Death Benefit. Reserve liabilities for the guaranteed minimum death benefit shall be the reserve needed to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would be paid in the absence of the guarantee, and shall be maintained in the general account of the insurer and shall not be less than the greater of the following minimum reserves:
- (1) The aggregate total of the term costs, if any, covering a period of one full year from the valuation date or, if less, covering the period provided for in the guarantee not otherwise provided for by the reserves held in the separate account, on each variable life insurance contract, assuming an immediate one-third depreciation in the current value of the assets in the separate account followed by a net investment return equal to the assumed investment rate; or
 - (2) The aggregate total of the “attained age level” reserves on each variable life insurance contract. The “attained age level” reserve on each variable life insurance contract shall not be less than zero and shall equal the “residue,” as described in Subparagraph (a) below, of the prior year’s “attained age level” reserve on the contract, with any such “residue,” increased or decreased by a payment computed on an attained age basis as described in Subparagraph (b) below.
 - (a) The “residue” of the prior year’s “attained age level” reserve on each variable life insurance contract shall not be less than zero and shall be determined by adding interest at the valuation interest rate to the prior year’s reserve, deducting the tabular claims based on the “excess,” if any, of the guaranteed minimum death benefit over the death benefit that would be payable in the absence of a guarantee, and dividing the net result by the tabular probability of survival. The “excess” referred to in the preceding sentence shall be based on the actual level of death benefits that would have been in effect during the preceding year in the absence of the guarantee, taking appropriate account of the reserve assumptions regarding the distribution of death claim payments over the year.
 - (b) The payment referred to in this paragraph shall be computed so that the present value of a level payment of that amount each year over the future period for which charges for this risk will be collected under the contract, is equal to (A) minus (B) minus (C), where (A) is the present value of the future guaranteed minimum death benefits, (B) is the present value of the future death benefits that would be payable in the absence of such guarantee, and (C) is any “residue,” as described in Subparagraph (a), of the prior year’s “attained age level” reserve on such variable life insurance contract. If no future charges for this risk will be collected under the contract, the payment shall equal (A) minus (B) minus (C). The amounts of the future death benefits referred to in (B) shall be computed assuming a net investment return of the separate account which may differ from the assumed investment rate or the valuation interest but in no event may exceed the maximum interest rate permitted for the valuation of life contracts.
 - (3) The valuation interest rate and mortality table used in computing the two minimum reserves described in Paragraph (1) and (2) of this subsection shall conform to permissible standards for the valuation of life insurance contracts. In determining such minimum reserves, the company may employ suitable approximations and estimates, including but not limited to groupings and averages.
- C. Incidental Insurance Benefit. Reserve liabilities for all fixed incidental insurance benefits and any guarantees associated with variable incidental insurance benefits shall be maintained in the general account and reserve liabilities for all variable aspects of the variable incidental insurance benefits shall be maintained in a separate account, in amounts determined in accordance with the actuarial procedures appropriate to the benefit.

Section 6. Separate Accounts

The following requirements apply to the establishment and administration of variable life insurance separate accounts by a domestic insurer:

- A. Establishment and Administration of Separate Accounts. A domestic insurer issuing variable life insurance shall establish one or more separate accounts pursuant to Sections [insert appropriate sections] of the insurance laws of this state.
 - (1) If no law or other regulation provides for the custody of separate account assets and if the insurer is not the custodian of the separate account assets, all contracts for custody of these assets shall be in writing and the commissioner shall have authority to review and approve of both the terms of the contract and the proposed custodian prior to the transfer of custody.
 - (2) The insurer shall not without prior written approval of the commissioner employ in any material connection with the handling of separate account assets any person who:
 - (a) Within the last ten (10) years has been convicted of any felony or a misdemeanor arising out of such person's conduct involving embezzlement, fraudulent conversion, or misappropriation of funds or securities or involving violation of Sections 1341, 1342 or 1343 of Title 18, United States Code; or
 - (b) Within the last ten (10) years has been found by any state regulatory to have violated or has acknowledged violation of any provision of any state insurance law involving fraud, deceit or knowing misrepresentation; or
 - (c) Within the last ten (10) years has been found by federal or state regulatory authorities to have violated or has acknowledged violation of any provision of federal or state securities laws involving fraud, deceit or knowing misrepresentation.
 - (3) All persons with access to the cash, securities, or other assets of the separate account shall be under bond in the amount of not less than \$[insert appropriate amount].
 - (4) The assets of separate accounts shall be valued at least as often as variable benefits are determined but in any event at least monthly.
- B. Amounts in the Separate Account. The insurer shall maintain in each separate account assets with a value at least equal to the greater of the valuation reserves for the variable portion of the variable life insurance policies or the benefit base for these policies.
- C. Investments by the Separate Account.
 - (1) No sale, exchange, or other transfer of assets may be made by an insurer or any of its affiliates between any of its separate accounts or between any other investment account and one or more of its separate accounts unless:
 - (a) In case of transfer into a separate account, the transfer is made solely to establish the account or to support the operation of the policies with respect to the separate account to which the transfer is made; and
 - (b) The transfer, whether into or from a separate account, is made by a transfer of cash; but other assets may be transferred if approved by the commissioner in advance.
 - (2) The separate account shall have sufficient net investment income and readily marketable assets to meet anticipated withdrawals under policies funded by the account.

D. Limitations on Ownership.

- (1) A separate account shall not purchase or otherwise acquire the securities of an issuer, other than securities issued or guaranteed as to principal and interest by the United States, if immediately after the purchase or acquisition the value of the investment, together with prior investments of the account in the security valued as required by these regulations, would exceed ten percent (10%) of the value of the assets of the separate account. The commissioner may waive this limitation in writing if the commissioner believes the waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state.
- (2) No separate account shall purchase or otherwise acquire the voting securities of any issuer if as a result of the acquisition the insurer and its separate accounts in the aggregate, will own more than ten percent (10%) of the total issued and outstanding voting securities of the issuer. The commissioner may waive this limitation in writing if he or she believes the waiver will not render the operation of the separate account hazardous to the public or the policyholders in this state or jeopardize the independent operation of the issuer of these securities.
- (3) The percentage limitation specified in Paragraph (1) of this subsection shall not be construed to preclude the investment of the assets of separate accounts in shares of investment companies registered pursuant to the Investment Company Act of 1940 or other pools of investment assets if the investments and investment policies of such investment companies or asset pools comply substantially with the provisions of Subsection C of this section and other applicable portions of this regulation.

E. Valuation of Separate Account Assets. Investments of the separate account shall be valued at their market value on the date of valuation, or at amortized cost if it approximates market value.

F. Separate Account Investment Policy. The investment policy of a separate account operated by a domestic insurer filed under Section 3B(3) shall not be changed without first filing the change with the insurance commissioner.

- (1) Any change filed pursuant to this section shall be effective sixty (60) days after the date it was filed with the commissioner, unless the commissioner notifies the insurer before the end of the sixty-day period of his or her disapproval of the proposed change. At any time the commissioner may, after notice and public hearing, disapprove any change that has become effective pursuant to this section.
- (2) The commissioner may disapprove the change if he or she determines that the change would be detrimental to the interests of the policyholders participating in the separate accounts.

G. Charges Against Separate Account. The insurer shall disclose in writing, prior to or contemporaneously with delivery of the policy, all charges that may be made against the separate account, including, but not limited to, the following:

- (1) Taxes or reserves for taxes attributable to investment gains and income of the separate account;
- (2) Actual cost of reasonable brokerage fees and similar direct acquisition and sale costs incurred in the purchase or sale of separate account assets;
- (3) Actuarially determined costs of insurance (tabular costs) and the release of separate account liabilities;
- (4) Charges for administrative expenses and investment management expenses, including internal costs attributable to the investment management of assets of the separate account;
- (5) A charge, at a rate specified in the policy, for mortality and expense guarantees;

- (6) Any amounts in excess of those required to be held in the separate accounts; and
 - (7) Charges for incidental insurance benefits.
- H. Standards of Conduct. Every insurer seeking approval to enter into the variable life insurance business in this state shall adopt by formal action of its board of directors a written statement specifying the standards of conduct of the insurer, its officers, directors, employees and affiliates with respect to the purchase or sale of investments of separate accounts. The standards of conduct shall be binding on the insurer and those to whom it refers. A code or codes of ethics meeting the requirements of Section 17j under the Investment Company Act of 1940 and its applicable rules and regulations shall satisfy the provisions of this section.
- I. Conflicts of Interest. Rules under any provision of the insurance laws of this state or any regulation applicable to the officers and directors of insurance companies with respect to conflicts of interest shall also apply to members of any separate account's committee or other similar body.
- J. Investment Advisory Services to a Separate Account.
- (1) An insurer shall not enter into a contract under which any person undertakes, for a fee, to regularly furnish investment advice to such insurer with respect to its separate accounts maintained for variable life insurance policies unless:
 - (a) The person providing advice is registered as an investment adviser under the Investment Advice Act of 1940; or
 - (b) The person providing advice is an investment manager under the Employee Retirement Income Security Act of 1974 with respect to the assets of each employee benefit plan allocated to the separate account; or
 - (c) The insurer has filed with the commissioner and continues to file annually the following information and statements concerning the proposed advisor:
 - (i) The name and form of organization, state of organization, and its principal place of business;
 - (ii) The names and addresses of its partners, officers, directors and persons performing similar functions or, if the investment advisory is an individual, of the individual;
 - (iii) A written standard of conduct complying in substance with the requirements of Subsection H of this section which has been adopted by the investment advisor and is applicable to the investment advisor, its officers, directors, and affiliates;
 - (iv) A statement provided by the proposed advisor as to whether the advisor or any person associated therewith:
 - (I) Has been convicted within ten (10) years of a felony or misdemeanor arising out of the person's conduct as an employee, salesman, officer or director of an insurance company, a banker, an insurance agent, a securities broker or an investment advisor involving embezzlement, fraudulent conversion or misappropriation of funds or securities, or involving the violation of Sections 1341, 1342, or 1343 of Title 18 of United States Code;

- (II) Has been permanently or temporarily enjoined by an order, judgment or decree of a court of competent jurisdiction from acting as an investment advisor, underwriter, broker or dealer, or as an affiliated person or as an employee of an investment company, bank or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity;
 - (III) Has been found by federal or state regulatory authorities to have willfully violated or have acknowledged willful violation of any provision of federal or state securities laws or state insurance laws or of any rule or regulation under these laws; or
 - (IV) Has been censured, denied an investment advisor registration, had a registration as an investment advisor revoked or suspended, or been barred or suspended from being associated with an investment advisor by order of federal or state regulatory authorities; and
- (d) The investment advisory contract shall be in writing and provide that it may be terminated by the insurer without penalty to the insurer or the separate account upon no more than sixty (60) days' written notice to the investment advisor.
- (2) The commissioner may, after notice and opportunity for hearing, by order require the investment advisory contract to be terminated if the commissioner deems continued operation under the contract to be hazardous to the public or the insurer's policyholders.

Section 7. Information Furnished To Applicants

An insurer delivering or issuing for delivery in this state a variable life insurance policy shall deliver the following to the applicant for the policy, and obtain a written acknowledgment of receipt from the applicant coincident with or prior to the execution of the application. The requirements of this section shall be deemed to have been satisfied to the extent that a disclosure containing information required by this section is delivered, either in the form of a prospectus included in the requirements of the Securities Act of 1933 and which was declared effective by the Securities and Exchange Commission; or all information and reports required by the Employee Retirement Income Security Act of 1974 if the policies are exempted from the registration requirements of the Securities Act of 1933 pursuant to Section 3(a)(2) thereof.

- A. A summary explanation, in non-technical terms, of the principal features of the policy, including a description of the manner in which the variable benefits will reflect the investment experience of the separate account and the factors that affect the variation. The explanation shall include notices of the provision required by Sections 4D(1)(e) and 4D(6);
- B. A statement of the investment policy of the separate account, including:
 - (1) A description of the investment objectives intended for the separate account and the principal types of investments intended to be made; and
 - (2) Any restrictions or limitations on the manner in which the operations of the separate account are intended to be conducted;
- C. A statement of the net investment return of the separate account for each of the last ten (10) years or such lesser period as the separate account has been in existence;
- D. A statement of the charges levied against the separate account during the previous year;
- E. A summary of the method to be used in valuing assets held by the separate account;
- F. A summary of the federal income tax aspects of the policy applicable to the insured, the policyholder and the beneficiary; and

- G. Illustrations of benefits payable under the variable life insurance contract. The illustrations shall be prepared by the insurer and shall not include projections of past investment experience into the future or attempted predictions of future investments experience, provided that nothing contained herein prohibits use of hypothetical assumed rates of return to illustrate possible levels of benefits if it is made clear that the assumed rates are hypothetical only.

Section 8. Applications

The application for a variable life insurance policy shall contain:

- A. A prominent statement that the death benefit may be variable or fixed under specified conditions;
- B. A prominent statement that cash values may increase or decrease in accordance with the experience of the separate account (subject to any specified minimum guarantees); and
- C. Questions designed to elicit information that enables the insurer to determine the suitability of variable life insurance for the applicant.

Section 9. Reports to Policyholders

An insurer delivering or issuing for delivery in this state a variable life insurance policy shall mail to each variable life insurance policyholder at his or her last known address the following reports:

- A. Within thirty (30) days after each anniversary of the policy, a statement or statements of the cash surrender value, death benefit, any partial withdrawal or policy loan, any interest charge, any optional payments allowed pursuant to Section 4E under the policy computed as of the policy anniversary date. However, the statement may be furnished within thirty (30) days after a specified date in each policy year so long as the information contained therein is computed as of a date not more than sixty (60) days prior to the mailing of the notice. This statement shall state that, in accordance with the investment experience of the separate account, the cash values and the variable death benefit may increase or decrease, and shall prominently identify any value described therein which may be recomputed prior to the next statement required by this section. If the policy guarantees that the variable death benefit on the next policy anniversary date will not be less than the variable death benefit specified in the statement, the statement shall be modified to so indicate. For flexible premium policies, the report shall contain a reconciliation of the change since the previous report in cash value and cash surrender value, if different, because of payments made (less deductions for expense charges), withdrawals, investment experience, insurance charges and any other charges made against the cash value. In addition, the report shall show the projected cash value and cash surrender value, if different, as of one year from the end of the period covered by the report assuming that planned periodic premiums, if any, are paid as scheduled; guaranteed costs of insurance are deducted; and the net return is equal to the guaranteed rate or, in the absence of a guaranteed rate, is not greater than zero. If the projected value is less than zero, a warning message shall be included that states that the policy may be in danger of terminating without value in the next twelve (12) months unless additional premium is paid.
- B. Annually, a statement or statements including:
 - (1) A summary of the financial statement of the separate account based on the last annual statement filed with the commissioner;
 - (2) The net investment return of the separate account for the last year and, for each year after the first, a comparison of the investment rate of the separate account during the last year with the investment rate during prior years, up to a total of not less than five (5) years when available;
 - (3) A list of investments held by the separate account as of a date not earlier than the end of the last year for which an annual statement was filed with the commissioner;
 - (4) Any charges levied against the separate account during the previous year; and

- (5) A statement of any change, since the last report, in the investment objective and orientation of the separate account, in any investment restriction or material quantitative or qualitative investment requirement applicable to the separate account or in the investment advisor of the separate account.
- C. For flexible premium policies, a report shall be sent to the policyholder if the amounts available under the policy on any policy processing day to pay the charges authorized by the policy are less than the amount necessary to keep the policy in force until the next following policy processing day. The report shall indicate the minimum payment required under the terms of the policy to keep it in force and the length of the grace period for payment of the amount.

Section 10. Foreign Companies

If the law or regulation in the place of domicile of a foreign company provides a degree of protection to the policyholders and the public that is substantially similar to that provided by these regulations, the commissioner to the extent deemed appropriate by the commissioner in his or her discretion, may consider compliance with such law or regulation as compliance with these regulations.

Section 11. Qualifications Of Agents For The Sale Of Variable Life Insurance

- A. Qualification to Sell Variable Life Insurance
- (1) A person shall not sell or offer for sale in this state any variable life insurance policy unless the person is an agent and has filed with the commissioner, in a form satisfactory to the commissioner, evidence that the person holds a license or authorization that may be required for the solicitation or sale of variable life insurance.
 - (2) An examination administered by the Department for the purpose of determining the eligibility of a person for licensing as an agent shall, after the effective date of this regulation, include questions concerning the history, purpose, regulation and sale of variable life insurance as the commissioner deems appropriate.
- B. Reports of Disciplinary Actions. A person qualified in this state under this Act to sell or offer to sell variable life insurance shall immediately report to the commissioner:
- (1) Any suspension or revocation of the agent's license in any other state or territory of the United States;
 - (2) The imposition of any disciplinary sanction, including suspension or expulsion from membership, suspension or revocation of or denial of registration, imposed upon him or her by any national securities exchange, or national securities association, or any federal, state or territorial agency with jurisdiction over securities or variable life insurance; and
 - (3) Any judgment or injunction entered against him or her on the basis of conduct deemed to have involved fraud, deceit, misrepresentation or violation of any insurance or securities law or regulation.
- C. Refusal to Qualify Agent to Sell Variable Life Insurance: Suspension, Revocation, or Nonrenewal of Qualification. The commissioner may reject an application or suspend or revoke or refuse to renew an agent's qualification under this Act to sell or offer to sell variable life insurance upon any ground that would bar the applicant or agent from being licensed to sell other life insurance contracts in this state. The rules governing a proceeding relating to the suspension or revocation of an agent's license shall also govern a proceeding for suspension or revocation of an agent's qualification to sell or offer to sell variable life insurance.

Section 12. Separability

If any provision of this regulation or its application to any person or circumstances is for any reason held to be invalid, the remainder of the regulation and the application of its provisions to other persons or circumstances shall not be affected.

Chronological Summary of Action (all references are to the Proceedings of the NAIC).

