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17 CFR Part 270

[Release No. IC-13632; S7-1004]

Request for Comments on Issues Arising Under the Investment Company Act of 1940 Relating to Flexible Premium Variable Life Insurance

AGENCY: Securities and Exchange Commission.

ACTION: Request for written comments.

SUMMARY: The Commission is requesting written comments on issues raised by a petition for rulemaking relating to a new type of insurance product known as flexible premium variable life insurance. Petitioner, an insurance industry representative, has asked that the Commission adopt a rule which would exempt separate accounts offering this product from various provisions of the Investment Company Act of 1940. To aid public discussion of the issues raised under the Act, the Commission is publishing petitioner's suggested exemptive rule. However, the Commission takes no position on the merits of the suggested rule.

DATE: Comments must be received on or before February 14, 1984.

ADDRESSES: All communications on this matter should be sent, in triplicate, to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. Such communications should refer to File No. S7-1004 and will be available for public inspection at the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Thomas P. Lemke, Special Counsel (202) 272-2061, or Jay S. Neuman, Attorney (202) 272-2067, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: On June 29, 1983, as supplemented on September 15, 1983, the Commission received a rulemaking petition (File No. 4-225) [1]

[1] The petition was submitted under section 553(e) of the Administrative Procedure Act (5 U.S.C. 553(e)) ("APA") and rule 4(a) of the Commission's Rules of Practice (17 CFR 201.4(a)).

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from the American Council of Life Insurance ("ACLI" or "Petitioner") [2] relating to flexible premium variable life insurance ("flexible life"). Flexible life is a new type of life insurance product that will be funded by separate accounts and will provide for flexible premiums and death benefits. The petition urges the Commission to adopt the suggested rule,[3] as a companion to rule 6e-2 [17 CFR 270.6e-2] under the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] ("Act"). Rule 6e-2 provides exemptive relief for separate accounts offering traditional scheduled premium variable life insurance ("traditional variable life").[4]

I. Petitioner's Suggested Exemptive Rule

Petitioner's rule would provide extensive exemptions from various provisions of the Act and the rules thereunder to any insurance company separate account offering flexible life. The relief also would be available to the investment adviser, principal underwriter, and depositor for the separate account. Similar to rule 6e-2 for traditional variable life,[5] the suggested rule would provide conditional exemptions from the following provisions of the Act:

(1) Section 9(a) [15 U.S.C. 80a-9(a)], which makes certain persons ineligible to serve in certain capacities with a registered investment company. Like Rule 6e-2, the suggested rule would limit these restrictions to life insurer personnel participating directly in variable life transactions and operations;

(2) Sections 13(a) and 15 (a), (b), and (c) [15 U.S.C. 80a-13(a) and 80a-15(a), 80a-5(b), and 80a-15(c)], which provides for shareholder authorization for changes in an investment company's investment policies, investment adviser, or principal underwriter, to permit some such changes to be made or disapproved by the life insurer of by state insurance authorities. These exemptions are intended to assure the solvency of the life insurers and preformance of its contractual obligations by enabling it or an insurance regulatory authority to act when certain shareholder proposals reasonably could be expected to increase the life insurer's risks;

(3) Section 14(a) [15 U.S.C. 80a-14(a)], which generally requires minimum initial funding for investment companies. This relief is conditioned on the sponsoring life insurer meeting certain capital and surplus requirements;

(4) Section 15(a), 16(a), [15 U.S.C. 80a-16(a)] and 32(a) [15 U.S.C. 80a-31(a)], which require, among other things, an investment company's initial shareholders to approve its investment advisory agreement; elect a board of directors; and ratify the selection of an independent public accountant. These exemptions recognize that the exemption from section 14(a) would leave the investment company without initial shareholders who could vote upon these matters, and provide for shareholder votes at the first shareholders' meeting following the effective date of the flexible life registration statement;

(5) Section 17(f) [15 U.S.C. 80a-17(f)], which limits the types of persons who may have custody of the securities and similiar investments of a management investment company, to allow the life insurer to act as custodian under certain conditions. In addition, the suggested rule would permit custodianship by the life insurer in reliance on the provisions of rule 17f-2 [17 CFR 270.17f-2], modified as necessary for compliance with applicable insurance laws and regulations or with established procedures of the life insurer. This would permit, for example, officers or employees of the lifer insurer (rather than of the investment company) to have access to the assets and would permit verification of the assets by an independent public accountant retained by the life insurer (rather than by the investment company);

(6) Section 18(i) [15 U.S.C. 80a-18(i)], which requires that every share of stock issued by a management investment company be voting stock and have voting rights equal with every other voting stock, to permit allocation of votes on the basis of cash value of flexible life contracts, and to permit the actions contemplated by the exemption from sections 13(a) and 15 (a), (b), and (c) described above;

(7) Section 19 [15 U.S.C. 80a-19], which governs dividend payments by investment companies, in recognition of the fact that "participating" variable life contracts will not pay "dividends" in the sense in which this term is used in this section;

(8) Sections 22(d) [15 U.S.C. 80a-22(d)], 22(e) [15 U.S.C. 80a-22(e)], 27(c)(1) [15 U.S.C. 80a-27(c)(1)], and rule 22c-1 [17 CFR 270.22c-1], which generally concern the pricing and redemption rights of "redeemable securities," to accommodate the traditional manner in which life insurance premiums are calculated and benefits are determined and other aspects preculiar to life insurance contracts, such as policy loans and transfers of premiums. In this regard, the suggested rule would differ from rule 6e-2 to reflect changes in rule 22c-1, and to accommodate arrangements where deductions from a policy's cash value (*e.g.*, to pay costs of insurance benefits and administrative expenses) are not made on a daily basis. In addition, because death benefits might not vary daily under certain flexible life options, the suggested rule would eliminate the need to calculate death benefits on such days; and

(9) Section 27 [15 U.S.C. 80a-27], which prescribes various requirements applicable to periodic payment plan certificates relating to the amount and manner of imposing sales load, refund rights, redeemability, and custodianship of payments for such certificates.

The suggested rule also would provide exemptive relief not fund in rule 6e-2. Most significant is the proposed exemption from the requirement of section 27 of the Act that sales load on a flexible life policy not exceed nine percent of premium payments to be made thereon. Petitioner states that because a flexible life policy generally will not require scheduled premium payments, this additional relief is necessary in order to permit insurance companies to demonstrate compliance with the sales load requirements of section 27 on a prospective basis.

The suggested rule keys this aditional exemptive relief to a "guideline annual premium." This concept is defined as the level annual premium, payable to the highest attained age at which a premium may be paid, that would provide the future benefits under the policy based on (i) the 1958 Commissioners' Standard Ordinary Mortality Table, (ii) an assumed interest rate of four percent, and (iii) the expenses specified in the policy.[6] In short, Petitioner states, the guideline annual premium equals the annual premium necessary to keep the policy in force for the life of the insured. The suggested rule provides relief generally if the sales load charged does not exceed nine percent of the sum of the guideline annual premiums payable during the policy period (which is the lesser of twenty years or the insured's actuarially determined life expectancy).

The ability of a flexible life policyholder to increase the level of insurance benefits provided by an existing policy, a feature not found in a traditional variable life policy, also raises questions of compliance with the sales load requirements of section 27. The suggested rule affords relief from section 27 in this context provided generally that the sales load charged on any increase does not exceed the amount of sales load that could have been charged had the policyholder

[2] Petitioner states that it is the principal trade association for life insurance companies and has a membership of 573 stock and mutual life insurers representing approximately 95 percent of the assets of all United States life insurance companies.

[3] Petitioner states that the Commission's authority to adopt an exemptive rule is found primarily in section 6(c) of the Act [15 U.S.C. 80a-6(c)], and also section 6(e) and 38(a) of the Act [15 U.S.C. 80a-6(e) and 80a-37(a)].

[4] Traditional variable life policies are scheduled (*i.e.*, fixed) premium policies that guarantee a minimum death benefit but, unlike conventional whole life insurance, also provide for a variable death benefit (in excess of the guaranteed minimum) and cash value that reflect the investment experience of one or more segregated asset accounts or "separate accounts" of the sponsoring insurance company.

[5] The releases proposing and adopting rule 6e-2 (Investment Company Act Rel. Nos. 9104 (Dec. 30, 1975) [41 FR 2256, Jan. 15, 1976] and 9482 (Oct. 18, 1976) [41 FR 47023, Oct. 27, 1976], respectively) discuss in detail the exemptions provided.

[6] Petitioner states that the guideline annual premium concept is derived from section 101(f) of the Internal Revenue Code [I.R.C. § 101(f) (1982)] relating to exclusion from gross income of the proceeds of a flexible life policy payable by reason of death.

instead been required to purchase a second policy in order to obtain the increased insurance benefits.

Petitioner states that adoption of the suggested rule is the best way to resolve the questions which this new product raises under the Act, and argues that adoption of the rule, as in the case of rule 6e-2, is consistent with the statutory standards set forth in section 6(c) of the Act.

II. The Commission's Decision to Request Public Comment and Publish Petitioner's Suggested Exemptive Rule

The Commission has decided to ask for public comment on the issues arising under the Act relating to flexible life. Since these issues are complex and the Commission has not yet had experience with this product through processing registration statements filed under the Securities Act of 1933 [15 U.S.C. 77a et seq.] or exemptive applications filed under the Act, the Commission is seeking input from those persons most familiar with and most likely to be affected by Commission action relating to flexible life. In order to aid public discussion of these issues, the Commission is publishing the ACLI's suggested rule and the ACLI's memoranda discussing it.[7] These documents reflect extensive insurance industry consideration of the issues, and may help the public in considering the issues raised by flexible life. Commenters should note, however, that in publishing Petitioner's rule, the Commission expressly takes no position either as to the need for or appropriateness of adopting Petitioner's rule or any other exemptive rule in his area.[8]

[7] The suggested rule and supporting memoranda, along with the text of a suggested rule under section 6(c) of the Act that is similar to rule 6c-3 [17 CFR 270.6c-3] for traditional variable life, are attached to this release (the suggested rule and supporting memorandum filed on June 29, 1983 are Attachment A; the supplemental rule and memorandum filed on September 15, 1983 are Attachment B). In addition to these documents, the ACLI's petition includes six appendices containing: (1) a copy of the National Association of Insurance Commissioners' Variable Life Insurance Model Regulation and Commentary; (2) an illustration of the death benefits options under flexible life; (3) a discussion of the definition of sales load under the suggested rule; (4) a demonstration of compliance with the suggested rule's test for sales loads other than front-end sales loads; (5) an illustration of the proposed test for sales load on or after increases in or additions of insurance benefits; and (6) formulas for calculations shown in certain of the appendices. These latter documents are available for public inspection in, or upon request from, the Commission's Public Reference Room.

[8] In addition, the Commission's action should not be interpreted as expressing any views on the status under the federal securities laws of any other products offered by insurance companies.

Following the comment period, the Commission may take any of several actions, including, (1) adoption of the suggested rule or a modified version of it, with or without further opportunity for comment; (2) proposal of a new rule for flexible life; (3) proposal of amendments to rule 6e-2 in order to accommodate flexible life; or (4) deciding to address flexible life issues by other means (*e.g.,* suggesting that potential flexible life issuers file individual exemptive applications or holding public hearings on flexible life prior to taking action).

III. Request for Written Comments

The Commission invites all interested persons to submit comments on how the issues under the Act raised by this new product should be resolved. In particular, comments are requested on the following questions:

(1) Should the Commission adopt an exemptive rule under the Act? If not, what alternative approach should be used and why?

(2) Assuming an exemptive rule is needed,

(a) Will the suggested rule permit a flexible life policy to be offered, and, if not, what additional relief is necessary?

(b) Would it be feasible to offer a flexible life policy with less extensive relief and, if so, what changes could be made in the suggested rule?

(c) Are there any recommended changes in the language of the suggested rule?

(3) As discussed above, Petitioner asserts that the guideline annual premium concept is the best way to resolve the novel questions concerning sales load and section 27 of the Act which this new product raises.

(a) Is this approach appropriate?

(b) Are there any feasible alternatives to this approach? Written statements must be received on or before February 14, 1984, and should be submitted in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, D.C. 20549. Such communications should refer to File No. S7-1004 and will be available for public inspection.

Regulatory Flexibility Act Certification

As noted above, one option reserved by the Commission is to adopt Petitioner's suggested rule, or an amended version thereof, without further opportunity for comment. Under these circumstances, the Commission's action may be deemed to be proposed rulemaking under this Act. Therefore, the Chairman of the Commission, pursuant to section 605(b) of the Regulatory Flexibility Act [5 U.S.C. 605(b)], has certified that petitioner's suggested rule, if it were adopted, would not have a significant economic impact on a substantial number of small entities. This certification, including the reasons therefor, is attached to this release.

Paper Reduction Act: The proposed action is not subject to this Act.

Statutory Authority

The instant action is being taken pursuant to the provisions of sections 6(c), 6(e), and 38(a) of the Act [15 U.S.C. 80a-6(c), 80a-6(e), and 80a-37(a), respectively].

List of Subjects in 17 CFR Part 270

Investment companies, Reporting and recordkeeping requirements, Securities.

By the Commission.

George A. Fitzsimmons,

Secretary.

November 23, 1983.

Regulatory Flexibility Act Certification

I, John S. R. Shad, Chairman of the Securities and Exchange Commission, hereby certify pursuant to 5 U.S.C. 605(b) that Petitioner's suggested rule under the Investment Company Act of 1940, if it were adopted by the Commission, would not have a significant economic impact on a substantial number of "small entities," as that term has been defined under the Commission's rules. I base this certification on the ground that the suggested rule, if adopted, would not affect a substantial number of small entities. Although the number and asset size of entities that will offer this new product is not knowable at this time, the Commission believes it probable that flexible life issuers most likely will be issuers of another type of registrable insurance product known as variable annuity contracts. In this regard, it has been the Commission's experience with variable annuity issuers that few, if any, qualify as small entities for purposes of the Act.

Dated: November 23, 1983.

John S. R. Shad

JUNE 29, 1983 PETITION

Table of Contents

I. Interest of Petitioner
II. Statutory Authority
A. Right to Petition
B. Rulemaking Authority
C. Rulemaking Format
III. Reasons for the Proposed Rule
A. Background
1. Scheduled Premium Variable Life Insurance
2. Universal Life Insurance
B. Flexible Premium Variable Life Insurance
1. Benefits
2. Premiums
3. Nonforfeiture Values

https://www.loc.gov/item/fr048231/

4. Sales Loads and Commissions
5. Other Provisions
C. Basis for Exemption from the 1940 Act
IV. Analysis of Proposed Exemptions from the 1940 Act
A. Definition of Flexible Premium Variable Life Insurance Separate Account and Policy
1. The Separate Account
2. The Policy
B. Sales Load Provisions
1. Definition of Sales Load
2. Front-End Sales Loads—Relief from Sections 27(a)(1), 27(h)(1), and 27(h)(4)
3. Front-End Sales Loads—Relief from Sections 27(a)(3) and 27(h)(3)
4. Front-End Sales Loads—Relief from Section 27(d)
5. Sales Loads other than Front-End Loads
6. Sales Loads in the event of Adjustments in Face Amount
7. Relief from Sections 27(c)(1), 27(d), and 2(a) (32)
8. Relief from Section 27(e), Rule 27e-1, Section 27(f), and Rule 27f-1
C. Other Provisions
1. Custodial Provisions
2. Pricing Provisions
3. Shared Funds
4. Definitions
D. Rule 6c-3
V. Text of Proposed Rule under Section 6(e)
VI. Text of Proposed Rule under Section 6(c)
VII. Conclusion
Appendix A—Variable Life Insurance Model Regulation and Commentary
Appendix B—Death Benefit Options
Appendix C—Operation of the Definition of Sales Load
Appendix D—Demonstration of Compliance with Proposed Test for Sales Loads other than Front-End Loads

Petition for Issuance of Rules and Rulemaking Proceeding Therefore

I. Interest of Petitioner

This petition for the issuance of rules and for a rulemaking proceeding therefore is submitted by the American Council of Life Insurance (hereinafter referred to as "Petitioner"). Petitioner is the principal trade association for life insurance companies and has a membership of 573 stock and mutual insurers. These companies represent approximately 95 percent of the assets of all United States life insurance companies. This petition reflects the joint efforts of the Council and the law firm of Sutherland, Asbill & Brennan.

The exemptive rule proposed in this petition is of substantial interest and importance to Petitioner and its member companies. The life insurance industry has expended considerable effort to develop and market flexible premium variable life insurance—a new life insurance product which should prove exceptionally beneficial to consumers. Accommodation of flexible premium variable life insurance under the Investment Company Act of 1940 is the final issue to be resolved before companies begin issuing these new policies.

This petition sets forth a rule which Petitioner believes will effectively achieve such accommodation. The rule maintains basic investor protections, but also recognizes the unprecedented qualities of flexible premium variable life insurance and provides the specific relief necessary to make this new form of life insurance viable. Petitioner, on behalf of the life insurance industry, urges prompt adoption of the rule to serve the interests of the insurance industry and insurance consumers alike.

II. Statutory Authority

Petitioner, on behalf of itself and its member life insurance companies, respectfully petitions the Securities and Exchange Commission (the "Commission"), pursuant to Section 553(e) of the Administrative Procedure Act and Rule 4(a) of the Rules of Practice of the Commission, for the issuance of an exemptive rule and for a rulemaking proceeding therefore in respect of flexible premium variable life insurance separate account contracts. The statutory authority for this Premium and for the Commission's issuance of an exemptive rule is as follows:

A. Right to Petition

Section 553(e) of the Administrative Procedure Act provides:

> Each agency shall give an interested person the right to petition for the issuance, amendment, or repeal of a rule.
>
> (5 U.S.C. 553(e) (1976))

Rule 4(a) of the Rules of Practice of the Commission provide:

> Any person desiring the issuance, amendment or repeal of a rule of general application may file a petition therefor with the Secretary of the Commission. Such petition shall include a statement setting forth the text or the substance of any proposed rule or amendment desired or specifying the rule the repeal of which is desired and stating the nature of his interest and his reasons for seeking the issuance, amendment or repeal of the rule. The Secretary shall acknowledge receipt of the petition and refer it to the appropriate Division or Office for consideration and recommendation * * *. The Secretary shall notify the petitioner of the action taken by the Commission.
>
> 17 CFR 201.4 (1982).