1974 Proc. I 12, 14, 405, 461-462, 463-485 (adopted).

1974 Proc. II 8, 10, 456, 538, 541-547 (adopted report as an interpretive guideline).

1975 Proc. I 2, 6, 573, 752, 761-786 (amended and reprinted)

1975 Proc. I 792-852 (commentary adopted).

1978 Proc. I 13, 15, 348, 578, 579 (amended).

1983 Proc. I 6, 35, 448, 583, 587-642 (amended commentary and regulation and all reprinted).

1989 Proc. I 9, 23-24, 642, 670-671, 674 (amended).

**COMMENTARY TO
VARIABLE LIFE INSURANCE MODEL REGULATION**

Section 2. Definitions

Note: Each definition should be reviewed to assure that the definition corresponds to the actual language used by the statutes of the particular state. Additional definitions may be necessary.

Subsection A. Affiliate

Source: NAIC Model Holding Company Act Section 1A, 1969 *Proceedings of the NAIC* II 739.

Comment: The circumstances in which a person becomes an affiliate must remain flexible, and depend on the particular facts of each case. However, a person would presumptively be affiliated if: (1) they owned more than 10 percent of the voting securities; (2) they furnished regular investment advice; (3) they were in control of, were controlled by, or were in common control with; or (4) were a director, employee, officer, partner of such a person or a member of that person's immediate family. It should be noted that a separate account is not a severable legal entity but rather is an integral part of the insurer. Therefore, it cannot be an affiliate of anyone.

The definition of an affiliate contains no percentage limitation. Therefore the definition of "control" (Section 2F) takes on added significance.

The definition of affiliate has been expanded from the NAIC Model Holding Company Act to include those persons (investment advisers, directors, partners, employees and relatives) who might obtain personal or corporate gain at the expense of variable life insurance policyholders. A finding of affiliation is significant because it (1) triggers the conflict of interest provisions (Section 6I), (2) imposes minimum standards of conduct (Section 6H), and (3) subjects the entire corporate structures of insurers to scrutiny by the commissioner relating to its variable life insurance operations (see Section 3A(2)(c)(iv) concerning those who would otherwise be non-affiliated persons).

The inherent close relationship of the insurer's general account and separate account, the nature of the insurer's obligation, and the ownership of separate account assets would have made application of the interested person concept (see 15 USC 80a-2(19) and 15 USC 80a-10(a)) not only inappropriate, but contradictory to the nature of variable life insurance. Because of the nature of an insurer's variable life insurance operations, the committee found no beneficial effect in requiring a separate account to have a management which was independent of the insurer. As a matter of fact, they expressly held the insurer's board responsible in a management context for all acts of the insurer involving its separate account. It was expected, however, that separate account operations would be carefully scrutinized (see, e.g., Section 6I).

Otherwise independent investment advisers who furnish regular investment advice are incorporated within the definition of affiliate in order to place protection against overreaching in general, and potential conflicts of interest within the scope of the regulation.

The definition purposely limits its application to those otherwise independent advisers who regularly furnish investment advice for which a specific fee is charged. This is done in order to avoid the possible construction that a broker who, as part of his normal brokerage commission gives incidental investment advice, would be an affiliate.

Subsection B. Agent

Note: Those states that have life insurance brokers or solicitors should modify the definition of agent to include them.

Source: NAIC Model Variable Contract Regulation Article II, Section 2, 1970 *Proceedings of the NAIC* II 1185.

Comment: See NAIC Agents and Brokers Licensing Model Act Section 4A(2)(a)(1) as amended by the NAIC in December, 1973 consistent with the recommendation contained in 1973 *Proceedings of the NAIC* II 383.

C. Assumed Investment Rate

Comment: This is the hypothetical rate of investment return, after the enumerated deductions, specified by the insurer in defining the plan of insurance benefits. In a variable whole life policy, for example, it is the rate of investment return at which the variable death benefit (Section 2R) will at all times equal the initial death benefit. It is the rate of investment return at which nonforfeiture benefits must be tested for conformity with those required by the Standard Nonforfeiture Law (see Section 4C(6)).

A low assumed investment rate will increase the net premium while simultaneously increasing the likelihood that the net investment return will exceed the assumed investment rate. That is, for a given net premium, a low assumed investment rate would produce a lower initial face amount, but a greater probability that subsequent variable death benefits would increase. Thus, there may be sound actuarial and marketing reasons for a lower than average assumed investment rate. However, too low an assumed investment rate would make premiums uncompetitively high.

On the other hand, a high assumed investment rate would produce a higher initial face amount, but with a greatly reduced chance of subsequent increases in the death benefit. In addition, it should be noted that the higher the assumed investment rate, the more costly any initial face value guarantees will become to the insurer. The Subcommittee was concerned with the possibility that excessive assumed investment rates could be deceptive in suggesting unrealistic policyholder expectations, and could impinge adversely on the insurer's solvency. The fourth sentence of Section 4C(6), limiting this rate to the maximum rate permitted under the Standard Nonforfeiture law, was included to prevent this.

Subsection D. Benefit Base

Comment: Prior to the 1983 amendments, the model regulation defined benefit base as the "amount . . . to which the difference between the net investment return and the assumed investment rate is applied in determining the variable benefits of the policy." In some of the early drafts of the model regulation, the Committee utilized the term "attributed fund." The term "benefit base" was substituted therefor as more descriptive and to specifically avoid the unintended connotation of individual policyholder proportionate ownership of identifiable assets being read by some into the term "attributed fund."

The 1983 amendments recognize that the benefit base of a flexible premium variable life insurance policy is the policy's cash value and that the concept of an assumed investment rate is not meaningful in the context of these products.

Thus, the definition of benefit base, as changed by the 1983 amendments, defines the amount for both flexible premium and scheduled premium policies. For this reason, for example, the 1983 amendments deleted the previous formulations which correlated the benefit base computation to the difference between the net investment return and the assumed investment rate. In addition, the cross-reference to Section 6B, which sets forth the benefit base computation, has been deleted to correspond to the deletion of the latter provision.

Subsection E. Commissioner

Note: Each state should modify the term "commissioner" so that it corresponds to the correct title of the insurance regulatory official in the state where this regulation is adopted.

Source: NAIC Health Maintenance Organization Model Act Section 2D, 1973 *Proceedings of the NAIC* I 205.

Subsection F. Control

Source: NAIC Model Holding Company Act Section 1C, 1969 *Proceedings of the NAIC* II 739.

Comment: This section closely parallels its source, but the percentage of ownership before control would be presumed was slightly amended from "ten percent (10%)" to "more than ten percent (10%)." This was done to eliminate an internal inconsistency with Section 6D that allows ownership of up to 10% of the securities of any one issuer in funding the variable life insurance separate account.

The term control (and therefore affiliate) is defined in terms of the ability to direct or cause the direction of the management of another person whether or not through stock ownership. Thus, control can in fact be found regardless of the absence of a presumption of control. The criteria for making such a finding are clearly contained within the definition, to wit, the ability to direct management.

There is no reverse presumption of a lack of control when 10% or less is owned. Rather, the burden would still always be on the person claiming no control to demonstrate this to the commissioner.

The facts of each particular case in determining control must be judged on their own merits. It is for this reason that the model regulation attempts to preserve maximum flexibility for the commissioner in order not to bind him or her in the future to decisions which lack relevance to the actual facts of a particular case. Nonetheless, it would seem that the percentage of stock ownership in question, as well as the existence or nonexistence and size of any other organized factions of shareholders, would be relevant inquiries in determining control.

The finding of control would in turn automatically establish an affiliate relationship and trigger the conflict of interest (Section 6I) and standards of conduct (Section 6H) provisions of the regulation notwithstanding the absence of a presumption of control. The last sentence of this section would also allow the commissioner to determine that control of or by persons without voting securities exists in fact.

The question of notice and procedure is designed to be governed by the administrative law and procedure of the particular state in question. In most instances, this would be a question that would be handled by the state of domicile (see also comment to Section 3E).

Subsection G. Flexible Premium Policy

Comment: A flexible premium variable life insurance policy is defined by reference to a scheduled premium variable life insurance policy as defined in Section 2. The demarcation between scheduled and flexible premium policies is a fundamental underpinning of the 1983 amendments to the model regulation. The classification of a product as a flexible premium or scheduled premium policy is, for example, determinative of important distinctions in the applicability and scope of mandatory policy benefit and design requirements and mandatory policy provisions (see, e.g., Sections 4C(2), 4D(2) and 4D(3)).

Structurally, the model regulation defines a flexible premium variable life insurance policy broadly as any variable life insurance policy other than a scheduled premium policy as defined in Section 2. Accordingly, if either the amount or timing of premium payments under a variable life insurance policy is not fixed by the insurer (see Section 2), or if both amount and timing have not been so fixed, then the policy is a flexible premium variable life insurance policy within the scope of Subsection G.

Subsection H. General Account

Comment: The general account of an insurer may not be an account as such but rather consists of all the assets of the insurer that are available to satisfy its overall obligations. The general account does not include any separate account of the insurer. However, to the extent that a particular separate account's assets may exceed separate account liabilities, they are of course available to satisfy obligations of the general account (see Section 4D(5)(a)). Separate accounts include variable annuity and any other separate accounts permitted by law. The reference to separate accounts established pursuant to the laws of the promulgating state should be interpreted to include the equivalent authorizing section of the insurer's state of domicile.

Subsection I. Incidental Insurance Benefit

Comment: This definition is intended to include all those riders and policy benefits, other than the variable death benefit and associated nonforfeiture benefits and any minimum death benefit, that are sold as a part of or in conjunction with the variable life insurance policy. Benefits are within this definition regardless of whether they also may be sold to variable life insurance purchasers as separate policies or whether the premiums are separately stated or determined. For example, disability waiver of premium and guaranteed insurability options are not normally offered as a separate policy but are offered as a part of a permanent fixed benefit policy and would therefore be incidental insurance benefits to the variable life insurance policy. Accidental death benefits may be purchased as a separate policy but are also normally sold as part of a permanent fixed benefit life policy and would also be incidental insurance benefits to a variable life policy. Incidental insurance benefits would also include incidental minimum guarantees (see Section 4C(6)).

Prior to the 1983 amendments, the model regulation precluded an insurer from offering incidental insurance benefits on a variable basis. This restriction was clear from the text of the prior definition, which referred, in part, to fixed benefit term riders, and from the statement in the original commentary that incidental insurance benefits must be fixed. The deletion of the reference to fixed benefit term riders is designed to be indicative of the intention to permit insurers to offer variable incidental benefits.

Subsection K. Minimum Death Benefit

Comment: Reserves underlying any minimum death benefit guarantee must be maintained in the general account (see Section 5). The minimum death benefit guarantee, if any, is not what makes this product life insurance.

Subsection L. Net Investment Return

Comment: The 1983 amendments revised the definition of net investment return by deleting the clause that had specified the permissible deductions to be utilized in computing the net investment return. Prior to the 1983 amendments, Section 6G limited permissible deductions from the separate account to the categories that were specifically enumerated in that section. Section 6G was amended in 1983 to require the insurer to disclose all deductions that are made from the separate account. The categories of charges set out in Section 6G were retained as illustrative of the charges that must be disclosed; permissible charges, however, were no longer limited to the specified categories. The amendment to the definition of net investment return corresponds to the revisions in Section 6G.

Subsection M. Person

Source: NAIC Model Holding Company Act Section IF 1969 *Proceedings of the NAIC* II 740.

Comment: This section was intended to include all forms of business enterprise no matter what their organization. It includes affiliates, and if applicable, governmental entities. An insurer's separate account by itself could not be a person (see comment to Section 2A).

Subsection N. Policy Processing Day

Comment: The definition of policy processing day was added by the 1983 amendments. As explained more fully in the discussion of Sections 4 and 9, the policy processing day plays a central role in triggering the grace period for flexible premium variable life insurance policies and in measuring the length of the grace period once it is so activated (see Section 4D(2)(b) and Section 9C).

Subsection O. Scheduled Premium Policy

The definition of a scheduled premium policy was added by the 1983 amendments to the model regulation. It is intended to establish the perimeters of contemporary traditional variable life insurance policies. Specifically, a variable life insurance policy is classified as a scheduled premium policy if the insurer has established (or fixed) both the amount of required premium payments and the times at which they are to be paid. Typically, under a scheduled premium policy, if a premium is not paid in accordance with the schedule that has been fixed by the insurer, and if the non-payment of premium is not remedied within the applicable grace period, the policy lapses, triggering the operation of nonforfeiture options.

It should be noted that a policy would not necessarily be classified as a scheduled premium policy simply because the specifications page might set forth a planned premium (a concept characteristic of current universal life insurance policies). This is because the planned premium, in most cases, is set by the insured, not the insurer.

Subsection P. Separate Account

Comment: See comments to Section 2G. The blank space in this section should be completed with the section of the Variable Contract Law authorizing separate accounts. The reference to the law of the promulgating state authorizing the establishment of a separate account should be interpreted as including the equivalent in the insurer's state of domicile. Prior to the 1983 amendments, this definition limited separate accounts to those established for variable life insurance. In 1983, the limiting phrase for variable life insurance was deleted to dispel the inference, present by implication in the prior definition, that a separate account may be established solely for variable life insurance, and to afford insurers the flexibility to utilize the same separate account to fund a variety of products, e.g., both variable life insurance and variable annuities. This desired flexibility is reflected in amendments that were made in 1983 to other portions of the model regulation (see, e.g., Section 4D(5)(a)).

Subsection R. Variable Death Benefit

Comment: For scheduled premium policies, when the net investment return of the separate account (see Section 2L) is greater than the assumed investment rate (or the net investment return minus assumed investment rate is positive), the variable death benefit will reflect the full application of this difference (after the necessary adjustments for policy loans) to the benefit base under the terms and design of the policy, and the variable death benefit payable to the policyholder will to that extent exceed the initial face amount or minimum death benefit (see Section 4C(4)). Section 4C(3) provides that the policy shall reflect the full net investment experience of the separate account.

Conversely, when the net investment return under a scheduled premium policy is less than the assumed investment rate, the variable death benefit will decrease and, depending on past performance, may become less than the minimum death benefit. In this situation, of course, assuming premiums have been duly paid, the insurer will be obligated to pay the initial face amount of the policy (minimum death benefit). Thus, for scheduled premium policies, the insurer is always obligated to pay the greater of the minimum death benefit or the variable death benefit.

For scheduled premium policies, the variable death benefit, even when it is less than the minimum death benefit, is a useful figure to policyholders in conjunction with various hypothetical investment returns as a disclosure device for the purpose of cost and benefit comparison of policies. It can illustrate the level of performance required to return above the minimum death benefit as well as the receptivity of the variable death benefit to market fluctuations and therefore the significance of the minimum death benefit guarantee.

Prior to the 1983 amendments, the variable death benefit was defined as the amount of death benefit payable in the absence of the minimum death benefit. The 1983 amendments revised the definition of variable death benefit to refer to any minimum death benefit instead of *the* minimum death benefit. This revision corresponds to the model regulation's divergent approach to the minimum death benefit that an insurer must afford under scheduled premium and flexible premium variable life insurance policies. As amended in 1983, the model affords insurers considerable flexibility in formulating death benefit guarantees for flexible premium products, in that a flexible premium policy need not afford a death benefit in an amount at least equal to the initial face amount of the policy (compare Section 4C(2) with Section 4D(2)(b)). An unequivocal reference to the minimum death benefit in this Subsection R might have been inconsistent with this flexible approach. Accordingly, the substitute language was inserted, essentially as a conforming amendment.

Subsection S. Variable Life Insurance Policy

Source: This section is derived from the NAIC Model Variable Contract Regulation, Article II Sections 1, 2b, 1970 *Proceedings of the NAIC* II 1185.

Comment: Prior to the 1983 amendments, the definition of variable life insurance policy generally corresponded to the generic description in which benefits fluctuate with the separate account's investment experience.

The 1983 amendment was intended to clarify an interpretive question that could have arisen under the original definition. Specifically, the original definition's reference to "*life insurance which varies*" according to the investment experience of the separate account could have been construed to mandate that the amount of the death benefit under a variable life insurance policy vary to reflect investment experience. Such an interpretation would not necessarily be compatible with flexible premium variable life insurance product design. Under a flexible premium variable life insurance policy, insurance coverage would continue as long as the amounts available under the policy are sufficient to support deductions for the cost of insurance and other charges. Thus, it may be the *duration* of the insurance coverage, rather than the amount of the death benefit, which varies with investment experience. Accordingly, in 1983 the definition of variable life insurance policy was expanded to encompass "any individual policy which provides for life insurance *the amount or duration of which varies*" in accordance with investment experience.

The definition does for the present specifically limit variable life insurance to individual policies. A master contract and certificate of enrollment relationship would not be permitted.

The blank space in this section should be completed in the same manner as described in the comment to Subsection P.

Section 3. Qualifications of Insurer to Issue Variable Life Insurance

Subsection A. Licensing and Approval to do Business in This State

Source: Derived from the original NAIC Model Variable Contract Regulation (see 1968 *Proceedings of the NAIC* II 777).

Comment: In Paragraph (1) the word organized can be read domiciled. Therefore, the insurer must be either an admitted or a domestic life insurer in the state promulgating the regulation.

Prior to the 1983 amendments this section required that the state of domicile of the insurer provide for substantially similar regulation of permissible investments and changes in investment policy as a condition to receipt of approval by the commissioner. While it is anticipated that there will be significant uniformity in all phases of the model regulation, the requirement of substantially similar regulation of permissible investments and changes in investment policy was deleted in the 1983 amendments.

As discussed at greater length in connection with Section 6, the deleted requirement reflected the hope of the insurance industry and the state insurance regulators at the time the model was originally adopted that this provision and the provisions of Section 6 would be considered an adequate substitute for the federal securities law provisions regarding investment policy. The fact that variable life insurance was ultimately found to be subject to the federal securities laws substantially changes the assumptions on which the existing model's provisions regarding investment policy were based prior to the 1983 amendments. Not only is extensive disclosure of separate account investment policy required by the federal securities laws, but restrictive regulations and limitations are imposed with regard to investment policies of separate accounts and procedures for changing such policies.

Under Subsection A(2)(c)(iii) the insurer must demonstrate to the insurance department that the laws and regulations of its state of domicile are not likely to render its operation hazardous to the public or the policyholders in the state. This requirement establishes adequate protection of the public interest as the principal consideration and renders unnecessary the mischievous substantially similar requirement.

Paragraph (2) requires the insurer wishing to write variable life insurance to obtain the written approval of the insurance commissioner. It also includes the standards that the commissioner must apply and the considerations that must apply in making a determination of whether to grant or deny approval.