B. Rulemaking Authority

Section 38(a) of the Investment Company Act of 1940 provides:

> The Commission shall have authority from time to time to make, issue, amend, and rescind such rules and regulations and such orders as are necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in this subchapter, including rules and regulations defining accounting, technical, and trade terms used in this subchapter * * *. For the purposes of its rules or regulations the Commission may classify persons, securities, and other matters within its jurisdiction and prescribe different requirements for different classes of persons, securities, or matters.
>
> (15 U.S.C. 80a-37(a) (1976))

Section 6(c) of the Investment Company Act of 1940 further provides:

> The Commission, by rules and regulations upon its own motion, or by order upon application, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this subchapter or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.
>
> (15 U.S.C. 80a-6(c) (1976))

Section 6(e) of the Investment Company Act of 1940 provides:

> If, in connection with any rule, regulation, or order under this section exempting any investment company from any provision of section 80a-7 of this title, the Commission deems it necessary or appropriate in the public interest or for the protection of investors that certain specified provisions of this subchapter pertaining to registered investment companies shall be applicable in respect of such company, the provisions so specified shall apply to such company, and to other persons in their transactions and relations with such company, as though such company were a registered investment company.
>
> (15 U.S.C. 80a-6(e) (1976))

C. Rulemaking Format

Section 553(b) of the Administrative Procedures Act provides:

> General notice of proposed rule making shall be published in the **Federal Register**, unless persons subject thereto are named ana either personally served or otherwise have actual notice thereof in accordance with law. The notice shall include—
>
> (1) a statment of the time, place, and nature of public rule making proceedings;
>
> (21) reference to the legal authority under which the rule is proposed; and
>
> (3) either the terms or substance of the proposed rule or a description of the subjects and issues involved.
>
> (5 U.S.C. 553(b) (1976). *Accord*, 17 CFR § 201.4 (b) (1982))

Section 553(c) of the Administrative Procedure Act further provides:

> After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for

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oral presentation. After consideration of the relevant matter presented, the agency shall incorporate in the rules adopted a concise general statement of their basis and purpose. (5 U.S.C. 553(c) (1976))

III. Reasons for the Proposed Rule

A. Background

During the last ten years, the life insurance industry has developed policies which provide the pooling of risks and losses necessary to life insurance but which differ from conventional whole life policies in various ways. There have been two major developments in this ongoing process which are relevant to flexible premium variable life insurance. One development was scheduled premium variable life insurance, which was the first whole life insurance product to be funded by a separate account. The second development was universal life insurance, a whole life product that provides for guaranteed policy values but at the same time affords policyholders the right independently to adjust premium and insurance benefits.

1. *Scheduled Premium Variable Life Insurance*

The variable life insurance policies developed and marketed to date generally might be described as scheduled (*i.e.*, fixed) premium policies that guarantee a minimum death benefit but, unlike conventional whole life insurance, also provide for a variable death benefit and cash value that reflect the investment experience of one or more segregated asset accounts or "separate accounts" of the insurance company. In this sense these policies represents the separate account version of conventional fixed premium whole life insurance with guaranteed values written out of the insurer's general account for many years.

The introduction of scheduled premium variable life insurance marked the first instance in which life insurance companies offered life insurance policies subject to the federal securities laws, particularly the 1940 Act. In late 1970, the industry approached the Commission and asserted that scheduled premium variable life insurance was not subject to the federal securities laws, although certain exemptive relief was sought to resolve any uncertainties about their application not these products. The Commission engaged in a lengthy examination of scheduled premium variable life insurance and took the position that the product would be sold primarily for its nonguaranteed cash values. Accordingly, in 1973 the Commission concluded that such policies are securities subject to registration for purposes of the Securities Act of 1933, that persons selling such policies are broker-dealers for purposes of the Securities Exchange Act of 1934, that separate accounts funding such products are investment companies subject to registration for purposes of the 1940 Act, and that persons rendering investment advice to such separate accounts are investment advisers for purposes of the Investment Advisers Act of 1940. *See* Securities Act Rel. No. 5360, Securities Exchange Act Rel. No. 9972, Investment Company Act Rel. No. 7644, Investment Advisers Act Rel. No. 359, 1 SEC Docket 1 (January 31, 1973). It was also concluded that scheduled premium variable life insurance policies are "periodic payment plan certificates" within the meaning of Section 2(a)(27) of the 1940 Act. *See* SEC Division of Investment Management Regulation, Variable Life Insurance and the Petition for Issuance and Amendment of Exemptive Rules 128–129 (January 30, 1973) (herinafter cited as "1973 Division Report"). Although the Commission simultaneously adopted Investment Company Act Rule 3c–4 and Investment Advisers Act Rule 202–1, providing complete exemptions from those acts with respect to scheduled premium variable life insurance policies meeting certain requirements, it ultimately rescinded those rules. *See* Investment Company Act Rel. No. 8826, Investment Advisers Act Rel. No. 463, 7 SEC Docket 221 (June 18, 1975). Instead, in October 1976, almost six years after the industry's initial submission to the Commission, Rule 6e–2 was adopted, providing conditional relief from specific provisions of the 1940 Act. *See* Investment Company Rel. No. 9482, 10 SEC Docket 751 (October 18, 1976).

2. *Universal Life Insurance*

The design of general account whole life policies also has evolved significantly in the last decade. In particular, since the advent of scheduled premium variable life insurance, more than 100 companies have introduced policies commonly known as universal life insurance. These policies provide for guaranteed policy values and for the pooling of risks and losses characteristic of conventional whole life insurance. They also, however, typically permit the policyholder to change the amount and timing of the premiums and (provided that underwriting requirements are met) the size of the death benefit as the policyholder's needs change. Universal life insurance policies are treated as life insurance policies for purposes of state insurance law and the Internal Revenue Code.

B. Flexible Premium Variable Life Insurance

Life insurance companies are now anxious to market flexible premium variable life insurance, which is a new class of variable life insurance policy funded by separate accounts *and* providing for flexible premiums and death benefits. These policies will combine certain characteristics of existing variable life policies (notably, a death benefit and cash value that may vary in certain respects to reflect the investment performance of a separate account) and existing universal life policies (notably, unscheduled premium payments and death benefits that may be adjusted by the policyholder). Accordingly, under this product design each individual policyholder can purchase a single policy, obtain an immediate insurance benefit many times in excess of the premium payment, and thereafter independently adapt premium payments and the level of death benefit to individual insurance needs as economic conditions and personal circumstances change. The policyholder also may participate in the investment perfomance of a separate account. In short, just as universal life insurance is an evolutionary form of conventional whole life insurance, flexible premium variable life insurance will be a further evolution of scheduled premium variable life insurance, modified to provide for the policyholder's adjustment of premiums and death benefits.

The combination of these fundamental characteristics in flexible premium variable life insurance is unprecedented and will provide unique benefits for consumers. Policyholders may, at their discretion and subject only to the insurer's underwriting rules, significantly adjust the insurance benefits under such a policy by changing the face amount of insurance and the pattern of premium payments. In addition, policyholders generally will not be constrained by schedules imposed by the insurance company regarding the timing or amount of payments. So long as the cash value of the policy is sufficient to meet current charges, policyholders will be free to adjust their premium payment pattern. Policy lapsation will not be linked to the nonpayment of a premium scheduled by the insurance company. These features will be offered in a policy under which the cash value and, indirectly, the death benefits reflect the investment earnings of one or more separate accounts. Finally, policyholders usually will realize greater convenience and cost

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savings by avoiding the need to purchase and maintain a new policy each time their insurance needs change. Thus, flexible premium variable life policies will offer policyholders an unmatched combination of insurance, convenience, economy, adjustability, and investment participation, and should prove to be exceptionally beneficial for consumers.

No flexible premium variable life insurance policies have been written at this time (primarily because of the need to accommodate state and federal law). The features of such policies, however, will be substantially shaped by state insurance laws and regulations and the applicable provisions of the Internal Revenue Code (in addition to the 1940 Act).

Flexible premium variable life insurance policies, like all insurance policies, will be subject to extensive regulation by state insurance commissioners. In particular, such policies will be required to conform to state insurance laws and applicable regulations. The Variable Life Insurance Model Regulation was amended by the National Association of Insurance Commissioners ("the NAIC") in December 1982 specifically to allow flexible premium variable life insurance. (A copy of the Model Regulation as amended, with commentary, is attached as Appendix A.) States are now in the process of considering and adopting the amended Model Regulation.[1] The Model Regulation, as amended, regulates the qualification of an insurer to issue fixed or flexible premium variable life insurance; insurance policy requirements (including mandatory benefit, design, and policy provision requirements); reserve liabilities; separate accounts; and policyholder disclosures, applications, and reports.

Similarly, it can be expected that most if not all policies will be designed to satisfy any applicable requirements of the Internal Revenue Code. These requirements currently are contained in Section 101(f), which generally should be applicable to flexible premium variable life insurance.

The feature common to all flexible premium variable life insurance policies will be adjustability of premium payments. Other features may vary from company to company. It is anticipated that, except for the nonguaranteed nature of the cash value benefits, most policies will be similar in design to existing universal life policies (although such similarity is not necessary and some flexible premium variable life policies may also resemble to some degree scheduled premium variable life policies). Flexible premium variable life insurance modeled on universal life insurance is expected to typically have the following features.

1. *Benefits*

Flexible premium variable life insurance, like conventional whole life insurance and scheduled premium variable life insurance, will provide an immediate death benefit many times the amount of the initial premium paid.[2] Upon payment of the first premium, the policyholder immediately will receive the full measure of death protection for which he or she has contracted. The death benefits will be payable in full so long as the policy remains in force,[3] without regard to the total amount of premiums paid *or* the pattern of those premium payments.

The death benefit payable while the policy remains in force will never be less than the face amount of the policy. The policyowner typically will be able to increase or decrease the face amount of the policy, subject to evidence of current insurability if the change entails an increase in the net amount at risk. Policies usually will prescribe a minimum face amount, however.

Flexible premium variable life insurance, like scheduled premium variable life insurance, will differ from traditional whole life insurance in that the amount of the death benefit may depend on separate account investment performance. Under existing variable life policies, the death benefit may increase or decrease in a manner determined by the insurer depending on the investment experience of the separate account relative to the assumed investment rate. The precise consequences of investment experience depend on the design utilized by the insurance company—*e.g.*, the "Equitable," the "New York Life," or some other design.

In contrast, under a flexible premium variable life insurance policy, the policyholder generally will have the right to elect one of two options set forth in the policy for calculating the amount of the death benefit. Under the first option, the death benefit will equal the face amount of the policy, or, if greater, the cash value plus a pure risk amount (either a specified amount or a specified percentage of the cash value, or, in some instances, the greater of the two). Under the second option, the death benefit will equal the face amount of the policy *plus* the cash value. Under this option some poicies may specify that the benefit payable must not be less than a minimum percentage of cash value. The policyholder may have the right from time to time to change the death benefit option initially selected. (These death benefit options are illustrated in Appendix B.) Thus, whichever option is selected, the death benefit will always exceed the cash value.[4] The cash value will increase or decrease with premium payments, investment performance, and charges authorized under the policy.[5]

Investment performance may also have a bearing on the duration of the death benefit. As described more fully below, a flexible premium variable life policy generally will remain in force so long as the cash surrender value is sufficient to meet policy costs. The investment experience of the separate account, as reflected in the cash surrender value, will positively or negatively affect the amount of funds (other than future premiums) available to keep the policy in force, and thus to perpetuate the death benefit.

While the variation in the amount or duration of the death benefit is, in part, a function of investment experience, the death benefit is inextricably bound to the pooling and distribution of mortality risks fundamental to life insurance. In order for an insurance company to provide a death benefit in excess of the premimums paid and the cash value, the mortality risk for each policyholder must be pooled and distributed among all policyholders. Each policyholder will pay charges for the cost of insurance commensurate with his or her own risk, actuarially computed upon the basis of factors such as age, sex, health, and occupation. The desired effect is that the death benefit for policyholders who die prematurely will be covered, through the pooling of costs, by the policyholders who die later.

[1] The Model Regulation as amended should provide the basic framework for state regulation of flexible premium variable life insurance. Each jurisdiction independently adopts its own regulation, however, and in all likelihood the precise provisions of the regulations as adopted will vary somewhat among the jurisdictions.

[2] If the policyholder pays a large initial premium, that is if he uses a flexible premium variable life policy as a single premium product rather than as a periodic premium product, the immediate death benefit of course will be a relatively smaller multiple of the initial premium.

[3] For a discussion of lapsation, see pages 21–22, *infra*.

[4] The Internal Revenue Code may independently place restrictions on the relationship between the cash value and the death benefit. For example, if the policy qualifies for life insurance tax treatment under the "guideline premium with limited cash value" test currently contained in Section 101(f)(1)(A), the death benefit will never be less than 140 percent of the cash value, grading down to 105 percent at higher attained ages.

[5] For a discussion of nonforfeiture values, see pages 17–18, *infra*.

https://www.loc.gov/item/fr048231/

As in the case of other life insurance policies, the insurance company will maintain live insurance reserves with respect to the death benefit payable under each flexible premium variable life insurance policy as required by state law. Flexible premium variable life insurance will provide for a death benefit which at all times is in excess of the reserves computed therefor, resulting in the insurer's assumption of a pure insurance risk (the death benefit less the policy reserves) to the extent of the excess. If the mortality experience of the insured group is unfavorable, the insurer will be required to draw upon its surplus to meet its contractual obligations. Similarly, if the expenses incurred with respect to its flexible premium variable life policies, as affected by inflation and other factors, exceed the expenses assumed in product pricing, the insurer will be required to draw upon its surplus.

Flexible premium variable life insurance policies may also provide for conventional incidental insurance benefits such as family term insurance, an accidental death benefit, a waiver of premium benefit, and the like. These additional coverages conceivably could be purchased through fixed premiums distinct from premiums for the basic coverage or, more likely, through periodic changes against the cash value of the policy.

2. *Premiums*

Flexible premium variable life insurance policies will provide for the payment of one or more pemiums that are not fixed by the insurance company as to both timing and amount. Thus, under such a policy the insurer may fix the timing of premium payments but not the amount, the amount of premiums but not the timing, or neither the timing nor the amount of one or more premiums. It is expected that both the amount and frequency of premium payments generally will be flexible and determined by the policyholder. Companies, however, may reserve the right to limit the amount and number of payments or may require minimum premiums for certain policy years. It will be mathematically possible to calculate a schedule of "target" periodic premiums to be paid under the policy, which will be intended to provide the insurance benefits desired by the policyholder at any given time. Many policies may stipulate a target premium schedule, and many companies and agents will encourage (but not require) purchasers to make payments in accordance with such a schedule. The failure to pay a target premium will not of itself cause the policy to lapse, however. (The circumstances under which the policy will be in default are explained more fully below.)

3. *Nonforfeiture Values*

The cash value of a flexible premium variable life policy will always be determined in a manner consistent with the calculation of the cash value of a conventional whole life insurance policy, but the cash value will change on a daily rather than an annual basis. The cash value as so computed will be consistent with the minimum requirements of the Standard Nonforfeiture Law as adopted in all the states and of the Variable Life Insurance Model Regulation.

The cash value of any day typically will be determinable as the sum of (1) the cash value on the preceding date, plus or minus (2) daily investment performance on the foregoing cash value, net of asset charges such as charges (if any) for income tax, investment expense, investment advice, and mortality risk, expense risk, and interest rate guarantees, plus (3) premiums credited to the policy since the preceding day, net of charges against premium for, *inter alia,* premium tax, administrative expense, and premium payment mode, less (4) charges for the cost of insurance, any guaranteed death benefit, administrative expense, incidental insurance benefits, and substandard insurance risks, which generally will be deducted on monthly or annual policy anniversaries rather than on a daily basis. (The actual form of the various charges likely will vary somewhat from company to company.) Sales loads may be charged in a number of forms, as discussed more fully at page 57, below. Although the *types* of charges deducted under flexible premium variable life insurance will generally correspond to the charges authorized under scheduled premium variable life insurance, the *form* of such charges in some cases may be a deduction from cash value rather than from gross premiums because of the unscheduled premium structure essential to the flexible premium variable life design. As is the case for scheduled premium variable life insurance, the cash value will be determinable on any day, although it actually will be computed only when necessary to satisfy legal requirements or the terms of the policy.

The cost of insurance reflected in the policy's cash value will be determined by multiplying the net amount at risk (the death benefit less the cash value of the policy) by the "cost of insurance rate." The cost of insurance rate reflects the charge for pure insurance coverage based on factors such as the sex, attained age, and rate class of the insured. The insurance company will guarantee that these rates, which will be based on its expectations as to future experience, will never exceed those listed in a table of guaranteed maximum rates set forth in the policy. The actual rates charged may be less than or equal to the guaranteed rates.

As in conventional whole life insurance and scheduled premium variable life insurance, the cash value for a flexible premium variable life policy is a feature that serves to accumulate amounts to help meet policy costs in later years, when the annual costs could become prohibitive if not prefunded. The cost to a policyholder of a specified death benefit is less in early policy years than in later policy years.