As an introduction to this requirement it is instructive to consider generally some of the concerns and approaches taken by the (C4) Subcommittee in developing this portion of the regulation.

The NAIC Model Variable Contract Law requires, in Section 3, that before a company can deliver or issue for delivery in any state a variable life contract, it must satisfy the commissioner that its condition or method of operation in connection with the issuance of such contracts will not render its operation hazardous to the public or its policyholders in this state. This requirement has been broken down primarily into the three paragraphs of Paragraph (2) and is not significantly different from the standard presently applied by insurance departments when considering a license application by a new company. However, there are a number of different factors to be considered by the departments before variable life authority should be granted:

- i. **Capital and surplus requirements.** All states presently have capital and surplus requirements for admission of foreign life insurers. The Subcommittee found no persuasive reason why higher capital and surplus requirements should be necessary for authority to write variable life insurance so long as the present standards adequately measure the stability of the company. Of course, the insurer, regardless of minimum capital and surplus requirements, must still demonstrate to the commissioner's satisfaction that its plan of operation is not unsound (see Section 3A(2)(a)). The Subcommittee also recommended that each state reexamine its capital and surplus requirements to assure their adequacy for variable life insurance operations. Until more experience is obtained, it appears advisable that each company either has a minimum earned surplus, or, in the alternative, is willing to submit to close monitoring by the insurance department as to premiums written, investments and operating costs. To some extent, the earned surplus requirement may discourage entry of new firms into the variable life market. However, the monitoring approach offers an alternative. Any special reporting requirements might be lifted once the department is confident of its regulatory system as it relates to variable life and the condition of a particular company indicates that such a move is responsible.
- ii. **Repeated violation of insurance laws.** There are many insurance laws and department regulations covering life insurance marketing. These laws and regulations, to the extent they are applicable and not inconsistent with the model variable life insurance regulation, will, of course, apply to variable life insurance. It can be anticipated that of the regulatory problems with variable life insurance, many will spring from its marketing side. Thus, a company's record in abiding by present life insurance marketing laws is crucial.
- iii. **Extra seasoning.** The Subcommittee considered the desirability of recommending that companies seeking variable life insurance authority be required to have a longer history of operations than a company seeking fixed benefit life authority. However, they found no persuasive reasons to make such a recommendation. Nevertheless, they strongly recommend that company management be closely examined as required by Paragraphs (2)(b) and (c), and that the financial stability of the company be closely examined.
- iv. **Management qualities.** It appears that most life insurers presently contemplating variable life insurance intend to invest the assets of the separate account in varied investments. Therefore, the Subcommittee recommends that each insurance department examine the investing experience, familiarity and expertise of the management of insurers requesting authority to write variable life insurance.

The commissioner is required to make the affirmative findings delineated Subparagraphs (a) to (c) in order to grant approval under Paragraph (2). If he or she does make these findings, the regulation requires the commissioner to give approval. However, in order to make the determination required, he or she should carefully consider the material required to be submitted by Section 3B as well as any other material that the commissioner deems relevant to the inquiries presupposed by the required findings of this section.

In order to grant approval under Paragraph 2(a) the commissioner must find that the insurer's plan of operation for the issuance of variable life insurance is not unsound.

There is no uniform consensus on what constitutes a plan of operation. A presentation to the commissioner pursuant to this section, however, should include a comprehensive examination of the reasonably expected impact of the insurer's proposed variable life insurance operations on the insurer, its policyholders within the state, and the general public. At a minimum it would seem to require a description of expected policy designs, the financial impact (including the impact on surplus), the insurer's proposed standards of suitability, standards of conduct (see Section 3C and Section 6H), and methods of operation (i.e., names of service companies, the nature of internal and adviser operations). Other information including sales projections may also be desirable. Since the need for approval to do business is continuous, this section implies a continuing obligation for the insurer to notify the commissioner when and if information that was relied upon in giving approval changes in any substantial degree (see also Section 6J). This would include key changes in either internal or external personnel.

In Paragraph (2)(a) the meaning of the words "not unsound" was intended to be flexible, and have a much broader interpretation than merely being actuarially sound. Rather, the term was intended to include a determination that the proposed plan is not fundamentally unfair or inequitable to any class of the insurer's policyholders or the general public. For example, a finding of unsoundness could result from a policy's design, benefit structure, possible impact on the insurer as a whole, or any other fact which indicates adverse impact on the public, including actuarial infirmity. This subparagraph contemplates a review of whether or not the plan is fundamentally fair and equitable to the public. An example of such unsoundness might be a policy design so inherently deceptive, unfair or confusing that even proper disclosure would not be likely to result in understanding by a prospective purchaser as to what he is buying.

Reference to the Unfair Trade Practices Act might be helpful in interpreting the term unsound in this context.

A separate account provides an accounting mechanism to measure the level of benefits the insurer owes to its variable life policyholders. In many cases assets of the insurer in addition to those underlying the separate account stand behind the insurer's obligation, including the assumption of mortality and expense risks and any guaranteed minimum death benefit. Consequently, state insurance regulators have the responsibility to examine closely the investment practice and management of the entire insurer and, where necessary, step in to protect the policyholders.

Paragraph (2)(a) could be utilized to require an insurer to participate in a guaranty fund to the extent of risks not assumed by the policyholders.

Paragraph (2)(b) requires the commissioner to examine the character and, in general, the qualifications of the management of both the insurer and those various organizations that are proposed to handle significant aspects of the insurer's methods of operation on a contractual basis.

Paragraph (2)(c), with the exception of Item (iv), is an expansion of portions of the original Model Variable Contracts Regulation. Thus, in addition to making the findings required by Subparagraphs (a) and (b), the commissioner must, after considering the information delineated by Items (i) through (iv) inclusive, be satisfied that the present and prospective financial condition of the insurer and method of operation will not be hazardous to the public.

The inquiry of Paragraph (2)(c) is basically one of financial soundness and the ability to satisfy all the obligations imposed on the insurer by variable life insurance operations. For example, one alternative requirement of Section 5 requires, under certain circumstances, reserves which anticipate an immediate one-third drop in the value of separate account assets. In order to satisfy the requirements of this section, the insurer must demonstrate that in a period of sharply declining values it has the surplus needed to meet these obligations without jeopardizing the public or any class of its policyholders. Thus the term policyholders means all policyholders of the insurer and not just variable life insurance policyholders.

Paragraph (2)(c)(i) is self-explanatory and relates to the previous discussion concerning seasoning, chronic insurance law violation, capital and surplus requirements and the willingness of the insurer to be subject to close insurance department monitoring.

While Paragraph (2)(c)(ii) may appear to repeat requirements contained in Paragraph (2)(b) of this section it should be noted that while Paragraph (2)(b) is itself a required finding of the commissioner, Paragraph (2)(c)(ii) is only one factor which must be considered in determining the prospective financial condition of the insurer. Of course, this item refers to both internal and external investment advisers, and the previous discussion relating to the relative investment expertise of insurers is clearly a consideration which should be made in this context (see also comment to Section 6A(1) relating to custody).

Under Paragraph (2)(c)(iii) the insurer must be able to demonstrate that the laws and regulations of its state of domicile are such as to protect the financial interests of the policyholders in the promulgating state. This item requires that the insurer seeking to do business in a state is under an obligation to convince the commissioner that the entire regulatory scheme of the insurer's domicile is not likely to be hazardous to the admitting state's policyholders.

Item (iv) obligates the commissioner to examine the possible effect of any affiliation by the insurer on the prospective financial condition of the insurer and the effect on the policyholders. As previously discussed, this aspect relates to management experience, the ability of the insurer to meet its obligations and the favorable or unfavorable experience that the insurance department has had with the insurer's corporate family in supervising compliance with applicable insurance laws and regulations. This section may also be useful in determining potential conflicts of interest.

Subsection B. Filing for Approval to do Business in This State

Source: Portions of this subsection are derived from the original NAIC Model Variable Contract Regulation (see 1969 *Proceedings of the NAIC II 777*).

Comment: This section permits the commissioner, at his or her discretion, to require filing with the insurance department of certain specified information before the insurer can deliver or issue for delivery a variable life insurance policy. Prior to the 1983 amendments; the section required that certain information be filed and permitted the commissioner to request other information. Under the section as currently drafted, if the information is already available to the department, or the commissioner feels that certain information is unnecessary, the commissioner can give the approval required by Subsection A without requiring the filing of that information by the insurer.

The 1983 amendments made two other significant changes in this section. A discussion of the methods of distribution of variable life insurance policies was added as a specified element of the description of methods of operation which the commissioner may require be filed pursuant to Paragraph (2). This change reflects the recognition that the methods of selling variable life insurance products may differ significantly from the methods of selling more traditional life insurance products and that commissioners may take a particular interest in these sales activities.

Paragraph (7) is new. As a result of the 1983 amendments, many of the traditional guarantees are no longer mandatory elements of variable life insurance policies (see Section 4C). This makes possible varied and innovative policy designs that allocate mortality and investment risks in ways not permitted under prior regulations. Under these circumstances, it is anticipated that commissioners may wish to obtain a statement from the insurer's actuary describing the mortality and expense risks that the insurer will bear under the policy.

Naturally, Subsection B, as well as Section 3F were not intended to be exclusive and these sections do not prohibit the commissioner from requiring additional relevant information that may be required to make determinations required by this regulation as well as other applicable laws and regulations. Subsection B implies a continuing obligation to amend as necessary any report made to the commissioner when the circumstances underlying the original report have changed.

Paragraph (1) relates to the findings under Section 3A(2)(a) and (c), as well as Section 4A.

Paragraph (2) relates to Section 3A(2)(a), (b), and (c)(ii) and (iv), as well as Section 3E and Section 6A and J.

Paragraph (3) relates to Section 3A(2) and Section 6F. A statement pursuant to this paragraph would include specific descriptions of the investment goals of the separate account (e.g., long term growth), the means by which these goals are to be met (e.g., primarily common stocks) and any internal investment restrictions (see Section 7B).

Paragraph (4) goes hand in hand with Paragraph (3) and relates to Section 3A(2).

Subsection C. Standards of Suitability

Source: Portions of this subsection are derived from the NAIC Model Regulation on Deceptive Practices Section 5(g), 1973 *Proceedings of the NAIC II 542*, Securities and Exchange Commission (SEC) Rule 15b 10-3, and the holding in *Anderson v. Knox*, 297 F.2d 702 (9th Cir.), cert. denied, 370 U.S. 915 (1961).

Comment: This section imposes a duty on both the insurer and its agents to make a good faith, reasonable inquiry as to the facts and circumstances concerning a prospect's insurance and financial needs and to make no recommendation that a prospect purchase variable life insurance when such a purchase is not reasonably consistent with the information that is known or reasonably should be known to the insurer or agent. The substantive standard set forth is:

that no recommendations shall be made to an applicant to purchase a variable life insurance policy and that no variable life insurance policy shall be issued in the absence of reasonable grounds to believe that the purchase of such policy is not unsuitable for such applicant on the basis of information furnished after reasonable inquiry of such applicant concerning the applicant's insurance and investment objectives, financial situation and needs, and any other information known to the insurer or to the agent making the recommendation.

Some of the factors which would presumably be considered are: age, earnings, marital status, number and age of dependents, the value of savings and other assets, and current life insurance program.

The substantive standard set forth above is derived from the federal securities laws. The genesis of the suitability doctrine is the ethical guidelines of the National Association of Securities Dealers (NASD). Article III, Section 2 of the NASD Rules of Fair Practice provides:

In recommending to a customer the purchase, sale or exchange of any security a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

New York Stock Exchange Rule 405 and American Stock Exchange Rule 411 place suitability limitations upon the members of those exchanges. The SEC has adopted Rule 15b 10-3 under the Securities Exchange Act of 1934 (the 1934 Act) to govern the suitability of recommendations by brokers who are not members of the NASD.

The NASD rule has generally been used in disciplinary actions involving flagrantly unethical or illegal conduct, and no reported case has involved violation of Rule 15b 10-3. However, the SEC has frequently sought to enforce suitability by incorporating the concept into the fraud provisions of the federal securities laws, particularly Rule 10b-5 under the 1934 Act. The development of suitability as a fraud concept has, however, received its greatest impetus from the courts in cases not arising under the federal securities laws. For example, in *Anderson v. Knox*, 297 F.2d 702 (9th Cir.), *cert. denied*, 370 U.S. 915 (1961), the U.S. Court of Appeals for the Ninth Circuit held that an insurance agent who had induced a client to purchase excessive amounts of bank financed insurance was liable for damages in common-law fraud because the policies were not suitable to the plaintiff's needs.

The 1983 amendments made changes in this section to achieve a more practical application of the suitability concept to sales of variable life insurance. While the concept originally set forth in this section was substantially similar to that utilized in the federal securities laws, the application of the concept was exaggerated as part of the effort to avoid SEC regulation of variable life insurance. For example, prior to the 1983 amendments, the section required that the insurer adopt the standards of suitability by formal action of its board of directors. This requirement of board adoption was found to be unprecedented in NAIC model insurance statutes and unnecessary to the application of the suitability concept to sales of variable life insurance. Similarly, the standards of suitability were "applicable to and binding on the insurer's officers, directors, employees, affiliates and agents with respect to the suitability of variable life insurance for the applicant." The potential for mischief of this broad requirement was considerable, raising, for example, the possibility of liability for violations of the suitability standards being imposed on individual officers, directors, employees or agents who never even knew of the transaction involved. These provisions were deleted in the 1983 amendments.

The duty to make a good faith reasonable inquiry must be stressed since an insurer or agent cannot continually seek to avoid the obligations imposed by this section by claiming that a prospect refused to divulge information sufficient to make a professional evaluation of the suitability of variable life insurance to particular circumstances.

At its June 1974 Meeting the NAIC adopted a staff report concerning this provision 1974 *Proceedings of the NAIC* II 540). This report emphasizes three basic areas of ideal suitability:

(1) needs perceived by the insured; (2) needs perceived by the agent; and (3) persistency. The report also included interpretive rules. It was adopted as an interpretive guide to this section and offers (p. 547) the following language as an informal consensus as to the meaning of suitability in the model variable life insurance regulation.

Definition.

“Suitability” means the likelihood that the purchase of variable life insurance is reasonably consistent with:

- (1) The expressed insurance objectives and needs as perceived by the prospective insured;
- (2) The reasonable objectives and needs of the prospective insured as determined objectively by a professional agent after a diligent reasonable inquiry into relevant financial, family and other background information concerning the prospective insured; and
- (3) The potential that the prospective insured will persist with the policy for such a period of time that the insurer’s acquisition costs are amortized over a reasonable period of time.

General Rules of Interpretation.

1. When variable life insurance meets characteristics (1) and (3) or (2) and (3), it is probably still “suitable” in most instances.
2. Variable life insurance is clearly “unsuitable” when it meets none of the three characteristics for a given prospect.
3. Variable life insurance is probably “unsuitable” in the absence of extraordinary factors when it does not meet characteristic (3).
4. Other situations must be judged on their individual facts.

In adopting the 1983 amendments, the NAIC recognized that the proliferation of variable life insurance product designs anticipated as a result of those amendments might make suitability, and particularly factors (1) and (2), even more important. On the other hand, it was understood that the possibility of more variable life insurance products designed to compete with investment oriented products of other financial institutions will make factor (3) less significant because policyholders will be more likely to move among competing financial institution products for reasons such as rate of return, tax considerations and economic conditions. As a result, persistency will be less and less relevant as a measure of suitability.

This section requires the insurer to formally adopt its suitability standards. Earlier drafts of this section specifically required that the insurer establish and file with the commissioner guidelines or profiles of applicants and situations in which variable life insurance would not generally be suitable. This specific requirement was deleted.

As to the potential legal implications of adopting standards of suitability, it is not unlikely in those jurisdictions where the doctrine of implied rights of action is accepted, that the theory would give rise to an enforceable obligation to the insured (see, e.g., *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961)). Furthermore, it is probable that the commissioner would have the authority (either formal or informal) to reverse an unsuitable sale upon the request of the policyholder. This would be in addition to the full range of sanctions available to him.

It was the intention of the Subcommittee that the requirements of this subsection would not be applicable with respect to each individual employee involved in a noncontributory pension plan situation.

Prior to the 1983 amendments, the section included provisions pursuant to which lapse rates were to be utilized as indicators of suitability. These provisions were based upon the realization that suitability is a difficult area to police and the hope that lapse rates, by indicating persistency, would be an accurate yardstick for suitability. The 1983 amendments eliminated references to lapse rates as measures of suitability. With regard to conventional insurance policies, lapse rates, even those reflecting experience over a very long period of time, are suspect as an indicator of whether or not sales of insurance were suitable when made. Lapse rates are even less relevant to the suitability of sales of variable life insurance. Lapse rates are affected by a variety of factors, the most significant of which ordinarily is changes in the policyholder’s perception of the attractiveness of the policy due to changes in the general economy and in the economic circumstances of the policyholder. In the case of variable life insurance, an additional important factor is the performance of the separate account relative to other financial alternatives. Because of the significance of these factors, the use of lapse rates as a measure of suitability was found

to be inappropriate.

It should be noted that Section 8C requires that variable life insurance applications contain questions designed to elicit suitability information from applicants.

Subsection D. Use of Sales Materials

Comment: This subsection requires that the insurer may not use false, misleading, deceptive or inaccurate sales materials, advertising materials or descriptive literature.

The primary purpose of the section is to prevent the use of sales materials that will intentionally or unintentionally mislead the public as to what they are purchasing and how much it is costing them. It is within this context that the determination of what is “false, misleading, deceptive, or inaccurate” must be made. The section was intended to reach any material that is designed for ultimate presentation to a prospective purchaser in attempting to convince him to purchase variable life insurance. The comments to this section prior to the 1983 amendments indicate that the NAIC was concerned with reconciling SEC and NAIC policies with regard to advertising and sales materials. Therefore, this section required that all variable life insurance advertising and agent training materials be submitted to the commissioner. This was considered an interim measure only and was not intended to modify the commissioner’s authority to regulate the dissemination of sales materials in the state.

At the time of the 1983 amendments, it was determined that mandatory filing of sales materials imposed an unnecessary burden on insurance departments. There was concern that approval of sales materials might be implied if materials were filed and the commissioner failed to act to prevent their use. Also, insurance departments wished to avoid the unnecessary cost and inconvenience of retention and storage of filed sales material.

Because the commissioner has the authority under state law to obtain all sales materials upon request (see, e.g., NAIC Rules Governing the Advertising of Life Insurance), it was determined that incorporation of that authority into this regulation would be adequate to permit the insurance department to police variable life insurance advertising.

The use of false or misleading sales material could give rise to the full extent of powers at the disposal of the commissioner. These would range from license revocations (for both the insurer and agents), fines and cease and desist orders, to informal disciplinary sanctions. Furthermore, the activities described would violate the state unfair trade practices acts. In addition, the commissioner as a practical matter probably possesses the power to rescind a sale based on a material misrepresentation. Common law fraud causes of action, as well as implied rights of action, also may exist depending on the law of each individual state.

Subsection E. Requirements Applicable to Contractual Services

Comment: This subsection was added to give the commissioner control over contracts for material variable life insurance services performed for the insurer by a third party. Since these material operations are functions which would normally be carried on by the insurer itself, and thus would be subject to the commissioner’s direct control, the Subcommittee inserted this subsection in order to assure that the interests of the public and the policyholders would be protected. This subsection, therefore, indirectly regulates service companies through the regulation of service contracts under which a variable life insurer is to be obligated. The subsection requires the contract to be in writing and requires the service company to subject itself to examination and to furnish the commissioner with information sufficient to determine whether or not the service operations conducted for the insurer are consistent with the relevant portions of both the model regulation and other applicable laws and regulations.

The word material was inserted so that functions that were not relevant to the welfare of the policyholders or the public were not required to be covered by this subsection. Naturally, the question of materiality must ultimately be answered by the commissioner. However, the contracts referred to in this subsection were not intended to include traditional agency compensation agreements and normal reinsurance treaties.

Service company operations are a significant part of the insurer’s plan of operation (Section 6A(2)(a)). Therefore, the insurer is under an obligation to notify the commissioner of any change. The commissioner was felt to possess the inherent power to terminate a service contract which he or she felt to be hazardous to the public or the insurer’s policyholders.

It is impossible to speculate in the absence of actual facts as to what particular circumstances might give rise to control of an insurer by a service company. The Subcommittee intended that the commissioner should have flexibility in making this decision.

The performance of services in the absence of stock ownership would not by itself seem to constitute control, since this would not appear to give rise to the ability to direct the management of the insurer. That is, if a service company performed all or substantially all of the administrative functions associated with the variable life insurance contracts, advised the insurer as to regulatory requirements associated with the contracts, managed to investment company in which all or substantially all of the separate account's assets were invested, and reinsured all or substantially all of the risks under the variable contracts, it would not necessarily be in control. However, the furnishing of regular investment advice would give rise to an affiliation between the insurer and the service company pursuant to Section 2A.

Subsection F. Reports to the Commissioner

Source: Portions of this subsection are derived from the original Model Variable Contract Regulation (see 1968 *Proceedings of the NAIC*, II 777).

Comment: This subsection was not intended to include all of the material that must be filed or reported to the commissioner of each state in which the insurer is doing business. Additional sections separately impose specific requirements (see, e.g., Section 3C and D and Section 4B).

Furthermore, as provided in Paragraph (1)(d), the commissioner may require such additional information concerning an insurer's variable life insurance operations as he or she deems necessary.

Paragraph (1)(a) is not intended to imply that a separate account is a severable distinct entity.

Paragraph (2) requires the commissioner to disapprove the material filed under this subsection if he or she finds it to be materially false, misleading, deceptive or inaccurate, and further requires distribution of amended material. Naturally, this distribution would be to those who received the defective report; however, some flexibility was intended for the commissioner.

The filing of an amended report is not the limit of sanctions that could be imposed on the insurer for defective reports. Rather, the full range of sanctions at the disposal of the commissioner delineates the potential liability of the insurer. This could include, depending upon the seriousness of the violation involved, informal disciplinary proceedings all the way up to and including revocation of an insurer's license.

Since a substantial amount of the material required to be filed under this subsection must be filed prior to its distribution, the Subcommittee hoped to lessen the problem of purchase in reliance upon disapproved material.

Subsection G. Authority of Commissioner to Disapprove

Source: NAIC Model Variable Contract Regulation (see 1968 *Proceedings of the NAIC* II 777).

Comment: This subsection is similar to Section 3F(2) and the comments made there are applicable here.

This subsection was added to deal with any material which is required to be filed and approved by law or provisions of the regulation other than Section 3F.

Section 4. Insurance Policy Requirements

Subsection B. Filing of Variable Life Insurance Policies

Source: Portions of this subsection are derived from the original NAIC Model Variable Contract Regulation (1968 *Proceedings of the NAIC* II 777).

Comment: This subsection requires specimens of all variable life insurance policies, riders endorsements, applications, and other related documents that are to be attached to or made part of the policy to be filed with the commissioner and approved prior to the use of that form in a particular state.

Prior to the 1983 amendments, Subsection B required the commissioner to approve variable life insurance policies and other forms in writing prior to delivery in the state. The 1983 amendments deleted this requirement, thereby subjecting variable life insurance policies to the same rules and procedures governing approval of other forms of life insurance in the state.

It was felt that perpetuating a separate requirement of written approval for variable life insurance was anachronistic and unnecessary. In the years that have elapsed since the promulgation of the original model regulation, state insurance departments have developed increased familiarity with the variable life insurance product and its regulation. Moreover, the commissioner possesses significant control over the issuance of variable life insurance in the state by virtue of Section 3A(2), which requires that the commissioner scrutinize the insurer's plan of operation, financial condition and other factors prior to granting written approval for the issuance of variable life insurance in the state.

The term "related forms" in the introductory paragraph of this subsection does not include either information to applicants required by Section 7 or reports to policyholders provided for in Section 9. However, these are also subject to approval prior to use (see Section 3F and G).

Paragraph (2) gives the commissioner the authority to approve policies and forms which he or she deems to be not less favorable to the policyholder and beneficiary than those required by the model.

Paragraph (2) is intended to allow companies to include provisions more favorable to the insured. This may be desirable for the insurer in order to promote uniformity of policy forms. For example, assume that State X allowed a two-year suicide exclusion and State Y allowed a one-year exclusion. The one-year exclusion is more favorable to the policyholder. Thus, this paragraph would enable the commissioner of State X to approve a company's form which contained the more favorable one-year exclusion, thus permitting the insurer to have the same form in both states. The commissioner of State X could not, pursuant to the model, impose the one-year exclusion on the insurer.

The determination of when a benefit is more favorable can be a very subjective determination. For example, a one-year "free look" would be a benefit to those who chose to take advantage of it. Those who had no intention of ever exercising such a provision and would be forced to bear the extra cost involved would be unlikely to look at this change as a benefit. Thus, what may be a benefit for some would be merely an extra mandated cost for others. Flexibility by individual commissioners in this area was intended to be preserved.

Prior to 1983, Paragraph (3) provided an exemption from several policy design and policy form requirements for policies sold to qualified pension, profit sharing and retirement plans. Because of the enhanced overall flexibility in product design envisaged by the 1983 amendments, and because of the deletion or amendment of the sections of the prior model to which it refers, Paragraph (3) was deleted.

Subsection C. Mandatory Policy Benefit and Design Requirements

Comment: The 1983 amendments substantially revised Section 4 to afford insurers the necessary flexibility to offer flexible premium variable life insurance and variations on more traditional forms of variable life insurance. The amendments were premised upon the recognition that the strictures embodied in the original version of Section 4 were adopted in the context of a regulatory atmosphere that no longer prevails in an effort on the part of the NAIC to avert dual (i.e., federal and state) regulation of variable life insurance. The revisions also spring from the conviction that the restrictive criteria reflected in the original model were unnecessary impediments to the development of innovative flexible premium products. It was felt that these limitations could be relaxed without impairing the thoroughness and efficacy of state insurance regulation of flexible premium variable life insurance.

The requirement of lifetime insurance coverage which originally appeared in Paragraph (1) was inserted in an attempt to convince the SEC of the predominant insurance nature of variable life insurance and thereby to avoid dual regulation of the product. The evolution of the federal role in variable life insurance regulation has rendered this limitation anachronistic. The requirement that coverage be provided "for the lifetime of the insured" was deleted in 1983 as an unnecessary impediment to the development of innovative flexible premium product designs. In this regard, it should be noted that the commentary to the original model clearly reflects the NAIC Subcommittee's assumption that the "whole of life" limitation would be applicable for the time being only.

Paragraph (1) has been further revised to read as follows: “Mortality and expense risks shall be borne by the insurer. The mortality and expense charges shall be subject to the maximums stated in the contract.” The purpose of this language is to indicate clearly that the insurer bears the mortality and expense risks under a variable life insurance policy. The charges for those risks cannot exceed the maximum which the insurer establishes in the policy.

Prior to 1983, Paragraph (2) provided that “[g]ross premiums for death benefits shall be a level amount for the duration of the premium payment period.” This limitation resulted from the Committee’s concern that it might be difficult for the public properly to understand the operation of variable premium–variable benefit policies and to evaluate the comparative cost of this type of product.

The registration of variable life insurance products with the SEC will help ensure thorough disclosure concerning the operation of these products and other varied policy designs. The enhanced familiarity and regulatory expertise that state insurance departments have developed with respect to variable life insurance will also aid in effectively protecting the public. In addition, it is noteworthy that traditional, fixed policies are not subject to any similar requirement.

Thus, the current regulatory structure has substantially weakened the original premise for this limitation. Accordingly, this restriction was deleted in 1983 to accommodate the flexibility in amount and timing of premium payments which is the cornerstone of the flexible premium variable life insurance product. The deletion will accommodate flexible premium products while permitting traditional forms of variable life insurance to continue to be written.

Reserve liabilities for any guaranteed minimum death benefit must be maintained in the general account (see Section 5B and C).

Prior to 1983, the model required that a variable life insurance policy provide a “minimum death benefit ... in an amount at least equal to the initial face amount of the policy so long as premiums are duly paid.” The minimum death benefit contemplated by the original model was “an initial stated amount of death benefit,” to be paid (assuming duly paid premiums) in the event that the stated amount exceeded the variable death benefit.

The Committee recognized that the minimum death benefit guarantee that the prior model Regulation mandated could not be required under a product design that is characterized by non-level premiums that are paid on an irregular basis. The minimum death benefit guarantee was premised on the assumption that the insurer would establish level periodic premiums that would have to be paid by the insured at the times specified by the insurer. As the commentary to the previous model regulation indicated, the minimum death benefit was required only so long as premiums were duly paid. In a flexible premium variable life policy, this required minimum death benefit may not be appropriate. The insured, not the insurer, controls the timing and the amount of each premium payment. In addition, in many of the anticipated policy designs, it will be the duration of the coverage, and not the amount that will vary. Accordingly, the minimum death benefit requirement was amended in 1983 to differentiate between the minimum death benefit that must be offered under scheduled premium policies, and the applicability of such a requirement to flexible premium policies. Under the amendment, the minimum death benefit guarantee contained in the original model is limited to *scheduled* premium variable life insurance policies. A minimum death benefit guarantee for flexible premium policies is addressed in the context of a new provision governing grace periods for flexible premium policies (see commentary to Section 4D(2)(b)).

The minimum death benefit under a scheduled premium policy is only required to be applicable so long as premiums are duly paid. This would include situations in which a policy was properly reinstated. Thus, assuming duly paid premiums, the death benefit payable at any time under a scheduled premium policy is the greater of the variable death benefit or the minimum death benefit adjusted by any policy loans, withdrawals or surrenders.

The model regulation does not require a minimum death benefit paid-up variable whole life insurance since the minimum death benefit guarantee under a scheduled premium policy is required only when premiums are duly paid. Early drafts of the model regulation required a minimum death benefit guarantee in this situation. However, it was determined that the cost of providing such a benefit was too great in relation to the corresponding benefit. This is because a relatively small decline in the value in the separate account portfolio could have a relatively great impact on the death benefit of a paid-up policy. Furthermore, such a guarantee on a reduced paid-up policy could expose the insurer to risks not present under the original policy. In fact, with variable life insurance it is not at all unlikely that the traditional reduced paid-up insurance could in

reality be increased paid-up insurance. After a period of good investment performance, it is possible that the guaranteed death benefit under a reduced paid-up policy could exceed the initial death benefit guarantee, thereby exposing the insurer to an unanticipated risk and giving rise to solvency concerns. It became clear that the imposition of a required minimum in this instance would in all probability have meant that such a nonforfeiture option would merely not have been offered.

In the situation where participating policy dividends are used to purchase additional paid-up variable life insurance additions (Section 4F(3)(b), the amount payable on death was intended to be increased by the then current amount of death benefit provided by these dividend options. Thus, it would equal the greater of the minimum death benefit or the variable death benefit adjusted for indebtedness plus the current amount of additions. The minimum death benefit itself would not be applicable to Section 4F(3)(c) (see comments to Section 4F(3)(c)).

While “initial face amount” as utilized in Section 4C(2) is an undefined term, it should not be interpreted to include the amounts of any incidental insurance benefits.

See also comments to Section 2K.

The minimum multiples that appeared in the model regulation prior to 1983 attempted to establish a relationship between the amount of death benefit and gross annual premiums. The 1983 amendments deleted the minimum multiples as another vestige of the ultimately unsuccessful attempt to avert dual regulation of variable life insurance. The minimum multiples are absent from the variable life insurance regulations of several states,* suggesting that they are not a necessary ingredient of effective state regulation of variable life insurance. It was also recognized that there is no similar requirement applicable to traditional fixed life insurance policies. Thus, it was concluded that the minimum multiples are a significant but unnecessary impediment to the development of designs for flexible premium variable life insurance products.

* e.g., Georgia, Massachusetts, Michigan, Minnesota, New York, North Carolina, and Pennsylvania.

Prior to 1983, Subsection C(3) required that excess investment performance (either positive or negative) be applied only to provide policy benefits, and defined the only methods by which such application could be made. The effect of this paragraph was to limit policy designs to those that applied excess investment performance to provide adjustments to the amount of insurance, and further limited the types of insurance that could be offered. To temper the rigidity of this paragraph and its attendant inhibiting effect on the development of flexible premium variable life insurance product designs, the Committee deleted the requirement that investment experience be reflected in the variable death benefit. Thus, investment experience could, for example, be used to increase cash value or the duration of coverage.

In addition, the portion of this subsection that prescribed and delimited the manner in which excess investment performance was to be applied has been deleted. In lieu of these detailed requirements, the 1983 amendments substituted a less specific provision requiring the insurer to demonstrate to the commissioner “that the reflection of investment experience in the variable life insurance policy is actuarially sound.” It is intended that this demonstration will pay particular attention to the manner in which the policy operates under both favorable and unfavorable investment conditions, and to the matching of current liabilities under the policy to the market value of assets.

Since the net investment return is a rate, the word “amount” in Paragraph (4) refers to the product of the net investment return times the benefit base.

Paragraph (5) requires death benefit determination to be at least annually. Paragraph (6) requires cash values to be determined at least monthly while Section 6A(4) (as well as Section 4D(5)(b)) requires underlying separate account assets to be valued at least as frequently as benefits are determined but in any event at least monthly. The comments to these sections refer to the Committee’s thinking with regard to the frequency of the valuations covered thereby.

Sections 4C(6) and 4D(3)(b) in combination require all policy benefits to commence varying according to the terms of the policy not later than the next separate account valuation date after a maximum interval of one month from the effective date of the policy. Paragraph (5), therefore, would permit a policy design under which the first change in the variable death benefit may not occur until as late as the first policy anniversary and subsequent changes may occur as infrequently as each anniversary thereafter.

Depending on separate account investment experience, less frequent death benefit valuation can be advantageous or disadvantageous. Certainly benefits will not achieve a high level of dollar cost averaging. However, there is a possible advantage which might arise out of the certainty that for the next full valuation period (up to one year for death benefits) the entire risk of either adverse or favorable separate account performance is shifted to the insurer and benefits will be as stated on the last determination date. There may be a number of counterbalancing reasons why persons might not wish to purchase a policy in which death benefits were valued annually. The Committee, however, decided that prospective purchasers of variable life insurance should not be precluded from purchasing such policies as a matter of law.

Comment: Subsection C(6) requires cash values (nonforfeiture benefits) to be determined at least monthly.

Either the policy or a statement filed with the commissioner of the state in which the policy is to be delivered must describe the method of computation of such values. The method of computation is required to be in accordance with actuarial procedures that recognize the variable nature of the policy. It is expected that insurers will make every effort to describe the process in as simple a manner as possible. Naturally, if the insurer opts to file its statement with the commissioner, a technically oriented description would be more acceptable than would be the case if the same description were placed in the policy. An insurer choosing to file with the commissioner would be obligated to call the filing to the policyholders' attention in the policy. In any event a technical benefit base description, if not placed in the policy, must be filed separately with the commissioner (see Subsection 3A(2)). Furthermore, the filing route would not relieve the insurer from its obligation to disclose the operation of the policy in general terms (see Section 3C; Section 4D(1), 4D(4), and Section 7A).

The most important portion of this subsection requires that policy benefits be designed in such a manner that the Standard Nonforfeiture Law is satisfied with necessary modifications for variable benefits. The NAIC recommends that a guideline be developed to assist the states in administering the standard nonforfeiture law as it applies to flexible premium variable life insurance.

Prior to 1983, Section 4C(6) required that the method of computation of cash values and other non-forfeiture benefits rest in all cases on the assumption "that at all times during the life of the policy the full net investment return ... exactly equals the assumed interest rate." (commentary of NAIC Subcommittee). The 1983 amendment added a sentence to Section 4C(6) to embody the recognition that flexible premium variable life insurance products might not contain an assumed investment rate. In that event, it is contemplated that, in lieu of an assumed investment rate, the calculation is to be based upon the maximum interest rate permitted under the Standard Nonforfeiture Law.