The policyholder generally will have the right at any time, as in the case of a conventional whole life policy or a scheduled premium variable life policy, to borrow at least 75 percent, and in some cases as much as 90 or 100 percent, of the policy's cash surrender value (less any outstanding indebtedness) on the sole security of the policy. The amount of the loan typically will be withdrawn from the separate account and transferred to the general account of the insurer, until repaid. Policy loans outstanding will bear interest at a rate guaranteed not to exceed a maximum rate determinable from the policy and limited by state insurance law. Any amounts borrowed but not repaid prior to the death of the insured will offset the amount of the death benefits. Policy loan provisions at least this favorable to policyholders are required by Article IV, Section 4 of the Variable Life Insurance Model Regulation.

The policyholder generally may, as in the case of traditional whole life and scheduled premium variable life policies, surrender the policy at any time for its "cash surrender value," *i.e.,* the full cash value less any indebtedness and less a possible deferred sales charge or other surrender charges. *Unlike* any existing variable life insurance policy, a flexible premium variable life insurance policy may permit a partial withdrawal of a portion of the cash value (subject to a possible deferred charge), which will typically reduce the death benefits currently payable under the policy, dollar for dollar. (It is anticipated that partial surrenders resulting in pro rata reductions in death benefits and the cash value generally will not be expressly provided for in these policies.)

https://www.loc.gov/item/fr048231/

4. *Sales Loads and Commissions*

Because flexible premium variable life insurance fundamentally is life insurance, issuers will incur characteristic insurance sales and distribution costs in marketing the new product. In particular, companies will pay first-year and renewal commissions to insurance sales personnel. These commissions may be computed on a variety of bases taking into account, for example, premium payments, the face amount of the policy, cash value or the cost of insurance.

Sales loads will generally be designed to recover sales and distribution expense, including any first-year expenses subsidized by the insurer's general account, in a manner that each company can afford. Accordingly, feasible sales load structures will vary among companies. It is contemplated that one or more issuers will find each of the following structures appropriate: (1) A front-end sales load, (2) a back-end sales load, which may or may not be contingent upon surrender or withdrawal, (3) a periodic charge against cash value to pay sales and distribution expense, computed as a fixed dollar amount, as a percentage of assets, or on some other basis, or (4) a combination of the above. This variety of load structures contrasts with scheduled premium variable life insurance policies currently being issued, which impose only front-end sales loads.[6]

5. *Other Provisions*

Some flexible premium variable life policies will mature or endow at a policy anniversary nearest a specified date—for example, the insured's 95th birthday. (Because the consequences of maturity will generally be equivalent to the consequences of a complete policy surrender, some companies may not specify a maturity date.) The owner may be able to change the maturity date, if any. On the maturity date, all insurance coverage under the policy typically will terminate. The proceeds payable upon maturity will equal the then cash value less any indebtedness.

In advance of maturity or surrender, the policy will terminate when the insured dies, or, if sooner, when the "grace period" ends. The grace period will begin on a policy processing day (that is, a day on which the charges authorized in the policy are deducted) on which the amount available under the policy is insufficient to cover the cost of insurance, policy loan interest (if any), and any expense charges payable on that day under the policy. (Under the Variable Life Insurance Model Regulation, the insurer must send the policyholder a notice indicating the minimum payment necessary to keep the policy in force and the length of the grace period.) The policy will lapse if additional premium is not received within a specified number of days (at least 61 days) after the grace period begins.[7] Thus, as stated above, the policy will not be placed in default merely by the nonpayment of any given premium but will simply continue, unless otherwise terminated by maturity, surrender, or death, until it terminates without value at the end of the grace period. Because of the unscheduled premium structure of flexible premium variable life insurance, these requirements differ from the provisions applicable to scheduled premium variable life insurance, which typically lapses upon nonpayment of a scheduled premium. Generally, a flexible premium variable life policy may be reinstated even after termination, upon compliance with conditions stated in the policy.

The proceeds payable under a flexible premium variable life policy upon surrender, maturity, or death will be in a lump sum, or in accordance with various settlement options described in the policy. It is expected that such settlement options will include those usually found in other insurance and annuity products. These settlement options typically are (1) payment for a fixed period, (2) life income, (3) payments for a fixed amount, (4) deposit at interest, and (5) joint and survivor life income. Under Article IV, Section 3(o) of the Variable Life Insurance Model Regulation, at least one settlement option must be provided on a fixed basis.

C. Basis for Exemption From the 1940 Act

Like scheduled premium variable life insurance, flexible premium variable life insurance policies generally will have nonguaranteed cash values funded by one or more separate accounts. Therefore, it has been assumed that the Commission would conclude, as it ultimately did in the case of scheduled premium variable life insurance, that the federal securities laws apply to flexible premium variable life policies, separate accounts funding such policies, persons marketing such policies, and persons providing investment advice with respect to such policies. It is not conceded for purposes of this petition or any other purpose that such conclusions are supported by the language, purposes, and policies of these statutes or by the judicial interpretations thereof. Even if these conclusions were correct, in light of the experience with respect to scheduled premium variable life insurance, it is clear that the application of the federal securities laws, particularly the 1940 Act, to a product with significant life insurance features is cumbersome, difficult, and in certain respects impossible.

It would be contrary to the interests of the public, the interests of the life insurance industry, and the Commission's interest in the orderly administration of the securities laws to debate the status of flexible premium variable life insurance under such laws. Instead, these interests are best served by a prompt resolution of those federal securities law issues impeding the development of flexible premium variable life insurance. It is imperative that the Commission expeditiously provide the exemptive relief necessary and appropriate for the industry to issue such policies. Accordingly, it is respectfully proposed that the Commission, pursuant to its authority under Sections 6(c), 6(e), and 37(a) of the 1940 Act, promulgate a rule exempting flexible premium variable life separate accounts and related persons from certain provisions of the 1940 Act.

Section 6(c) empowers the Commission to:

> conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title.

Congress intended Section 6(c) to provide the Commission flexibility in applying the strict requirements of the 1940 Act to situations unanticipated at

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[6] The uniform nature of sales load structures in scheduled premium variable life insurance policies issued to date in part has resulted from the regulatory pattern of Rule 6e-2, which was drafted primarily with reference to then existing front-end loaded policies. Such uniformity, however, is neither necessary nor desirable. Indeed, the benefits of deferred sales load to consumers have in several contexts led companies to shift from front-end to back-end loads. This trend toward back-end loads is well established among variable annuity issuers. A new scheduled premium variable life insurance product is currently being registered that provides for what might be described as a deferred sales charge. Some companies are also introducing certain types of unregistered general account life insurance products that explicitly provide for a back-end load.

[7] These grade period provisions are required by Article IV, Section 3(b)(2) and Article IX, Section 3 of the Variable Life Insurance Model Regulation.

https://www.loc.gov/item/fr048231/

the time of enactment, provided that the statutory criteria are satisfied.[8]

Congress obviously did not anticipate the application of the 1940 Act to variable insurance or annuity products that were not in existence in 1940. Indeed, the literal requirements of the 1940 Act are so incompatible with such products that since 1960 it has been necessary for the Commission to provide general or individual exemptive relief with respect to *each* variable annuity contract and scheduled premium variable life insurance policy registered under the 1940 Act. It is self-evident that flexible premium variable life insurance necessarily presents an exceptional situation unforeseen by Congress in enacting the 1940 Act, which warrants resort to Section 6(c).

The statutory prerequisites to the exercise of the Commission's authority under Section 6(c)—that the exemption "is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the 1940 Act]"—are amply satisfied with respect to flexible premium variable life insurance, just as they were with respect to scheduled premium variable life insurance. Although the industry is not contesting the status of flexible premium variable life insurance at this time, the considerations that ultimately led to the adoption of Rule 6e-2 are equally applicable in this new context.

The Commission provided exemptions in Rule 6e-2 "[i]n recognition of the unique insurance aspects of variable life insurance and the extensive insurance regulatory pattern to which the contracts, issuers and related persons will be subject. . . ." Investment Company Act Rel. No. 8691, Investment Advisers Act Rel. No. 440, 6 SEC Docket 364, 364 (February 27, 1975) (notice of intention to propose a rule under Section (6e)). It recognized that scheduled premium variable life insurance provides current insurance protection to policyholders and is therefore distinguishable from strictly investment-oriented products like mutual funds. *Id.* It further determined that scheduled premium variable life insurance represented a "combination of investment and insurance elements" which is "different" from any other product regulated by the 1940 Act. *See* Investment Company Act Rel. No. 8000, Investment Advisers Act Rel. No. 391, 2 SEC Docket 481, 483 (September 20, 1973) (notice of proposed amendments to Rules 3c-4 and 202-1). The Commission also acknowledged that traditional state insurance regulation and state laws specifically drafted for variable insurance products [9] both paralleled a substantial number of the protections afforded by the federal securities laws and conflicted to a certain extent with the 1940 Act. *See* Investment Company Act Rel. No. 8691, *supra*, at 364. Finally, the Commission recognized that various provisions of the 1940 Act presented difficult compliance problems of simply should be modified in the context of variable life insurance. *See* Investment Company Act Rel. No. 9104, 8 SEC Docket 932, 932-33 (December 30, 1975) (notice of proposal to adopt Rule 6e-2).