Prior to 1983, the model regulation was designed to provide effective protection for variable life insurance policyholders against the possibility of an insurer's acquisition costs becoming too high with the resulting premium being unreasonable in relationship to the benefits provided. The approach reflected the conclusion that the only form of control that would provide meaningful safeguards to purchasers was one which was applicable to the total premium charged rather than to an artificial subdivision. The Committee considered and rejected any approach that attempted to regulate the expenses of the insurer since this would not necessarily affect the premiums charged the policyholder. This approach, in effect, required vastly increased nonforfeiture benefits if a premium that exceeds the conditional maximum was charged. This approach was chosen by the Committee rather than direct premium rate regulation—a concept alien to the life insurance industry in the United States. The Committee deleted this subsection in 1983 on the rationale that it is unnecessary to the regulation of variable life insurance by state insurance departments. Deletion was also supported by the fact that traditional fixed life insurance is not subject to any similar requirement.

Prior to 1983, the model regulation limited the deductions that could be made in determining net investment return to four of the categories of charges enumerated in Section 6G. The 1983 amendments modified Section 6G so that the specifically enumerated categories no longer limit permissible charges, but merely illustrate charges which must be disclosed in writing prior to or contemporaneously with delivery of the variable life insurance policy. Because Section 4 provisions were obsolete in view of the restructuring of Section 6, the Committee has deleted it.

Subsection D. Mandatory Policy Provisions

Source: Portions of Paragraph (1) are derived from the original Model Variable Contracts Regulation.

Comment: The primary purpose of this subsection is disclosure in order to assure that the policyholder is aware of the risks that both he and the insurer are assuming. This subsection requires that the mandated statements be prominently displayed on the cover page of the policy (see also Section 8).

Paragraphs (1)(a) and (1)(b) require that the cover page of the policy contain a prominent statement highlighting the variable nature of death benefits and cash values respectively. These paragraphs were revised in 1983 by deleting the requirement that these statements be set forth in type at least four points larger than the typesize used in the text of any provision on the page. The statements required by these paragraphs will be adequately distinguishable from the surrounding text since they must in any event be set forth either in contrasting color or boldface type.

The 1983 amendments also made several changes of an editorial nature in Subsection D(1). New matter was added in Paragraphs (1)(a) and (1)(c) to conform those paragraphs, respectively, to the amended definition of “variable life insurance policy” (Section 2S) and to the bifurcated approach to the minimum death benefit guarantee for scheduled premium and flexible premium policies (Section 4C(2) and Section 4D(2)(b)).

The “free look” provision incorporated in Paragraph (1)(e) was amended in two significant respects.

First, Paragraph (1)(e) as amended provides that the free-look right may be exercised only during the ten-day period following the policyholder’s receipt of the policy; the 1983 amendment deleted the language in the model that provided, alternatively, that the policyholder could return the policy either within the foregoing 10-day period or within 45 days of the date of the execution of the application, whichever was later.

Second, the 1983 amendments changed the calculation of the amount that the insurer must refund upon return of the policy within the specified period. Specifically, to the extent permitted by state insurance law, the insurer is permitted to utilize a refund calculation similar to the method prevalent in computing free-look refunds for variable annuities. Thus, it is contemplated, in essence, that the amount to be refunded upon return of a variable life insurance policy during the prescribed 10-day period will equal the sum (determined as of the date on which the returned policy is received by the insurer or its agent) of (1) the amount designated as loading, plus (2) “value of the amounts allocated to any separate accounts under the policy,” i.e., the cash value corresponding to the policy.

The 1983 amendments recognized that state insurance law may have to be amended to permit insurers to utilize the foregoing refund approach. Accordingly, Paragraph (1)(e) preserves the status quo—requiring the insurer to refund “the total of all premium payments for such policy”—until any necessary statutory amendments have been enacted.

The premise underlying the 1983 amendments to Paragraph (1)(e) was that the requirements of the former model were inequitable to insurers because their effect was to impose the entire investment risk on the insurer during the free-look period. By correlating the required refund to the value of the amounts allocated to the separate account, the 1983 amendments permit an insured to benefit from favorable investment performance during the free-look period. Conversely, the amount to be refunded will reflect the results of adverse investment performance during the prescribed period.

As already noted in discussing the minimum death benefit provisions, the 1983 amendments to the model regulation differentiate between the minimum death benefit that must be offered under scheduled premium and flexible premium policies. The required minimum death benefit for flexible premium variable life insurance is, in turn, closely intertwined with the grace period that must be afforded by such products. Paragraph (2) was accordingly amended in 1983 to achieve dual objectives: it demarcates the different grace periods and establishes the scope of the required minimum death benefit under a flexible premium product.

Prior to 1983, Paragraph (2) required that a variable life insurance policy afford “a grace period of not less than thirty-one (31) days from the premium due date...” This language applied the standard life insurance policy grace period to variable life insurance. Thus, it was contemplated that there would be no change in either variability or amount of benefits owing under the policy if premiums were paid within the grace period. Policy benefits were to be the same as if the premium were paid on the due date.

The 1983 amendments placed the thirty-one day grace period requirement in a separate paragraph and limited its applicability to *scheduled* premium policies. This was done because (1) the concept of a “premium due date” was thought to be inapposite to flexible premium policies and (2) a 31-day, “standard life insurance policy” grace period is consistent with the longer grace period that is typically required for current general account flexible premium policies.

Paragraph (2)(b), added by the 1983 amendments, requires a 61-day grace period for flexible premium variable life insurance policies, measured by reference to the “policy processing day” as defined in Section 2N. The 61-day grace period, akin to the grace period that must be provided under current universal life insurance policies in some states, begins to run on the “policy processing day when the total charges authorized by the policy that are necessary to keep the policy in force until the next policy processing day exceed the amounts available under the policy to pay such charges...” The policyholder report required

by Section 9C will notify the policyholder that the amounts available under the policy are insufficient to keep the policy in force. The policyholder will thereby be afforded an opportunity to pay sufficient premiums to maintain the coverage in effect. Paragraph (2)(b) provides that the flexible premium policy grace period will terminate no sooner than sixty-one days after this warning notice is mailed.

The death benefit under a flexible premium variable life insurance policy will remain in force as long as sufficient amounts are available under the policy to support the deductions necessary to maintain the coverage in force. However, even if the amounts available are insufficient to carry the policy to the next policy processing day, Paragraph (2)(b) nonetheless mandates that an insurer provide a minimum death benefit during the grace period. The death benefit that must be paid is the death benefit that was in effect immediately prior to the grace period, less any overdue charges. Of course, nothing precludes an insurer from offering a greater minimum death benefit guarantee under a flexible premium variable life insurance policy.

Paragraph (3) is derived from the original Model Variable Contract Regulation. It was adopted from the normal fixed benefit life insurance reinstatement provision with modifications required by the nature of variable life insurance.

Paragraph (3) was amended in 1983 to limit the mandatory reinstatement privilege to scheduled premium variable life insurance policies. State insurance statutes typically require reinstatement only when (1) there has been a default in premium payments; (2) on default, the value of the policy has been applied automatically to the purchase of other insurance; and (3) other insurance is in force and the original policy has not been surrendered to the company and cancelled. Under a flexible premium variable life insurance policy, however, the concept of a default in premium payments is not meaningful; coverage remains in effect until the amounts available under the policy to support the coverage are depleted by deductions for charges in accordance with the policy's terms. Thus, it is not appropriate to require a mandatory reinstatement privilege for flexible premium policies; once the value of the policy has been fully consumed, there is nothing to reinstate. However, it should be noted that Paragraph (3) does not preclude an insurer from developing and offering a reinstatement privilege in the context of a flexible premium policy.

Just as with fixed benefit life insurance, evidence of insurability is required on reinstatement in order to protect against anti-selection. With death benefits and cash values subject to fluctuation, a fixed benefit type reinstatement would have offered an opportunity for speculation against the insurer. A policyholder could lapse his policy and, assuming he or she remained insurable, the policyholder could wait to see whether separate account performance resulted in increased or decreased benefits. If benefits decreased, he would not reinstate and could purchase a new policy. If benefits had increased, in the absence of Subparagraph (b), he or she would pay back merely the overdue premiums as interest.

While this might appear to be an attractive scenario, it would rarely be in either the policyholder's or the insurer's interest. The insured is always risking his or her insurability. More importantly, however, in lapsing and purchasing a new policy the policyholder would be paying policy acquisition costs again as well as reestablishing the suicide and incontestability clauses (see, e.g., NAIC Replacement of Life Insurance and Annuities Model Regulation, 1970 *Proceedings of the NAIC* 1345).

Reinstatement in the situation described above could also be costly to the insurer (and, in the case of an insurer issuing participating policies, other classes of policyholders). It imposes a significant investment risk. For example, in scheduled premium variable life insurance the allocation of premium to the separate account is made on a uniform basis independent of the date the premium is actually paid. Consequently, cash will have to be advanced from the general to the separate account to "purchase" the investments necessary to support the promised benefits. These advances create an investment risk for the insurer. If the premium is not paid by the policyholder, the advance from the general account must be reversed when the policy lapses, at which time the market may be depressed.

This, of course, is in addition to the normal risks of anti-selection and administrative costs of keeping the policy in suspended animation during the reinstatement period. In response to these problems, the model regulation conditions reinstatement on the payment of the greater of: (1) both overdue premiums and outstanding indebtedness at the maximum policy loan interest rate permitted by law in that state; or (2) 110% of the increase in cash surrender value resulting from the increase.

For discussion of the benefit base, see the comment to Section 4C(6). While the description of the benefit base is required elsewhere in different degrees of technicality (see e.g., Section 7A), the purpose of Paragraph (4) is to make it a contractual matter.

Paragraph (5) makes the identification of the separate account utilized a contractual matter. It was modified in 1983 by deleting Subparagraph (a), which required that the separate account be used to fund only variable life insurance benefits. This deletion was intended to afford insurers the flexibility to utilize the same separate account to fund several products, e.g., variable annuities in addition to variable life insurance. The commissioner's pervasive regulatory control over the separate account, the contents of variable life insurance policies, and the insurer's operations made it clear that continuation of this restriction was no longer essential in order to assure regulation of variable life insurance which will not be detrimental to the public or the policyholders of an insurer (see commentary to original model regulation).

Subparagraph (a) is derived from the original Model Variable Contracts Regulation, Article IV, Section 2. It has the effect of insulating the assets underlying separate account liabilities.

Prior to 1983, Paragraph (b) required that a variable life insurance policy contain a provision stating that "the policy and any papers attached thereto by the insurer, including the application if attached" comprised the "entire insurance contract under state law." This requirement was originally imposed to prevent the insurer from incorporating by reference in its policy, provisions which were contained in documents to which the insured had limited access. Paragraph (6) was amended in 1983 in response to the realization that the former language was, at best, too narrow and, at worst, misleading in that it might have been read to imply that the entire insurance contract was uniform from state to state. Accordingly, the paragraph was broadened to take account of possibly divergent statutory formulations of the documents which constitute the entire insurance contract.

This provision would not destroy a policyholder's rights as a third-party beneficiary of a contract made by the insurer for the policyholder's benefit assuming any such rights exist. The provision was designed to protect the policyholders from losing any rights, not to destroy rights arising outside the contract.

Paragraph (12) was amended in 1983 by adding a proviso to subject increases in the policy's death benefits subsequent to the policy issue date to a new 2-year contestability period. The new period of contestability applies only to the amount of the increase and only in those cases in which (1) the increased coverage is attributable to a new application or request by the owner, and (2) the insurer asked for satisfactory evidence of insurability. Thus, for example, the insurer would not be permitted to contest increased death benefits that have resulted from successful investment performance of the separate account, or from the exercise of a contractual right (e.g., a guaranteed purchase option) that was applied for, underwritten and approved at the time of original issue.

The deferral contemplated by Paragraph (14) might be necessary in times of financial difficulty when in the opinion of the insurance commissioner there might be a "run" on the insurer that would jeopardize the remaining policyholders. This might also exist in a liquidation, a situation in which the commissioner might allow death benefits, but not cash values, to be paid pending the liquidation process.

Insurers are exempted from the federal bankruptcy laws in order that liquidation can take place in a manner that will serve to protect the policyholders. This protection of all policyholders (variable and fixed) would be placed in severe jeopardy were the separate account given preferential treatment over the general account.

This provision is similar to one that is required in most states for fixed benefit life insurance in order to protect the policyholders in the instances described. This paragraph grew out of the depression economy. Although relatively few insurance companies failed during the depression, there was a concern that a run on insurance companies in a future depression could have very severe consequences not only on the insurers and their policyholders, but to the general economy (Gregg, *Life and Health Insurance Handbook*, 2nd edition, p. 1151).

Again, it is important to realize that a separate account is not a severable entity but rather an integral part of the insurer. A separate account alone could not operate a variable life insurance policy. A part of the reserve underlying a variable life insurance policy may be in the general, not the separate, account at any given time. Thus, a combination of the two may be required in order to pay benefits. Without the protection of this paragraph, the insurance commissioner might be in the position of being able to protect the policyholders in a liquidation only to the extent of the reserves in the general account.

This paragraph has particular importance to variable life insurance. Since the separate account's portfolio may consist of equity investments to a much larger extent than the general account's portfolio, determination of the proper amounts payable under a policy will be difficult during periods when the stock exchanges are closed.

The phrase “except when used to pay premiums” is intended to apply to the payment of premiums under an automatic premium loan provision as permitted in Section 4F(4) and not to any other situation.

Prior to 1983, Paragraph (15) required that every variable life insurance policy contain settlement options that shall be provided on a fixed basis only. The 1983 amendments provide that at least one settlement option must be provided on a fixed basis, but permit the insurer to provide variable settlement options.

A review of the commentary accompanying the prior version of Paragraph (15) reveals that the restriction to fixed basis settlement options was intended to ensure that no one would attempt to impose dual regulation as a result of variable settlement options. The federal role in the regulation of variable life insurance has, however, eliminated the justification for this limitation. In this connection, it should be noted that, in a memorandum dated September 9, 1976, the NAIC Counsel specifically noted that “[c]ontinuance of this provision in the event of dual SEC-state regulation would be unnecessary, and in that event its deletion is recommended.” “Proposed Changes to the NAIC Model Variable Life Insurance Regulation” (September 9, 1976), Memorandum of Richard A. Hemmings, NAIC Counsel. The prior restriction imposed unnecessary costs on consumers; a policyholder or beneficiary desiring a variable settlement option was constrained to surrender the variable life insurance policy and purchase a separate variable product, incurring the costs associated with the surrender and replacement.

Prior to 1983, Paragraph (16) required that a variable life insurance policy contain a description of the basis for computing the cash surrender value under the policy and display the value in the format of a schedule of cash values. The function of these schedules was to set out the cash values under the policy at specified durations per \$1,000 of variable death benefits then in force, regardless of investment performance. The schedules did not involve assumptions as to what the amount of variable death benefit or cash values would in fact be at the specified future durations.

The alternative cash value schedules that were set forth in Paragraph (16) were deleted in 1983 on the grounds that they might be, at best, meaningless, and, at worst, misleading in the context of flexible premium variable life policies characterized by nonguaranteed cash values that fluctuate in accordance with investment experience. In lieu of these alternative cash value schedules, the 1983 amendments made mandatory the furnishing of illustrations of benefits payable under variable life insurance policies.

As amended in 1983, Paragraph (16) required the insurer to describe the basis for computing the policy’s cash value in addition to its cash surrender value. This requirement was added to provide the policyholder with useful information which juxtaposes the two amounts and thereby focuses the policyholder’s attention on the costs, if any, associated with surrendering the policy.

Paragraph (17) was amended in 1983 to require that charges for incidental insurance benefits, in addition to premiums for the benefits, be separately stated. This language was added to indicate that while premiums for incidental death benefits could be paid directly by the policyholder, the cost of the benefits might also be deducted as charges from the separate account.

Prior to 1983, Paragraph (20) required that a variable life insurance policy afford at least one non-forfeiture benefit on a fixed basis from the due date of the premium in default, and prohibited an insurer from offering variable extended term insurance as a nonforfeiture benefit. The commentary accompanying the prior model regulation stated that the prohibition upon variable extended term insurance was being imposed “for the time being” only. Thus, it was apparently contemplated that the need for these restrictions would be reexamined.

The 1983 amendments respond to the clear incompatibility between these constraints and rudimentary design characteristics of flexible premium policies. The hallmark of flexible premium products is the latitude and discretion that the policyholder possesses over the amount and timing of premium payments. Thus, the concepts of a discrete, identifiable premium due date and of a premium in default—which are readily defined and easily applied in the context of fixed life insurance and traditional variable life products—are inadaptable to flexible premium products. Nonpayment of premiums under a flexible premium product would not necessarily result in termination of insurance coverage; instead, coverage continues until the charges necessary to keep the policy in force exceed the value of the amounts allocated to the separate accounts under the policy. In other words, if premium payments are discontinued, the duration of coverage would vary in accordance with investment performance.

The model’s constraints upon the types of nonforfeiture insurance benefits that may be offered were deleted in 1983 because it was felt that they posed unnecessary obstacles to the evolving development of flexible premium products. Moreover, it was felt that sound state regulation of these products did not require that these strictures be retained.

The concluding language of Paragraph (20) allows an insurer to limit certain nonforfeiture benefits to a reasonable minimum amount. In other words, the regulation recognizes that costs associated in offering certain benefits in minute amounts may be unrelated to the size of the benefit. Therefore, it was thought unreasonable to require an insurer to absorb costs below a reasonable minimum benefit amount. The commissioner must ultimately approve of the reasonable minimum.

As amended, this provision, which was formerly included in Subsection E, is most appropriately classified as a mandatory policy provision, and therefore has been placed in Subsection D. This permits Subsection E to be devoted solely to policy loans.

Subsection E. Policy Loan Provisions

Comment: Prior to 1983, this subsection encompassed partial surrenders and partial withdrawals in addition to policy loans. In 1983, the Committee restructured Subsection E so that it addresses only policy loans. This was accomplished by deleting references to partial withdrawals and partial surrenders from Subsection E (see, e.g., former Paragraph (b)(10) and Paragraphs (9) and (10) as amended) and inserting instead, in Subsection F(5), a permissive provision that a variable life insurance policy may contain a provision allowing the policyholder to make partial withdrawals.

The original model regulation formulated the loan value by reference to the cash value of the policy. The 1983 amendments correlated the loan value to the cash surrender value of the policy to accomplish two principal objectives.