For the same reasons, exemptions should be provided from the 1940 Act for flexible premium variable life insurance. Unlike mutual funds, the primary feature of flexible premium variable life policies will be to provide current insurance benefits to purchasers. Thus, in addition to providing investment participation, such policies will provide benefits involving insurance and other risks borne by the insurance company, as discussed more fully above.[10]

Flexible premium variable life policies will also be treated as insurance policies for purposes of state insurance law [11] and, accordingly, such policies, the issuing insurance company, and related persons will be subject to state insurance regulation. As noted above, in December 1982, the NAIC amended the Variable Life Insurance Model Regulation specifically to take account of flexible premium variable life insurance. The Model Regulation provides a variety of safeguards for policyholders that operate in harmony with the federal securities laws.[12] For example, the qualifications of insurance companies to engage in a variable life insurance line of business are specified.[13] The insurance policy must be filed with and approved by the state insurance commissioner prior to issuance.[14] The Model Regulation also regulates the determination and valuation of cash values,[15] and requires that the policyholder be accorded a "free look" right, to the extent required by state law.[16] (Some states also require that the policyholder be permitted to convert a variable benefit policy to a fixed benefit policy during the first 18 months.) Certain disclosures and reports to policyholders are required,[17] and the use of false, misleading, deceptive, or inaccurate sales material is prohibited.[18] The operations of the separate account [19] and the establishment of reserves for policy liabilities are also regulated.[20]

To a certain extent, however, the state regulation of insurance conflicts with the 1940 Act. In large part, state law seeks to protect policyholders by assuring the solvency of insurance companies, the adequacy of their reserves, and thus their ability to meet their contractual obligations to policyholders. The operation of a flexible premium variable life insurance separate account will not only affect a company's ability to meet its obligations to flexible premium variable life policyholders, but also to its general account policyholders (to the extent that the general account underwrites the risks borne with respect to the separate account). Accordingly, in the interest of either type of policyholder, state insurance regulators are empowered to act to protect a company's solvency (*e.g.*, to object to the elected separate account management, to modify separate account investment policies or to terminate the investment advisory

[8] *See, e.g.*, Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 197, 872 (1940); Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on International and Foreign Commerce, 76th Cong., 3d Sess. 120 (1940); SEC, Report on Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 37 (1966).

The Commission's authority under Section 6(c) is supplemented by Section 38(a), which empowers the Commission to make, issue, amend, and rescind rules necessary or appropriate to the exercise of the powers conferred upon the Commission elsewhere in the 1940 Act, including rules and regulations defining accounting, technical, and trade terms used in the 1940 Act. The full text of Section 38(a) is set out at page 3, *supra*.

[9] The NAIC promulgated the Model Variable Contract Law and Regulation in 1970, and supplemented that model with the Variable Life Insurance Model Regulation in 1973. As of December 1982, 47 states had enacted variable contract statutes and 27 states had issued regulations governing variable life insurance policies.

[10] Congress has accorded the same tax treatment to flexible premium life insurance meeting certain requirements as it has to traditional whole life insurance. Since flexible premium variable life insurance will generally meet the requirements of Section 101(f) of the Internal Revenue Code, it will receive the same tax treatment as other life insurance products.

[11] It should be noted in this regard that 1940 Act exemptions are requested only for policies that are treated entirely as life insurance policies under state law. Relief is not sought for insurance programs treated under state law as providing, for example, a combination of term life insurance with an annuity or a deposit fund.

[12] It should again be noted that the laws and regulations of each jurisdiction may differ from the Model Regulation.

[13] Variable Life Insurance Model Regulation, arts. III, XI.

[14] *Id.*, art. IV, Section 1.

[15] *Id.*, art. IV, Sections 2 (e), (f).

[16] *Id.*, art. IV Section 3(a)(5).

[17] *Id.*, arts. VII, IX.

[18] *Id.*, art. III, Section 4.

[19] *Id.*, art. VI.

[20] *Id.*, art. V.

https://www.loc.gov/item/fr048231/

contract [21]) in a manner that may conflict with the 1940 Act.

Finally, the inherent difficulties in complying with the 1940 Act recognized by the Commission during the promulgation of Rule 6e–2 are not limited to scheduled premium products; rather, they are generic problems encountered with respect to all forms of life insurance subjected to the 1940 Act. Indeed, these problems are more acute in the context of flexible premium variable life insurance. The flexibility of premium payments and the face amount of insurance fundamental to flexible premium variable life insurance makes compliance with certain provisions of the 1940 Act even more difficult and inappropriate, and justifies somewhat different exemption than those granted in Rule 6e–2 for scheduled premium variable life insurance.

For these reasons, and exemptive rule from the 1940 Act for flexible premium variable life insurance is warranted.

IV. Analysis of Proposed Exemption From the 1940 Act

The rule proposed in this petition provides important exemptive relief from many provisions of the 1940 Act. The rule contains in substance many of the exemptions now provided variable life insurance in Rule 6e–2. The rule provides relief different from Rule 6e–2 only where the novel characteristics of flexible premium variable life insurance mandate, or where the experience of the past seven years has shown that Rule 6e–2 should be clarified or modified.[22] For the reasons outlined in this petition, the rule as proposed will maintain the basic investor protections provided by the 1940 Act and thus will satisfy the requirements of Section 6(c). At the same time, the proposed rule recognizes the unprecedented qualities of flexible premium variable life insurance and the special relief necessary to make this valuable form of insurance protection viable.

A. Definition of Flexible Premium Variable Life Insurance Separate Account and Policy

As in Rule 6e–2, the proposed rule provides relief from the 1940 Act only if the flexible premium variable life insurance separate account and policy meet certain requirements.

1. The Separate Account

The proposed requirements for the separate account in substance correspond to those now contained in paragraph (a) of Rule 6e–2. with two exceptions.

The proposed rule permits the separate account to fund both scheduled premium *and* flexible premium variable life policies. The interests of scheduled premium and flexible premium variable life policyholders, the insurer's interests with respect to the two types of policies, and the regulatory frameworks for the two types of policies will be sufficiently parallel that funding both policies through a single separate account should not prejudice any policyholder. Furthermore, the increased pooling, diversification, and scale economies in expenses realized from the use of a single separate account would benefit both types of policyholders. Therefore, the funding of both types of life insurance policies with a single separate account is permitted.[23] However, Rule 6e–2 and the proposed rule would separately govern the terms (including the level of charges) of scheduled premium variable life policies and flexible premium variable life policies, respectively, funded by a single separate account.

The proposed rule also permits funds corresponding to dividend accumulations to be placed in the flexible premium variable life insurance separate account. A dividend is a return of part of the premium on participating insurance to reflect the difference, if any, between the premium charged and the combination of actual mortality, expense, and investment experience (although a flexible premium variable life policy generally would not have any excess interest earnings to be applied to a dividend because net earnings are credited in full to the separate account). Policyholders typically are given the option of receiving dividend distributions in cash, applying dividends to premium payments, or accumulating dividends at interest with the insurer. Rule 6e–2 prohibits the placement in separate account (and therefore participation in the investment experience of the account) of dividend accumulations, along with other liabilities not involving life contingencies.[24] Policyholders should be permitted to allocate dividend distributions to the flexible premium variable life insurance separate account. Dividends are an integral element of the pricing of participating insurance products and, to the extent that a flexible premium variable life policyholder dedicates funds to the policy which prove unnecessary to satisfy the claims on and expenses of the insurance pool, those funds should be permitted to remain in the separate account at the policyholder's direction. Indeed, an exclusion of dividend accumulations would be ineffectual; since premium payments are flexible rather than fixed and are not subject to a maximum annual amount, a policyholder could in practice accumulate dividends in the separate account through the simple divice of endorsing dividend checks back to the insurer, in addition to paying new premiums. A prohibition on dividend accumulations thus would lack substance.

2. The Policy

The difinition of "flexible premium variable life insurance policy" in the proposed rule is comparable to the "variable life insurance contract" definition in Rule 6e–2, but has been modified to reflect the differing character of the new product and to correspond to the amendment to the Variable Life Insurance Model Regulation. In particular, the definition reflects the unscheduled premium payments and the variable amount *and* duration of death benefits (depending on separate account investment performance) fundamental to flexible premium variable life insurance. Consistent with the features of such policies, particularly the policyholder's ability to adjust the premium payments and the face amount of insurance once the policy is issued, the definition does not *require* a guaranteed minimum death benefit of a specified amount.

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[21] *Id.*, art. VI, sections 1(b), 6, 10.

[22] Although this petition does not discuss amendments to Rule 6e–2, that rule should also be amended to the appropriate extent. Rule 6e–2 would generally govern scheduled premium variable life products; the proposed rule would govern flexible premium products.

[23] Similarly, under the proposed rule, a flexible premium variable life insurance separate account organized as a unit investment trust should be permitted to invest its assets in registered management investment companies which offer their shares to other purchasers as well. For a discussion of this point, see page 74, *infra*.