First, defining the loan value in terms of the cash surrender value conformed the model regulation to the insurance laws of most states. These statutes define the loan value as the cash surrender value and provide that when total indebtedness equals or exceeds the loan value, the policy may be terminated provided that at least thirty days' prior notice has been given to the policyholder.

Second, relating the loan value to the cash surrender value avoids disparate treatment of a policyholder who takes out a policy loan vis-a-vis a policyholder who surrenders the policy. Specifically, it was felt that if the original language were retained and a policyholder were permitted to borrow the full cash value of the policy, he or she could thereby circumvent imposition of a surrender charge and would be more favorably treated than a surrendering policyholder.

In 1983, the Committee added an exclusion for term insurance policies and pure endowment policies to the introductory language to Subsection E to make it clear that a policy loan provision is mandatory for all policy designs except term insurance and pure endowment policies. In addition, because of the unscheduled nature of premium payments characteristic of flexible premium products, it was felt that the previous introductory language which tied the availability of policy loans to payment of a specified number of full years' premiums was inapplicable. Accordingly, in 1983 this language was amended to provide that policy loans would be available after the policy has been in force for a specified period of time.

Paragraph (2) was amended in 1983 to replace the reference to a maximum permissible interest rate with language which would permit insurers to charge a variable interest rate on policy loans where permitted by state law.

Paragraph (5) requires that the insurer notify the policyholder of the insurer's intention to terminate the policy if excess indebtedness is not repaid within thirty-one days. Thus, rather than merely allowing the insurer to cancel the policy, this paragraph requires the insurer to allow the policyholder to repay immediately the excess indebtedness over the cash surrender value. The Committee fully recognized that this placed a substantial risk on the insurer during the thirty-one day period. Furthermore, the Committee was aware that in fluctuating markets the insurer could be forced to send frequent notices. However, this is the risk the insurer must take, and is one of the reasons for the 75% limitation of Paragraph (1).

Paragraph (5) was amended in 1983 to apply different notice requirements to scheduled and flexible premium policies. The 31-day notice of intention to cancel is triggered when the indebtedness exceeds the cash surrender value of the policy, rather than the policy's cash value. Finally, the word "any" was inserted in the clause "notice of any intent to cancel" (emphasis added) to make it clear that cancellation of the policy is not mandated by the regulation, but is to be at the option of the insurer.

Paragraph (6) was intended to allow, but not to require, the insurer to permit full restoration of benefits upon the repayment of 110% of the increase in cash value and the furnishing of evidence of insurability satisfactory to the insurer. The 110% repayment is inserted to discourage speculation against the insurer. Evidence of insurability is required to protect against anti-selection (see comment to Section 4D(3)).

Paragraph (7) is intended to prevent a policyholder from borrowing amounts that are so small as to generate high costs in administering the loan by the insurer with limited corresponding benefits to the policyholder. Of course, the commissioner must ultimately determine what will constitute a reasonable minimum amount.

Paragraphs (9) and (10) must be read together. They were inserted in order to attempt to solve problems which have long been associated with fixed benefit policy loans.

The NAIC model regulation does not specify any particular method of making policy loans. It does, however, specifically require in Paragraph (9) that the insurer shall construct policy loan provisions so that all policyholders (variable and fixed) of the insurer who have not exercised policy loan provisions are not disadvantaged by the exercise of loan provisions by other policyholders. There is no restriction as to how companies shall accomplish this result.

One method that is likely to be utilized requires the transfer of policyholder loans from the separate to the general account (again illustrating the constant interrelationship of the two) and blending of the different (variable and fixed) rates of net investment return earned by the policyholder taking the loan. As a result, only the variable life insurance policyholders actually taking policy loans receive a net investment return based on the policy loan rate on that portion. The return to nonborrowing policyholders (both variable and fixed) is unchanged. It was suggested by some, however, that loans should be required to be made from the insurer's general account because transfer of the loan amount from the separate account might, depending upon that account's investment performance, decrease the return to borrowing variable life insurance policyholders. This approach reflected little concern over the fact that such a provision would require the insurer's fixed benefit policyholders to subsidize the borrowing variable life policyholders, and, further, that the risk of poor return was no longer imposed on the borrowing policyholder, and was rejected for that reason.

This aforementioned approach, in effect, applies the difference between the net investment return based on the policy loan interest rate and the net investment return of the separate account against the policy loan indebtedness to adjust the benefits otherwise payable. Under this approach, the borrowing variable life policyholders will be credited with a net investment return based on the policy loan interest rate rather than the separate account net investment return for the purpose of calculating policy benefits. Thus, to the extent of the borrowing, variable life insurance policyholders have a policy which is totally insulated from both favorable and unfavorable separate account performance, and nonborrowing policyholders remain unaffected. Borrowing policyholders are affected only to the extent of their loans.

Subsection F. Other Policy Provisions

Source: Paragraphs (1), (4), and most of (3) are based on standard fixed benefit life insurance policy provisions.

Comment: The requirements of this subsection are optional. However, if provisions are made they must resemble in substance the mandates of this subsection. In 1983, Paragraph (3)(b) was amended to eliminate a requirement that certain forms of life insurance purchased under dividend options be paid-up. In addition, the amendment permitted forms of fixed benefit life insurance besides whole life. These changes were made to add needed flexibility to permissible dividend options.

Paragraph (1) allows a two-year suicide clause. Of course, the clause must be in conformity with applicable state law.

As amended in 1983, the suicide exclusion parallels the mandatory policy provision governing incontestability (Subsection D(12)). As with the incontestability clause, the new two-year period during which the insurer may deny liability for death resulting from suicide applies "to the extent of the increased death benefits only," i.e., only to the portion of the death benefit that resulted from a new application by the policyholder for the additional coverage. Because a misrepresentation of the insured's health is not necessary to contest liability under the suicide provision, the amendment to Paragraph (1) allows the insurer to deny liability for death resulting from suicide, within two years of the date of any increase, irrespective of whether or not evidence of insurability was supplied.

Paragraph (2) was amended in 1983 to afford insurers the flexibility to offer incidental insurance benefits on a basis other than fixed. See the discussion of the 1983 amendment to the definition of "incidental insurance benefit" in Section 21.

Paragraph (4) allows an insurer to offer an automatic premium loan provision on an optional basis. The policyholder must elect its use in writing either in the application or later. If offered, the loan must be on a basis at least as favorable to the policyholder as Section 4E(1). The language that allows the imposition of a 2-premium limitation is for the policyholders' benefit in order to prevent a previously applied for automatic premium loan from destroying cash values without the policyholder being aware of this occurrence. If the policy holder renews his or her request for the automatic premium loan, the 2-premium period should commence running anew.

Paragraph (6) was added to the model regulation in 1983. Its intent is to make it clear that the permissive policy provisions specifically set forth in Subsection E do not, by implication, preclude the insurance commissioner, in his or her discretion, from approving other policy provisions submitted by the insurer.

Section 5. Reserve Liabilities for Variable Life Insurance

Comment: Subsection A refers to reserve liabilities arising from variable benefits and requires their being held in the separate account and determined on a basis consistent with the Standard Valuation Law.

The Standard Valuation Law is prospective in nature and requires a knowledge of future benefits. Since under variable life insurance future benefits are unknown, this subsection recognizes that the Standard Valuation Law cannot be applied without appropriate modifications. Thus, this subsection requires the application of the principles contained in the Standard Valuation Law in a manner that is actuarially consistent with the variable nature of the benefits provided.

Subsection B deals with the reserves for a minimum death benefit guarantee under a scheduled premium policy (see Section 2K and Section 4C(2)). This subsection was originally adopted by the Subcommittee in substance in December of 1972. It was modified in 1983 to limit it to scheduled premium policies. The following comments drawn from the Subcommittee's December 1972 report provide an explanation of this subsection:

The purpose of the reserve for the minimum death benefit guarantee (MDBG) is to accumulate funds to provide for the contingency of death occurring when the guaranteed minimum death benefit exceeds the death benefit that would have been payable in the absence of such a guarantee. The amount payable under the minimum death benefit guarantee, as referred to below, means the excess of the minimum death benefit over the death benefit that would have been payable if there were not such a guarantee. The reserve for the minimum death benefit (MDBG reserve) means the reserve for that excess death benefit. The amount payable under the minimum death benefit guarantee tends to increase if the investment earnings on the assets of the separate account funding the contract are less than the assumed investment return for the contract and vice versa.

Taking into account the purpose of the MDBG and the nature of the minimum death benefit guarantee, the Subcommittee concluded that the acceptable MDBG reserve system should have the following characteristics:

1. The MDBG reserve should be held in the general account of the company so that it will be backed by the general assets of the company, most of which are debt obligations valued at amortized cost and, therefore, are of a fixed dollar nature. It would not be proper to hold the MDBG reserve in the separate account since the reserve would not be supported by fixed dollar assets but by assets that are moving in the opposite direction from the risk, i.e., value moving downward while the risk increases and vice versa.
2. The MDBG reserve should be adequate to cover, under all but the most extreme circumstances, the MDBG death claims for the next year, so that the regulatory authorities can be assured the company will not run into financial trouble from this source before the next annual statement is filed.
3. The MDBG reserve should react slowly but steadily to an extended period of poor investment experience of the separate account.
4. The MDBG reserve should not overreact and cause unnecessary fluctuations in surplus by increasing too rapidly in a sharp market downswing. Also, the reserve should not decrease too rapidly in a sharp market upswing after a period of poor market experience.

The reserve should be subject to the same valuation standards with respect to mortality and interest as any other life insurance reserve, currently the 1958 CSO mortality table and a rate of interest not in excess of 3.5%, and should not be discounted by rates of withdrawal because of their uncertain nature and a great variation in rates between one company and another. Withdrawal rates are particularly uncertain for variable life insurance since no U.S. companies have yet written such insurance.

After extensively testing the operation of many proposed reserve systems against these criteria under various assumptions as to the investment performance of the separate account, the Subcommittee decided to recommend a 3-part MDBG reserve system, consisting of (1) an accumulation of amounts allocated by the insurer to the MDBG reserve, less actual MDBG claims paid, subject to a 2-part minimum equal to the greater of, (2) a one-year term reserve to assure coverage of next year's claims, and (3) a reserve designed to protect against an extended period of poor investment experience of the separate account.

The amounts allocated by the insurer to the first part of the reserve system depend upon the design characteristics of an insurer's variable life insurance contract, the insurer's judgment of the risk it has assumed, and its assessment of the possible impact on its surplus of future changes in the 2-part minimum.

The second part of the reserve system is a requirement that the reserve be sufficient to cover all MDBG claims of the following year if there is an immediate one-third depreciation in the value of the separate account assets.

The third part of the reserve system forces an insurer to gradually increase its reserve if this is necessary to cover MDBG claims arising from an extended period of poor investment performance. The technique used is to fund the cost of future MDBG claims by level payments over the future premium paying period of the contract.

The Subcommittee's proposal also provides that suitable approximations and estimates may be used to shorten the work of computing the reserve for the minimum death benefit guarantee.

The requirements for a reserve for the MDBG originally adopted by the NAIC (1973 *Proceedings of the NAIC* I 504) included a provision that amounts be regularly allocated by insurers to be accumulated to form a reserve which would be charged with any excess of actual death benefits paid over those which would have been paid in the absence of the MDBG. This requirement was subsequently deleted from the model regulation because of the difficulty of specifying the amounts to be regularly allocated since such amounts vary depending on factors such as the plan design and the assumed investment return. The Subcommittee felt that it would be better for companies to include in their plan of operation, a specification of the amounts to be regularly allocated for this purpose (see Section 3A(2)(a)). Only the second and third parts of the reserve system are retained in the present regulation.

Subsection C requires the application of the Standard Valuation Law to incidental insurance benefits. Reserves for the variable aspects of variable incidental insurance benefits shall be maintained in a separate account; reserves for any guarantee associated with the benefits shall be maintained in the general account.

Section 6. Separate Accounts

Subsection A. Establishment and Administration of Separate Accounts

Comment: Section 6 deals generally with separate account operations and the management of the insurer. Therefore, within the context below it was expected that conduct under this section would primarily be regulated by the state of domicile.

Totally aside from the model regulation, any matter which might pertain to the insurer's ability to perform its obligations within a particular state is always subject to the scrutiny and regulation of the commissioner of that state. Thus, the commissioner of any state can always change his or her regulations or bar an insurer from doing business in the state as well as invoking all other enforcement remedies available. However, as a general proposition, the internal management of the insurer is normally regulated by the state of domicile, and in the absence of unusual circumstances, this regulation is accepted by other states in which the insurer does business. In fact, this is the reason underlying Section 3A(2)(c) and 3B(5). In 1983, the introductory language to Subsection A was expanded to make clear that the domiciliary state has exclusive jurisdiction over the establishment of separate accounts and to clarify that a commissioner may not require foreign insurers to establish separate accounts in his or her state.

Subsection A relates to the creation of separate accounts. Paragraphs (1) to (3) relate to custodianship, bonding requirements and the background of persons associated with the material handling of separate account assets.

It is important to note in any discussion of these areas that the assets of the separate account are only significant with respect to solvency. Unlike a mutual fund in which the shareholder owns a proportionate share of the assets that exist, the variable life insurance policyholder owns the right to be paid benefits according to the contract, regardless of whether the assets underlying the policy actually exist. In this regard the commissioner's sole concern as to the existence of assets is limited to solvency. The insurer's obligation exists regardless of whether or not the assets have been stolen. Misconduct has no effect on the determination of benefits owed to the policyholders. Therefore, the interest of the commissioner with respect to misappropriation is exactly the same for fixed benefit and variable life insurance—namely, the ability to pay benefits under the policy.

Paragraph (1) relates to custody of separate account assets. The laws of some states are quite specific in this regard and were intended to govern over this provision. In the normal instance, the Subcommittee certainly expected that the insurer would maintain custody over its assets including those allocated to its separate account. In this context it was recognized that an insurer is never really acting as custodian of separate account assets.

Since a variable life insurance separate account is an integral part of the insurer, the insurer is acting as custodian (really owner) of its own assets, including those which it may have internally allocated to the separate account. Neither the separate account nor the variable life insurance policyholders own any assets. As a matter of fact, the Model Variable Contract Law Section 1E provides that "amounts allocated to a separate account in the exercise of the power granted by this Act shall be owned by the company, and the company shall not be, nor hold itself out to be, a trustee with respect to such amounts."

An affiliate of the insurer holding custody of the insurer's assets would not be the same thing as the insurer itself holding them. Clearly, assuming no contradictory requirement, the model regulation provides the commissioner of the state of domicile with the authority to review and approve the terms of a custodianship contract and the custodian itself. The standards to be reviewed would presumably be (1) safety of the assets; (2) cost; and (3) the absence of a conflict of interest which might be detrimental to the policyholder.

Paragraph (2) requires the prior written approval of the commissioner in order for an insurer to employ the persons described therein in any material capacity with the handling of assets allocated to the separate account. As noted earlier, this is primarily a solvency concern. However, because the assets underlying variable life insurance separate accounts are inherently liquid in nature, they are more easily converted and this subsection was felt to be desirable.

The term "material" as it is used in this subsection is designed to cover a person who is employed in a position which would enable misappropriation of funds. It was the Subcommittee's understanding at the time the model regulation was drafted that to consent to an injunction would be an acknowledgment of a violation and, therefore, approval would be required under this subsection. The prohibition of this subsection would not define a narrower class of persons that is covered under the Investment Company Act.

As previously discussed, since the operations of the separate account would generally be regulated only by the state of domicile, approval under this subsection would not necessarily have to be obtained in every jurisdiction in which a company proposed to sell variable life insurance. However, the provisions of Section 3A(2) would still be applicable.

Paragraph (3) refers to bonding requirements for persons with access to separate account assets. Since bonding is not uncommon in state insurance regulation, the Subcommittee determined to leave the particular amount to each particular state.

Paragraph (4) should be read in conjunction with Section 4C(5) and (6) as well as Section 4D(5)(b).

The model regulation allows annual death benefit determination and monthly cash value determination. However, each can be determined much more frequently (daily is a common variation). Allowing cash value determination which was less frequent than monthly combined with "backward" valuation (see comment to Section 4C(6)) would have exposed the insurer to great speculation risks and could affect solvency. Therefore, monthly cash value determination was required. Since it would be impossible to determine benefits without valuing assets, this provision merely restates the obvious in requiring asset valuation at least as frequently as benefits are determined.

Prior to 1983, a paragraph of Subsection A had required that an insurer desiring to establish more than one separate account for variable life insurance file with the commissioner a justification for the action and obtain the commissioner's approval for the establishment of each additional separate account. The paragraph also prohibited the creation of additional separate accounts for the purpose of avoiding lower maximum charges against the separate account. This paragraph was deleted in 1983 because separate accounts funding scheduled and flexible premium variable life insurance products will be registered with the SEC under the Investment Company Act, which regulates permissible charges against registered separate accounts.

In 1983, the Committee also eliminated a provision in Subsection A that provided that a separate account, exempt from regulation under Section 3(c)(11) of the 1940 Act because of the tax qualified status of the policies funded thereby, should not be used to fund other variable life insurance policies. This provision had originally been included in the model regulation in order to prohibit companies from jeopardizing the exempt status under the Investment Company Act of Section 3(c)(11) separate accounts by placing in those accounts assets from nonexempt policies. This provision was deleted to afford insurers the flexibility to decide whether there are economies or benefits to be gained from pooling 3(c)(11) assets with nonexempt assets in one separate account.

Similarly in 1983, the Committee determined to remove another provision in Subsection A that stated that except for separate accounts exempt pursuant to Section 3(c)(11) of the Investment Company Act, variable life insurance separate accounts should not be used for variable annuities or the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies. This provision had originally been included in the model regulation to assure that insurers not jeopardize the partially exempt 1940 Act status of variable life insurance separate accounts by pooling them with assets funding variable annuities when variable annuity separate accounts were subject to full 1940 Act regulation. The Committee eliminated this provision in 1983 in order to give insurers the option of deciding whether it is more advantageous to pool the separate account fully subject to the 1940 Act, or, on the other hand, to maintain two separate accounts, one a 1940 Act regulated variable annuity separate account and the other a variable life insurance separate account that is partially exempt from the Investment Company Act.

Subsection B. Amounts in the Separate Account

Comment: The valuation reserves underlying the variable portion of the policy measure the amount of current liabilities arising from the obligation to pay future variable benefits. Thus, this section requires corresponding assets to be maintained in the separate account for solvency reasons since the required reserve will fluctuate in direct response to changes in variable benefits (see Section 5A).

Assets at least equal to the benefit base must be maintained in the separate account in order to assure that sufficient excess investment return exists to provide the benefits required by Section 4C(3) and 4C(4). The reference to the "valuation reserves for the variable portion of the policy" is not intended to encompass reserves for fixed nonforfeiture benefits, reserves either for dividend accumulations or for dividends applied to purchase paid-up insurance, or reserves for fixed insurance benefits.

In 1983, the Committee eliminated portions of Subsection B defining benefit base and stipulating reserves because several provisions contained in other sections of the model regulation ensure that the benefit base for variable life insurance policies will be soundly defined and that benefits generated under the policies will be adequately reserved for. For example, Section 4C(3) requires that the policy reflect the separate account investment experience and that the investment experience be reflected in an actuarially sound manner. Section 4C(4) mandates that the full net investment return applied to the benefit base is credited to the policy. Section 4C(6) requires that the method for computing nonforfeiture benefits is consistent with Standard Nonforfeiture Law. Reserve liabilities for variable life insurance policies must be established under the Standard Valuation Law, pursuant to Section 5A.

Subsection C. Investments by the Separate Account

Source: Paragraph (1) is from the original Model Variable Contract Regulation.

Comment: For various reasons the Subcommittee was concerned about the valuation of separate account assets. First, these assets form the basis for most of the reserves underlying the policy's benefits. Proper valuation is essential to assure solvency. Second, the separate account serves as the measure by which investment performance and, therefore, ultimately policy benefits are determined. Consequently, the model regulation must balance sometimes competing concerns, e.g., assuring that the insurer does not artificially inflate the appearance of its investment performance by initially undervaluing its separate account assets (and thus the basis on which investment return is calculated) vis-a-vis the traditional insurance view of conservatively valuing assets in order to assure that the insurer can meet its obligations to the policyholders.

With variable life insurance this traditional concern assumes special significance because of the interrelationship between the separate account and the insurer's general account and the resultant possibility that the general account (and indirectly the insurer's fixed benefit policyholders) will be forced to backstop any significant under valuation to the extent of any initial face value guarantee. On the other hand, too high an initial valuation will tend to artificially deflate investment performance and, therefore, inadequately credit variable policy benefits. Thus, in establishing valuation requirements, the Subcommittee sought to balance these potentially competing concerns and to minimize the potential for insurer manipulation. The Subcommittee had to be sure that valuation methods were appropriate to the nature of variable life insurance and the need to protect all—not just variable—policyholders.

The provisions of Paragraph (1) are common to many existing statutes and regulations and are intended to prevent unfair or discriminatory transfer between accounts. Regular cash flow should permit those transfers to and from the general account necessary to the question of the insurer's variable life insurance business to be made in cash. The introductory language to this paragraph recognizes that the separate account is not a separate entity and is not an affiliate of the insurer. Therefore, the transactions covered by this subsection include those between: (1) the insurer's general assets and the separate account, (2) one separate account of the insurer to another, and (3) an affiliate of the insurer to either the insurer's general assets or a separate account.

Subparagraph (a) recognizes the need of seed money to establish a separate account of adequate minimum size and further the need for the constant periodic flow of cash in the form of the valuation net premium from the general account to the separate account to support the operation of policies (see also Section 6G).

Subparagraph (b) presumes that all transfers will be in cash. However, it permits transfers of assets other than cash if approved by the commissioner in advance. A transaction that is fair and equitable to both variable and fixed benefit policyholders is, of course, the standard that must be applied in determining approval. Naturally, assets transferred into the separate account must satisfy the requirements of Paragraph (2).

This subsection does not permit interest-bearing loans by the general account to the separate account to establish the latter. Section 4C(5) makes no provision for allocating separate account earnings to amortize any indebtedness.

In 1983, the Committee revised Paragraph (2) to establish a standard providing adequate safety and liquidity for separate accounts, while also affording investment flexibility. Paragraph (2) requires that the separate account maintain in its portfolio readily marketable assets and assets producing investment income such that the total of the assets and income are sufficient to meet anticipated withdrawals under policies funded by such separate account. In other words, to determine liquidity of the account, the net income from investment plus the aggregate amount of publicly traded securities, cash items and other readily marketable assets will be compared with anticipated withdrawals to meet obligations under the policies. In this way, the standard for liquidity focuses upon the entire separate account rather than individual assets in the separate account. The Committee also concluded not to prohibit specified types of investments by the separate account in view of the liquidity standard established in Paragraph (2), which determines liquidity by reference to the aggregate separate account rather than requiring that every separate account investment meet conservative liquidity standards. Moreover, since separate accounts funding scheduled and flexible premium products will be registered under the Investment Company Act, contract holders will be protected by that act and its regulations that prohibit certain specified forms of investments. The investment restrictions deleted from the model regulation, however, were more restrictive than those contained in the Investment Company Act. The Committee determined to eliminate these more restrictive limitations so that companies would have the flexibility to design products that can compete economically with alternative products offered by other financial service institutions that are not so limited. The NAIC recommends that a guideline be formulated as soon as possible to assist states in administering Section 6C(2).

Subsection D. Limitations on Ownership

Source: Paragraphs (1) and (2) are derived from the Model Variable Contract Regulation.

Comment: Paragraph (1) provides that separate accounts cannot purchase or otherwise acquire shares in any one issuer (other than the United States) if the acquisition would result in investments in that issuer exceeding 10% of the value of assets allocated to the separate account. This quantitative limitation is imposed to promote diversification and limit investment risk. The commissioner is given authority to waive this restriction in unusual circumstances where the waiver is found not to be hazardous to the public or the policyholders.

Paragraph (2) prohibits the acquisition of the securities of an issuer if the acquisition would result in the insurer's ownership of more than 10% of the voting securities of the issuer (see Section 2F.) As in Paragraph (1), the commissioner may waive this condition where such waiver is found not to be hazardous to the public or the policyholders. However, in addition, a waiver under this paragraph must also be based on an affirmative finding that the independent operation of the issuer will not be jeopardized. In this regard, coordination with the SEC may be desirable.

Paragraph (3) was inserted in order to assure that Paragraph (1) would not preclude investment in mutual fund shares, so long as the mutual fund complied with the investment restrictions of Section 6C and 6D as well as all other applicable portions of the regulation. In 1983, Paragraph (3) was expanded to make clear that Paragraph (1) was not intended to prevent separate accounts from acquiring interests in other pools in investment assets, such as interests in a pool of real estate assets, which may not be registered under the Investment Company Act. Any such investments would also have to substantially comply with the investment restrictions of Section 6C and other applicable provisions of the model regulation.

Subsection E. Valuation of Separate Account Assets

Comment: The Subcommittee was concerned with uniform portfolio valuation for a number of reasons.

A particular security may be held by separate accounts and by life company general accounts. It would appear unreasonable for the same security, held by several different variable life insurance separate accounts, to have different values. Only uniform valuation can avoid this result.

The insurance commissioners have a vital interest in the values given assets in the separate account because of the impact on the solvency of the general account caused by minimum guaranteed death benefits, if any. In fact, it can be argued that the commissioner's interest equals that of the variable life policyholders. Thus, it is important that the commissioner be satisfied with the values given the separate account assets.

Death benefits and cash values will depend to some degree on the investment performance of the separate account. Clearly in the absence of regulation a company could change its valuation procedures to alter the separate account investment results, either up or down.

Uniform valuation of separate account assets is required by the SEC under the Investment Company Act of 1940. That Act provides that portfolio securities for which market quotations are readily available shall be valued at current market value, and that other securities and assets shall be valued at "fair value" as determined in good faith by the board of directors of the investment company. The SEC has interpreted fair value to mean the value that would be received upon the current sale of a security or asset. These valuation principles, by assuring that valuation procedures reflect current market factors, eliminate the potential for understating or overstating the value of separate account assets.

In 1983, the Committee modified Subsection E to permit separate account asset to be valued at their amortized cost if it approximates market value. This change was initiated to allow valuation consistent with the current SEC position permitting conditional use of the amortized cost method of valuation. Under this valuation method, which seeks to attain a stable net asset value, a debt security is valued at its cost and interest to be earned on the security (plus any discount received or less any premium paid upon purchase) is accrued ratably over the remaining maturity of the security.

Subsection F. Separate Account Investment Policy

Comment: In 1983, Subsection F was modified to require that changes in separate account investment policy must be filed with the insurance commissioner of the domiciliary state before they become effective. Any changes in investment policy will be deemed automatically effective 60 days after the filing date with the commissioner, unless the commissioner informs the insurer of disapproval during that period because a change is viewed as detrimental to the interests of separate account policyholders. This provision, of course, would not preclude a commissioner from also considering the interests of other policyholders of the insurer. The provision simply seeks to make the interests of separate account policyholders the principal focus of the commissioner's consideration in evaluating changes in investment policy. The automatic effectiveness provided in this subsection extends to all proposed investment policy changes and is not limited to non-material changes. In revising Subsection F, the Committee intended to make clear that commissioners are not required formally to approve all investment policy changes that are filed. Under this provision, a commissioner retains the authority to disapprove, at any time, a change in investment policy that has become effective pursuant to the deemer provision of the section. Disapproval would be subject to the requirements of notice and public hearing.

In addition to the commissioner's scrutiny of proposed changes investment policy, the Investment Company Act of 1940 provides policyholders with the right to vote upon proposed changes in investment policy.

Certain regulations under the Investment Company Act, however, provide a conditional limited exemption from shareholder voting requirements to the extent that an insurance regulator requires, pursuant to insurance law or regulation, that the separate account make certain investments that would result in changes in the subclassification or investment policies of the separate account. A similar exemption is provided to the extent that changes in the investment policy of the separate account initiated by contract holders or the separate account committee are disapproved by the life insurer under limited circumstances, provided that the disapproval was reasonable and based upon a good faith determination.

Any changes in investment policy requiring policyholder approval under the Investment Company Act, as well as those excluded from shareholder vote pursuant to the limited exemptions mentioned above, must be disclosed in the proxy statement distributed to contract holders of the variable life insurance separate account. With this mechanism, the SEC also has an opportunity to review the adequacy of disclosure regarding proposed changes in separate account investment policy.

Through the combination of procedures required under Subsection F requirements proposed by the Investment Company Act of 1940, separate account policyholders are adequately protected against adverse changes in separate account investment policy. Any proposed changes are subject to: (i) disapproval of the insurance commissioner, either within 60 days of filing or subsequently following notice and hearing; (ii) shareholder vote, unless exempt under limited regulatory conditions; and, (iii) disclosure in proxy materials filed with the SEC which are distributed to policyholders and are subject to SEC review.

Prior to 1983, the subsection provided dissenting policyholders with the right to convert to a fixed benefit policy. This provision was included in furtherance of the goal of avoiding SEC regulation, as a substitute for the voting procedures required by federal securities laws. In view of the subsequent application of the securities laws to variable life insurance and the protection from detrimental investment changes afforded by requirements enumerated in the preceding paragraph, the 1983 amendments deleted the prior paragraph.

Subsection G. Charges Against Separate Account

Comment: Prior to 1983, Subsection G set forth a restricted list of charges permitted to be deducted from the separate account. Subsection G was amended in 1983 to require written disclosure of all charges that are made against the separate account, including, but not limited to, 7 specified categories. The requirements of this provision can be satisfied by disclosing these charges either in a policy delivered to contract holders or in a prospectus distributed prior to or at the same time as the policy. All charges must be disclosed in one document or the other. Consequently, a company may not selectively disclose a portion of the charges in the policy with the remainder appearing in the prospectus. A complete listing of all separate account charges must be disclosed in the policy or in the prospectus. It was determined that permissible charges against the separate account should not be limited to those specifically enumerated in order that future product design would not be unreasonably limited.

Paragraph (1) pertains to deductions from the separate account for taxes or reserves for taxes attributable to investment gains or income attributable to the separate account. This paragraph would require disclosure of such taxes or reserves.

Paragraph (2) requires disclosure of the actual cost of brokerage fees. The conflict of interest provisions of Article VI, Section 9, of Section 17 of the Investment Company Act of 1940 and the standards of conduct in Section 6H would be relevant to prevent the insurer or its affiliates from being unfairly benefited at the expense of the variable life insurance policyholders.

Paragraph (4) requires disclosure of charges against the separate account for administrative expenses and investment management expenses. It is important to note that the term "management" is much broader than the term "advisory" services which was intentionally not utilized. The expenses for investment management consist of all costs that are necessary to secure and transact the investment obligations of the insurer. It would include advisory services as well as other associated expenses. If, for example, an outside mutual fund were utilized, sales commission, printing fees, outside directors fees, registration fees, required reports, custodian fees, etc. would all be a cost of investment management and would be included in this paragraph.

In 1983, Paragraph (4) was expanded to specifically include charges for administrative expenses in the category of investment management expense charges. Also in 1983, specific limitations on investment management expenses as a percentage of average net asset value were eliminated from Paragraph (4). This change was incorporated because the Investment Company Act of 1940, under which scheduled and flexible premium policies would be registered, regulates amounts that can be charged for investment management expenses. That Act prohibits management fees against registered separate accounts organized as either management investment companies or unit investment trust, exceeding reasonable amounts prescribed by the SEC. In addition, regulations under the Investment Company Act require that administrative expenses paid to trustees or custodians for performing bookkeeping and other services be limited to amounts that are reasonable in relation to services rendered and expenses incurred, and the SEC retains jurisdiction regarding the fees. Further, Section 36(b) of the Investment Company Act provides that investment advisers to registered investment companies have a fiduciary duty with respect to the receipt of compensation for services, and provides an express cause of action for recovery of excessive management compensation. The SEC performs its oversight regarding the reasonableness of investment management expenses and administrative expenses both when registrations are initially declared effective and when periodically updated.

Paragraph (5) was also modified in 1983 to eliminate any specific limitation on the amounts charged for mortality and expense guarantees. This revision occurred in the interest of regulatory consistency, because regulations under the Investment Company Act stipulate that mortality and expense risk charges must be disclosed in the prospectus and shall not be less than 50% of the maximum charge for risk assumption as disclosed in the prospectus and as provided for in the contract.

Subsection G was modified in 1983 to eliminate a prohibition against investment advisory charges against the separate account that would vary in accordance with the differences between the investment performance of the separate account and any index of securities, prices or other measure of investment performance. This change was initiated because in 1970 Congress amended the Investment Advisers Act of 1940 to permit registered investment advisors to contract a limited type of performance fee with registered investment companies. Performance fees, if any, will be presented in prospectus disclosure accompanying schedule and flexible premium policies and will be evaluated by contract holders pursuant to the voting procedures required under the Investment Company Act. Also, the SEC has oversight concerning performance fees in the course of reviewing initial and periodic disclosure materials.

Subsection H. Standards of Conduct

Comment: This subsection provides the minimum standards of duty and care that are owed by the insurer to the policyholders. They can be enforced by the commissioner through the full range of methods available. In addition, the insurer itself can enforce the standards as can an individual policyholder if an implied private right of action exists.

The standards of conduct would not be required to form part of the insurance contract pursuant to Section 4D(6), although an insurer might choose to include them in the policy.

Additional items might include expressions of the nature of the quasi-fiduciary duty of management to the policyholders and the obligations of good faith under which the insurer's management is bound to operate.

The Committee modified Subsection H in 1983 to provide that codes of ethics fulfilling the requirements of Section 17(j) under the Investment Company Act of 1940 would satisfy the obligations required by this Section pertaining to standards of conduct. Rule 17(j)-1 under the Investment Company Act of 1940 would satisfy the obligations required by this Section pertaining to standards of conduct. Rule 170-1 under the Investment Company Act, 17 CFR 270.170-1, implements the requirements of Section 170(j) and provides guidance to investment companies as to the minimum standards of conduct appropriate for a persons who have access to information regarding the purchase and sale of portfolio securities by investment companies. The rule prohibits certain activities on the part of persons affiliated with registered investment companies and their investment advisers or principal underwriters. Significantly, the rule requires those types of entities to adopt a written code of ethics containing provisions reasonably necessary to prevent fraudulent trading by persons affiliated with investment companies and their investment advisers or principal underwriters. with respect to securities held or to be acquired by the investment company. In addition, Rule 170-1 requires specified persons with access to information concerning portfolio transactions to file a report with their respective investment company, investment adviser or principal underwriter regarding personal securities transactions, including date, price, nature of transaction and execution broker or bank. Through the required code of ethics, monitoring and reporting obligations, Rule 170-1 provides a significant deterrent against fraudulent, manipulative or deceptive practices in connection with investment company portfolio transactions.

The code of ethics required by Rule 17j-1 provides a comprehensive and meaningful benchmark in fulfillment of the obligations under Subsection H regarding appropriate standards of conduct with respect to the purchase or sale of separate account investments.

Subsection I. Conflicts of Interest

Comment: Subsection I is designed to incorporate by reference and apply all state conflicts of interest laws. As such, it should be broadly interpreted.

“A separate account committee or other similar body” was intended to include any form of internal management group responsible for the operation of the separate account. For example, if an insurer did not form a variable life insurance subsidiary but rather formed a new committee of its board of directors (similar, for example, to the executive committee) to make the more day-to-day type of variable life insurance management decisions, this would be the type of group to which the model regulation refers. The intention of this subsection was clearly not to permit the insurer’s board of directors to delegate the ultimate management responsibility for separate account activities to any other group, such as the policyholders, or distinct separate account management. This was in recognition of the nature of the separate account’s integrated relationship with the insurer as a whole.

Furthermore, this language was meant to preclude policyholder voting for the management of variable life insurance operations. Finally, this subsection was inserted to assure no misunderstanding that the conflict of interest provisions applied to any group associated with a separate account regardless of its description.

The model regulation contains no other reference to such a body. The responsibility of the board of directors to manage the insurer including its variable life insurance operations is much broader than only those acts treated in the conflicts of interest subsection. It is spelled out in detail in state insurance laws. This responsibility would include a quasi-fiduciary duty to act in the interest of the policyholders and in compliance with the standards of conduct.