[24] The prohibition on holding dividend accumulations in the separate account contained in Rule 6e–2 apparently was derived from paragraph (a)(2) of Rule 3c–4, which was rescinded in its entirety in 1975. Although the public record is not entirely clear, the requirement of Rule, 3c–4 in turn apparently was derived from the insurance industry's original request for exemptive relief for variable life insurance. The intent of the requirement was to assure that the separate account operated as a mechanism to pool mortality risks rather than as an investment fund. *See* Petitioners' Memorandum in Support of Petition, *In re* American Life Convention and Life Insurance Association of America, SEC Administrative Proceeding File No. 4–149, at 10 (August 21, 1972). For the reasons discussed above, the requirement would not serve such purpose (and is unnecessary to serve such purpose) in the case of flexible premium variable life insurance.

https://www.loc.gov/item/fr048231/

The proposed definition does require assumption of mortality and expense risks by the insurance company. However, a limitation on the minimum amount of the charge for such risks (and thus, indirectly, on the maximum charge) is not included in the rule.[25] The required *assumption* of risks necessarily implies that a maximum charge will be guaranteed, and Article IV, Section 2(a) of the Variable Life Insurance Model Regulation requires that maximum charges be stated in the policy.

B. Sales Load Provisions

As was the case with respect to variable life insurance, significant relief from the sales load restrictions applicable to periodic payment plan certificates that are contained in Section 27 of the 1940 Act is necessary and justified for flexible premium variable life insurance. Section 27 was enacted to regulate a specific security—contractual plans—within the context of the practices and characteristics of a specific industry—the mutual fund industry. In developing Rule 6e-2, the Commission determined that certain exemptions from this section were necessary to reflect the nature of scheduled premium variable life insurance, the risks assumed by the insurer, and the regulatory activities of state insurance authorities. *See* Investment Company Act Rel. No. 8691, *supra,* at 365. It recognized that Section 27 would present difficult compliance problems for issuers of scheduled premium variable life insurance. *See* Investment Company Act Rel. No. 9104, *Supra,* at 932. The Commission was also aware that the requirements of Section 27 were inconsistent with the traditional methods and levels of compensating insurance sales personnel and amortizing sales expense in early policy years. *See* Investment Company Act Rel. No. 8888, 7 SEC Docket 588, 593–594 (August 13, 1975) (notice of EVLICO application); 1973 Division Report at 138.

For the same reasons, comparable exemptions should be provided for flexible premium variable life insurance. Furthermore, the flexibility inherent in this new product, which is the basis of its advantages for policyholders, makes compliance with Section 27 even more difficult, and necessitates a revised statement of relief.

1. *Definition of Sales Load*

The proposed rule defines the term "sales load" in a manner analogous to the definition in Rule 6e-2. By defining sales load as the difference between gross premiums and certain enumerated items determined *not* to be sales load, this approach recognizes that the timing of expenses to the insurer and of corresponding charges to the policyholder characteristically cannot be matched in insurance products, and that charges may be deducted from either premiums or cash value under flexible premium variable life insurance.

In this regard, the charge for the cost of insurance subtracted in calculating sales load should be noted. Like Rule 6e-2, the proposed rule specifies that this charge is computed on the basis of the 1958 Commissioners Standard Ordinary Mortality Table ("the 1958 CSO Table"). The Standard Valuation Law, promulagated by the NAIC and adopted by all the states, makes the 1958 CSO Table mandatory as the minumum basis for valuing reserves for ordinary life insurance policies issued on or after January 1, 1966. The Commission specified in Rule 6e-2 that the cost of insurance deduction be computed on the basis of this mandatory mortality table. The Commission was aware, however, that the table was conservative in its mortalilty projections, that the insurance company (whether organized as a stock company or a mutual company) consequentially might realize in its general account amounts reflecting the difference between projected and actual mortality experience, and that any current shortfalls in charges to pay sales and distrubution expenses might be satisfied out of general account funds, which mght be attributable in part to any margin in the cost of insurance charge.

The 1958 CSO Table remains the standard mortality table in use in the insurance industry today for computing reserves and minumum cash values. The cost of insurance charge in all variable life insurance policies issued to date is computed on the basis of the 1958 CSO Table. It is anticipated that most insurance companies will guarantee a maximum charge for the cost of insurance for flexible premium variable life insurance policies on the basis of the 1958 CSO Table. The NAIC has adopted a new, less conservative table—the 1980 Commissioners Standard Ordinary Mortality Table ("the 1980 CSO Table")—which will be mandatory for all life insurance policies issued on or after January 1, 1989 (in the jurisdictions that adopt the model law). Adoption of NAIC amendments to the Standard Valuation Law, however, requires positive legislative enactment by each separate jurisdiction. Companies operating only in the substantial number of states which have already amended their statutes are currently permitted to value reserves for new policies on the basis of the 1980 CSO Table, but such companies may choose to postpone use of that table until it becomes mandatory.[26] The 1958 CSO Table will remain mandatory in a jurisdiction until such an amendment is enacted, and thereafter may continue to apply with respect to policies issued before 1989.

In specifying the 1958 CSO Table, the proposed rule is intended to permit the subtraction of an amount based on that table in the computation of sales load even where the cost of insurance actually charged under a particular policy or class of policies is computed on some other basis. This apppoach is essential to provide a level of sales load relief necessary and appropriate for flexible premium variable life insurance (as was the case for scheduled premium variable life insurance).[27] Accordingly, the proposed rule, like 6e-2, specifies that in *all* cases the cost of insurance deduction is based on the 1958 CSO Table in computing sales load.

The proposed definition of sales load applicable to flexible premium variable life insurance differs in certain respects from the definition contained in Rule 6e-2. Because schedule variable life insurance provides for fixed, periodic premium payments and for the deduction of several charges directly from gross premium, it is possible to attribute such charges to particular payments, as a matter of regulatory definition. The unscheduled, adjustable payments that will be the hallmark of flexible premium variable life insurance make a similar approach impossible, or at best artificial and inappropriate, in this new context. Charges under a flexible premium variable life policy generally will be deducted from cash value when due, without regard to the pattern of premium payments and without tracing the charge to the proceeds of any particular payment. The amount of sales load deducted under this new product up to a given point in time should therefore be measured on

[25] Rule 6e-2 currently requires that the mortality and expense risk charge msut be disclosed in the prospectus and must not be less than 50 percent of the maximum charge disclosed.

[26] Insurance companies may well delay valuing variable life reserves on the basis of the 1980 CSO Table, in order to avoid the collateral effect of such an action on other lines of business (in particular, certain specialized products). Once a company utilizes the 1980 CSO Table for any policy, it will be required to utilize that table at least for all subsequently introduced classes of *similar* products and, in some states, *all* subsequently introduced products. Under New York's interpretation of the Standard Valuation Law, the 1980 CSO Table would have to be used for all subsequently *purchased* products, regardless of when the class of products was introduced.

[27] See the discussion on page 42, *infra*.

https://www.loc.gov/item/fr048231/

an aggregate basis, taking into account all activity under the policy. For purposes of regulatory compliance, this approach would require a demonstration that the sales load computed on, generally, a policy year basis complies with the appropriate limitations. (Because the sales load definition in Rule 6e-2 contemplates premiums and charges on an annual basis, the proposal essentially follows the approach taken in Rule 6e-2 and entails only a formal difference.) While even this approach does not fully reflect the flexible nature of the product, a sales load definition on a policy year basis approximates the statutory definition contained in Section 2(a)(37) of the Act as now applied in Rule 6e-2 and at the same time acknowledges the characteristics of the new product.

In addition to clarifying and conforming revisions, the flexible nature of flexible premium variable life insurance necessitates certain other departures from the sales load definition in Rule 6e-2. In particular, because there will not be a structured relationship between cash value and death benefits (in the absence of a minimum death benefit guarantee), an "assumed investment rate" is relevant to flexible premimum variable life insurance, if at all, only in determining the cost of insurance charge. Therefore, the proposed definition specifies a net annual effective investment rate of 4 percent but otherwise deletes references to this concept. With respect to charges for mortality risk, expense risk, or interest rate guarantees, the proposal directly subtracts such charges in computing sales load to the extent that they are assessed as policy charges (i.e., charges against premium or made on a per policy basis) rather than as asset charges (as is the case with scheduled premium variable life insurance). Similarly, because sales load is defined on a policy year basis taking into account cash value activity, the sales load computation deducts the proceeds of a surrender or withdrawal or of death benefits, offsetting the corresponding negative increase in cash surrender value not attributable to investment experience. Because of the flexible payment structure, an additional actuarial assumption regarding payment patterns is stated with respect to the deduction for dividends. Finally, a "catch-all" deduction for charges not chargeable to sales or promotional activity that are reasonable in relation to expenses incurred has been added. This provision is intended to encompass unforeseen categories of charges that possibly might evolve for this product. Such a provision is consistent with sound regulatory policy in that it authorizes the Commission staff to apply the rule in a manner consistent with the purposes and policies of the 1940 Act, expedites the processing of individual filings, and obviates the need for additional, technical relief. (An illustration of the operation of this definition of sales load is provided in Appendix C.)