In 1983, the Committee eliminated specific prohibitions that had previously existed under Subsection I because they duplicated parallel provisions contained under Section 17 of the Investment Company Act of 1940 and its rules relating to transactions with affiliated persons and underwriters. Since separate accounts funding scheduled or flexible premium policies will be registered under the Investment Company Act and subject to the SEC’s jurisdiction, the interests of policyholders will be thoroughly and adequately regulated with respect to transactions involving potential conflicts of interests on the part of the separate account, the insurer or any affiliated persons.

The Investment Company Act defines the term “affiliated person” very broadly in the Investment Company Act for purposes of the prohibitions contained in Section 17. Section 17 prohibits an affiliated person or principal underwriter for an investment company from selling securities to, purchasing securities from, or borrowing money or property from the investment company or a company it controls. Section 17(d) also prohibits affiliated persons from engaging in joint transactions with an investment company without first having been granted an order of exemption from the SEC after the SEC has thoroughly scrutinized the transaction and evaluated the basis on which the parties participate. Section 17(e) also prohibits affiliated persons of investment companies from accepting any compensation in connection with the purchase or sale of any property to or for the investment company, except in the course of brokerage transactions. In those events, the broker is prohibited from receiving commissions exceeding usual and customary brokerage commissions or 2% of the sales price in connection with secondary distributions of securities, or 1% of the sale price of other securities.

Similar to a parallel provision eliminated from Subsection I in 1983, Section 17(b) provides a mechanism for registered companies to obtain exemption from the prohibitions of Section 17 for transactions that are reasonable and fair, and do not involve overreaching and that are consistent with the policy of the company as recited in its registration statement. Any such exemptive applications must be publicly noticed in the Federal Register and would permit interested persons, such as policyholders or state insurance commissioners, to request an administrative hearing on the matter.

Subsection J. Investment Advisory Services to a Separate Account

Comment: In most instances the Subcommittee anticipated that investment advice should be performed by the insurer internally in the same manner as fixed benefit life insurance. However, the Subcommittee was aware that a substantial number of insurers might wish to utilize investment advisory services either within or outside their corporate family—hence this subsection was inserted.

It should be noted that a separate account is not a “person” and cannot contract with an investment adviser. Consistent with this philosophy, this subsection has no application to an insurer’s internal investment management. Naturally, the remainder of the regulation including the standards of conduct and conflicts of interest provisions are applicable in the internal management situation (see also comment to Section 6G).

An investment advisory contract must be in writing. The adviser must be either a registered investment adviser under the Investment Advisers Act of 1940, or the insurer must file a statement in compliance with Paragraph (1)(c) of this subsection annually. This report, in effect, requires the adviser to adopt standards of conduct that are sufficient to satisfy Section 6H.

As noted above, while Paragraph (1)(c) is derived from the Investment Advisers Act, Subparagraph (c)(iv)(III) includes an additional statement of any insurance law or regulation violations.

Paragraph (1)(c) does not prohibit employment of persons noted in Subparagraph (c)(iv). However, the insurer would be placed under an extremely heavy burden to demonstrate no hazard to the public.

Paragraph (1)(d) requires an advisory contract to be in writing and terminable by the insurer without penalty on at most 60 days notice.

Under Paragraph (2), the commissioner has the authority after notice and the opportunity for hearing to compel termination of a contract which imperils the public or the policyholder of the insurer (either variable, fixed or both).

A change of investment advisers or the assignment of an advisory contract, would in all probability be a change in investment policy. As a change, it would have to be submitted to and approved by the commissioner pursuant to Section 6F. The continuing supervisory nature of Section 3A and 3B(2) would imply notification of the commissioner of a change in the plan of operation. Thus, the commissioner would have to be notified.

Section 7. Information Furnished to Applicants

Source: Subsections A and B are derived from the addendum to the original NAIC Model Variable Contracts Regulation.

Comment: This section was designed to provide information to a prospective purchaser concerning the operation and performance of a particular policy.

The question of what is adequate disclosure is quite subjective. The primary concern is, of course, that a prospect has enough information to make a reasonably informed judgment as to whether the purchase of a particular policy is consistent with the needs he or she perceives. Another important concern is that the prospective purchaser be able to compare premiums and benefits of various otherwise similar policies.

In view of this there is virtually no limit to the information which could be provided. This was revealed in the approximately 110,000 pages of data produced in the Hart Committee’s inquiry into only a relatively small segment of cost comparison. Submerging the prospective purchaser with information can as a practical matter thwart the purpose of disclosure as well as failing to provide sufficient information. It was felt that at the time of sale the prospect would be overwhelmed with disclosure information required by both the states and the SEC. Therefore, an attempt was made to limit information to that which would perhaps be most understandable and relevant. For example, early drafts of the model regulation required disclosure of the percentage of premiums that made its way into the separate account. It was recognized that this figure was totally unrelated to benefits payable or the relative merits of a particular policy. Therefore, this proposal was deleted.

The question of proper “cost comparison” and disclosure, particularly with regard to variable life insurance, has never been adequately resolved. This complex issue is currently under study in connection with the proposed revision of the NAIC Life Insurance Disclosure (Solicitation) Model Regulation.

The model regulation provides in Section 3F(2) that any information furnished to applicants pursuant to Section 7 be furnished to the commissioner prior to its use in the state in question. Additionally, Section 3 requires a written acknowledgment of receipt by the applicant coincident with or prior to the execution of the application for a variable life insurance policy. The insurer is required to maintain the receipt at least until its examination in order to be able to prove compliance with this section, and probably for a longer period in order to protect itself against claims that the mandates of this section were ignored.

The commissioner will further have the market conduct portion of the examination system as well as the normal complaint mechanism to see that insurers are fulfilling their obligations pursuant to this section.

Failure to comply with this section would subject the insurer to the entire range of remedies available to the commissioner. Furthermore, rescission would presumably be available to the policyholder either as a personal equitable remedy or administratively through the commissioner.

Subsection A was intended to remain flexible and can be utilized to require proper disclosure of significant policy features. However, the commissioner may wish to amend this section to specifically require inclusion of these sections.

Subsection B refers to investment policy. Both the description of investment policy and the restrictions enumerated must, of course, comply with the regulations (see, e.g., Section 4D and E). It will be a significant factor in determining what constitutes a change or material change in investment policy since this description is what a policyholder was entitled to rely upon.

This statement should include, for example, such items as limitations on investments in particular industries as well as the expected diversification of investments allocated to the separate account.

With respect to Subsection C, the net investment referred to will not take into account policy loans if held as an asset of the separate account. It is recognized that the net investment return of the separate account is a figure that is extremely unlikely to apply to any single policy, because of differences in timing of transfers of net premiums and tabular costs of mortality, etc. This figure is intended to provide a useful indication of the general investment performance of the separate account, after deductions, for comparative purposes. It is anticipated that this figure will be shown in the NAIC annual statement and will be computed in accordance with instructions for completing the annual statement. This subsection, as well as Subsection E, does not preclude the use of figures that are not more than 16 months old. Applicants during the first 4 months of a calendar year cannot be expected to receive information for the calendar year just ended less than 4 months ago.

Prior to the 1983 amendments, the subsection required a statement describing, as an approximate percentage of an annual gross premium for each year and for the life of the policy, all commissions or other payments to be paid to all agents or other persons as a result of the proposed sale. This requirement was deleted in the 1983 amendments because it was felt that the disclosure was more likely to be misunderstood than helpful. The purpose of this disclosure was to show the interest of the agent in selling the particular product. However, because commission disclosure was not required for any other form of life insurance, the disclosure provided no basis of comparison between variable life policies and others. Also, as the commentary to the pre-1983 model regulation concedes, meaningful cost comparisons on the basis of commissions are impossible, even if the business methods of insurers were uniformly comparable. To further confuse matters, the pre-1983 model did not require disclosure of sales-related costs other than commissions and conceded that, for example, a direct mail insurer, which might have ample sales expenses but no commissions, would have a distinct advantage in this regard over an insurer doing business in the traditional agency method.

For these reasons, and because projections of this type of disclosure are difficult for flexible premium products, it was determined that it was appropriate to treat variable life insurance like other life insurance and dispense with the commission disclosure.

Prior to the 1983 amendments, the current Subsection D required a statement of the annual taxes, brokerage fees and similar costs, and the charges, expressed as an annual percentage, levied against the separate account during the previous year. The NAIC was concerned that this subsection permitted a negative inference that charges or deductions from the separate account other than those mentioned were not required to be disclosed. Therefore, Subsection D was simplified to require disclosure of all charges levied against the separate account during the previous year. These would include annual taxes, brokerage fees and all other charges.

Subsection F requires a discussion of all material federal income tax aspects of the policy to the insured, the policyholder, and the beneficiary. Prior to the 1983 amendments, only disclosure of the income tax liabilities was required. A discussion of the income tax liabilities will be subsumed in a more comprehensive discussion of the policy's tax aspects.

The subsection refers to the federal income tax aspects relative to persons insured, policyholders and beneficiaries in general and not to particular specific circumstances of each insured, etc. Opinions of counsel, if necessary in the absence of specific rulings, should be labeled accordingly.

Subsection G refers to illustrations of benefits payable under variable life insurance contracts. Prior to 1983, this section did not require the furnishing of illustrations, but merely regulated their format and content in the event they were furnished. However, since the 1983 amendments deleted the requirement that variable life insurance policies contain schedules of cash values (see comment to Section 4D(16)), the illustrations specified in this subsection were made mandatory, thereby ensuring that policyholders will receive an illustrative explanation of the way in which a policy operated under certain assumptions. The NAIC recommends that guidelines be developed as soon as possible to assist states in administering this provision and to address issues regarding guaranteed and non-guaranteed aspects of a variable life insurance policy. This subsection prohibits the projections of past investment performance into the future, or any predictions of future performance. However, past performance can be shown with appropriate caveats. The Subcommittee specifically requires all benefit illustrations to be prepared by the insurer in order that they take full responsibility and to preclude unfair, or inexact, off-the-cuff illustrations prepared at the point of sale. This subsection does require a clear identification of hypothetical rates and an indication that they are unrelated to actual performance. While no single commissioner would have the power to require uniformity in hypothetical rates of return nationwide, he or she certainly would require all the information provided to all applicants in his or her state to be identical, thereby as a practical matter allowing comparison.

Prior to the 1983 amendments, the subsection required a prominent statement in contrasting color or in bold-faced type at least 4 points larger than the type size of the largest type used in the text of any provision on the page, providing:

“The purpose of this variable life insurance policy is to provide insurance protection for the named beneficiary.

No claim is made that this variable life insurance policy is in any way similar or comparable to a systematic investment plan of a mutual fund.”

These required disclosures were originally included in the regulation as part of the effort to assure that variable life insurance would be considered to be insurance not involving an investment company subject to SEC regulation. Because the insurance and securities aspects of products are now determined on the basis of the characteristics of each product, it was determined to delete these paragraphs. The first required statement is self-evident and the second statement may not be accurate in the context of certain policy designs.

Section 8. Applications

Comment: Subsections A and B should be read with reference to the comments to Section 4D(1)(a) and (b). Subsection C is referred to in the comment to Section 3C.

Section 9. Report to Policyholders

Comment: The paramount objective of Section 9 is to provide a policyholder with thorough disclosure concerning the operation of his or her variable life insurance policy and with current, reliable information concerning the status of insurance coverage. In accordance with this objective, the 1983 amendments to Section 9 expanded the information that must be included in an annual report in the case of flexible premium policies (Subsection A) and, in Section C, required insurers to provide policyholders of flexible premium policies with notice of impending expiration coverage. These amendments were both designed to alert the policyholder to the possible insufficiency of the amounts available under the policy to keep the policy in force and the corresponding need to make additional premium payments.

Subsection A. Long-range Warning Notice

Comment: In 1983, Subsection A was amended to provide the policyholder of a flexible premium variable life insurance policy with a long-range warning that his or her policy may terminate without value if additional premium is not paid. In addition to setting forth information concerning changes in the policy's cash value and cash surrender value during the preceding policy year, the expanded annual report must also contain a projection, based upon specified assumptions, of cash value and cash surrender value as of the next policy anniversary. If the projected value is less than zero, the annual report must include a warning message stating that the flexible premium policy “may be in danger of terminating without value in the next 12 months unless additional premium is paid.” In order that the long-range warning notice is not misunderstood, insurers may wish to indicate that notification provided pursuant to this section is based on certain assumptions and is a projection, which should not be construed as a guarantee.

Subsection C. Notice of Impending Expiration of Coverage

Comment: Although the long-range warning notice required by Subsection A provides the policyholder with important information concerning the *possibility* that the amounts available under the policy will be insufficient to keep the policy in force, the model recognizes the need for an additional immediate notice if the amounts available under the policy are in fact insufficient to keep the policy in effect without payment of additional premium. Accordingly, as mentioned above in the commentary to Sections 2 and 4, Subsection C requires that the insurer send a report to the policyholder in the event that “the amounts available under the policy on any policy processing day to pay the charges authorized by the policy are less than the amount necessary to keep the policy in force until the next following policy processing day.” The mailing of this report triggers the 61-day grace period for flexible premium policies (Section 4D(2)(b)). Subsection C requires that the report indicate the minimum payment required under the terms of the policy to keep it in force until the next following policy processing day. Thus, the policyholder is provided with prompt notice of the possible impending expiration of his or her coverage and of the correlative need to take immediate action to assure that the policy continues in effect. At the time the 1983 amendments were adopted, consideration was given to extending the Subsection C notice requirement to scheduled premium policies. Concern was expressed that future scheduled premium policy designs might be such that similar problems with the sufficiency of funds available to keep a policy in effect might result. Ultimately, Subsection C was not extended to scheduled premium policies because an insufficiency of funds resulting from a policy loan under a scheduled premium policy would trigger the 31-day notice provision of Section 4E(5). Only a scheduled premium policy that is actuarially unsound from the outset could otherwise present such a problem.

Other Aspects of Section 9

Comment: The 1983 amendments implemented several additional revisions to Section 9. In Subsection A, the requirement that the information contained in annual reports to policyholders be computed as of 45 days prior to mailing was changed to 60 days to be consistent with the corresponding time period under current SEC regulations. See 17 C.F.R. § 230.486. The portion of Subsection A that required the use of contrasting color or distinctive type to highlight the variable nature of the cash value and death benefit was deleted on the rationale that the principal function of a policyholder report, unlike a policy application, is to report information, and that Section 8 already requires that an applicant for a variable life insurance policy be provided with a prominent statement of this same information. In addition, requiring that printing be done in contrasting color imposes an unnecessary additional expense.

The required contents of the annual statement contemplated by Section 9B were also amended in 1983. First, Subsection B(2) was amended to permit an insurer, as a matter of state law, to furnish comparison of the investment rate of the separate account for more than a 5-year period. In addition, the requirement embodied in previous subsections (f) and (g) that the statement include information concerning the insurer’s principal executive officer, directors, parent companies and 10% beneficial owners was deleted, on the rationale that this information will normally be provided to the policyholder pursuant to the federal securities laws. In addition, this information is not directly relevant to the more material information contained in the report concerning the policyholder’s status with regard to his or her policy. Finally, a conforming amendment was made in Subsection B(4) to be consistent with the deletion of the limitations on the types of charges that may be levied against the separate account (see Section 6G and 7D).

Unlike Section 7, this section would not be satisfied by delivery of a document meeting the requirements of the Securities Act of 1933 or the Securities Exchange Act of 1934, but rather requires separate notice.

Subsection B(1) requires a summary of the financial statements of the separate account based on the annual statement last filed with the commissioner. In reality, the separate account not being an entity, has no financial statement. The assets allocated to the separate account form an integral part of the insurer’s annual statement and a summary of that, including separate account information, is what is required by this subsection.

Section 10. Foreign Companies

Section 10 was added and the remaining articles renumbered by 1978 *Proceedings of the NAIC I*.

Section 11. Qualifications of Agents for the Sale of Variable Life Insurance

Source: Subsections A(1), B and C are derived from Article IX of the Model Variable Contracts Regulation.

Comment: The present division of regulatory authority over variable life insurance between the state insurance departments and the Securities and Exchange Commission has resulted in the potential dual licensing of salesmen. The states developed, for variable annuities, a special variable contract agent license which required licensing as a life insurance agent plus successful completion of a variable contracts exam given by the insurance department, plus ownership of a federal securities sales license. An alternative manner of obtaining the latter was successful completion of a federal securities examination administered by the insurance departments, developed by the NAIC, and approved by the SEC. A few years ago, the NAIC withdrew from participation in this examination procedure. Thus, at present, only a federal securities examination administered by a securities regulatory body will satisfy step 3 noted above.

Whether they are selling variable life insurance or competing against it, life insurance agents must know how variable contracts work and how they are regulated. In order to assure that they have the required knowledge, the Subcommittee believed all life agents and brokers should be examined on variable contracts just as they are examined on aspects of traditional life insurance and its regulation. The model regulation reflects this position, as does the NAIC Agents and Brokers' Licensing Model Act.

Subsection A(1) requires a person to be licensed as an agent in order to be eligible to sell variable life insurance to the public (see Section 2B). The person must provide satisfactory evidence that he or she holds any securities license that may be required for the sale of variable life insurance.

Subsection A(2) reflects the single life insurance agent licensing approach.

Subsection B requires that an agent report to the insurance commissioner any disciplinary actions against him or her by other insurance departments or by securities exchanges, associations or regulators. Upon receipt of such notification, the commissioner may find the agent ineligible for further licensing as a life insurance agent or unqualified as a variable contract agent, or the commissioner may investigate for similar violations by the agent in that state for which further disciplinary action or remedial action is needed (see Section 10C).

The difficulty with this scheme is the need for an independent source of information for the commissioners. Obviously, it is somewhat unrealistic to expect all agents to report disciplinary actions against themselves. With regard to disciplinary actions by insurance departments, an independent source is available through the monthly NAIC Agents List. The Subcommittee recommends that each state religiously report disciplinary actions through this system and utilize the resulting national monthly list.

Subsection C applies the rules and regulations applicable to fixed benefit licensing, revocations, suspensions, etc. to variable life insurance.