2. Front-End Sales Loads—Relief From Sections 27(a)(1), 27(h)(1), and 27(h)(4)[28]

As the Commission is aware from its experience with scheduled premium variable life insurance, the life insurance industry historically has incurred relatively high front-end costs in the sales and distribution of its products, compared to other financial institutions. The Commission has recognized that the need for such costs arises from the effort requred to sell a life insurance policy as opposed to variable annuities, mutual funds or other securities. The most significant single expense incurred is the payment of first-year commissions to sales agents. Companies traditionally have paid commissions for the sale of whole life insurance of at least 50 percent, and frequently as much as 60 to 80 percent, of first-year premiums. Since the total sales and distribution expenses incurred at issuance commonly exceed the first-year premium for a policy (much less the permissible sales load), state insurance laws generally permit a company to pay these excess expenses out of the surplus in its general account and to amortize the cost over several years against future premiums.

In issuing flexible premium variable life insurance, insurance companies generally will continue to incur sales and distribution expenses in this pattern. These expenses generally are applicable to any given life insurance product and in large part are beyond any given issuer's control, because they are inherent in the nature of life insurance and the structure of the industry. In particular, it will be necessary for many companies to pay sales commissions comparable to those paid for traditional whole life insurance, if flexible premium variable life insurance is to be financially feasible. Many insurance salesmen still will actively market only those products that provide the accustomed level of compensation. Any reduction in the commission rate prevalent for insurance products that require a comparable sales effort would provide such sales agents with a disincentive to sell flexible premium variable life insurance to suitable customers. Thus, if the insurance-buying public is to be offered the choice between flexible premium variable life insurance and other products free from a conflict of interest on the part of many insurance salesmen, and if such salesmen are to have the financial incentive (relative to other products) necessary to make flexible premium variable life insurance feasible for issuers, many companies will need to pay traditional first-year commissions, which frequently will equal 50 percent or more of first-year premiums.

The most fundamental restrictions of Section 27 are contained in Sections 27(a)(1) and 27(h)(1), which limit the sales load under a periodic payment plan certificate to "9 per centum of the total payments to be made * * *" If flexible premium variable life insurance is to be a viable product for the industry, it is essential that the rule provide relief from these provisions permitting insurance companies to receive sales loads under the policies that are adequate to cover the sales and distributions costs of life insurance products. In addition, it is important that the relief be framed to permit companies prospectively to demonstrate that their policies meet the requirements of these provisions. Because flexible premium variable life will not require scheduled payments, the ability to rely on such prospective demonstrations of compliance not only will be an important part of the relief for the industry but also will facilitate the Commission's administration of the regulation.

Relief similar to that contained in Rule 6e-2 should be promulgated for flexible premium variable life insurance, modified as necessary to take into account the unique features of this new product. Rule 6e-2 balances the protections of the 1940 Act, the industry's need for relief, and the desirability of prospective determinations of compliance by providing that the sales load may not exceed 9 percent of the payments to be made during the lesser of 20 years or the insured's life expectancy based on the 1958 CSO Table.

The proposed rule provides the same period for compliance with the 9 percent requirement. Although the basis for the 20 year period stated in Rule 6e-2 is not entirely clear from the public record,

[28] Because front-end loads are more clearly contemplated by Section 27 (and are more familiar to the Commission in the context of variable life insurance products) than deferred sales loads, the proposed exemptions from Section 27 are first discussed with reference to front-end structures. The application of the proposed exemptions to sales loads other than front-end loads is separately discussed at pages 57-66.

https://www.loc.gov/item/fr048231/

that period apparently represents a conservative estimate of the duration of a scheduled premium variable life insurance policy, based on the industry's experience with conventional life insurance. The 20 year period or, if less, the insured's life expectancy based on the 1958 CSO Table remains a reasonable period for compliance.

It is, of course, also necessary to prospectively specify the premiums to be paid for the policy during this period. In the case of scheduled premium variable life insurance, the payments to be made are fixed by the policy. Flexible premium variable life insurance, however, generally will leave the amount and frequency of payments to the discretion of the policyholder. Nonetheless, established actuarial principles may be employed to determine prospectively the premiums which, while not contractually required, are appropriate for such a policy.

The proposed rule keys the exemptions from Sections 27(a)(1) and 27(h)(1) to a "guideline annual premium." That is, exemptions from Sections 27(a)(1) and 27(h)(1) generally are provided if the sales load charged during the policy periods equal to the lesser of 20 years or the insured's life expectancy based on the 1958 CSO Table does not exceed 9 percent of the sum of the guideline annual premiums that would be payable during such periods. The guideline annual premium concept is derived from Section 101(f) of the Internal Revenue Code.

The guideline annual premium is defined as the level annual premium, payable to the highest attained age at which a premium may be paid under a policy, that would provide the future benefits under the policy (subject to certain restrictions [29]), based on the 1958 CSO Table, a 4 per cent assumed interest rate, and the expenses specified in the policy. Regarding the components of this definition, it is anticipated that in most cases policyholders will contemplate paying premiums on a level annual basis. Use of the 1958 CSO Table is explained at pages 37–39. The 4 per cent rate of investment return is a historically sound, reasonable estimate of long-term investment performance, and was specified by Congress in Section 101(f)(1)(C) of the Code.

The significance of the guideline annual premium is that it represents the annual premium necessary to keep the policy in force for its life, provide the future benefits as specified, and provide a benefit at maturity (the cash value) equal to the initial death benefit, under the assumptions specified above. Thus, the guideline annual premium is the annual payment which would be contemplated and paid by a reasonable purchaser of insurance on the basis of these reasonable conservative assumptions.

The guideline annual premium is also equivalent to the annual fixed premium payable to obtain an equivalent insurance benefit under a scheduled premium variable life insurance policy containing the same actuarial factors. Indeed, because the premiums calculated for scheduled premium variable life insurance may take into account future benefits beyond the limitations specified above, the guideline annual premium for a "comparable" flexible premium variable life policy may be *less* than the fixed premium for the scheduled premium variable life policy. Accordingly, the guideline annual premium approach would yield a permissible dollar amount of sales load for a flexible premium variable life policy equal to or less than the amount of sales load for a flexible premium variable life policy equal to or less than the amount of sales load for an equivalent scheduled premium variable life policy under Rule 6e–2, a level which the Commission determined to be consistent with the public interest, the protection of investors, and the purposes of the 1940 Act.

The unique advantage of the guideline annual premium is its reliance on objective factors (the specified actuarial assumptions), certain general features of a class of policies (the maturity date and the policy charges), *and* certain individual features of each separate policy (the level and type of benefits), in appropriate combination. Accordingly, this approach has substantive and procedural virtues superior to those of other possible methods of specifying premium payments, as follows:

- A prospective demonstration of compliance with the exemption can be made with reference to the guideline annual premium, without inappropriately restricting sales load designs.[30]
- The approach permits sales loads to be designed and tested for compliance on the basis of a class of policies, rather than on an *ad hoc* policy by policy basis. The approach therefore should be relatively straightforward for the Commission to administer.[31] Furthermore, reference solely to individual policy features could result in an abuse of policyholders and inflated sales loads.
- The objective factors result in the equitable treatment of various purchasers of a given policy, and of the various issuers in the industry.
- The guideline annual premium approach permits companies to structure sales loads in a manner that reduces the opportunity for unfair manipulation by policyholders. Because of the unscheduled premiums permitted by flexible premium variable life insurance, there is a dnager that a policyholder would pay minimal premiums when front-end sales loads are heaviest, thereafter pay increased premiums (including an increment equal to the payments forgone to avoid the front-end load, with interest), and at all times enjoy the same level of insurance benefits. The sales expenses attributable to such a policyholder would be unfairly borne by other policyholders or the insurer. A test based on the guideline annual premium permits sales load structures that reduce this abuse.
- The guideline annual premium approach provides a basic similarity between the current requirements of the Internal Revenue Code and the federal securities laws, thereby minimizing possible incompatibilities and improving administrability and policyholder understanding.
- As discussed above, equal amounts of sales load are permitted under Rule

[29] In computing the guideline annual premium, (1) the net amount at risk should be assumed never to exceed the net amount at risk at issue, in order to avoid artificial inflation of the guideline amount through an assumption of increased, but not actually intended, future benefits, (2) the maturity date should be the latest date permitted under the policy, but not less than 20 years after issuer or, if earlier, age 95, also in order to avoid artificial inflation of the guideline amount, and (3) any endowment benefit should be assumed not to exceed the smallest death benefit at any time under the policy, in order to compute the guideline premium on a basis consistent with a traditional endowment policy. These possible abuses and restrictions were identified by Congress during the enactment of Section 101(f).

The proposed rule defines guideline annual premium to take account of incidental insurance benefits as well as the basic death benefit. Because the rule also limits "incidental insurance benefits" to conventional insurance benefits, which in most cases will be treated as an integral part of the basic policy (see page 75, *infra*), this definition is appropriate.

[30] In contrast, if compliance was tested on the basis of *actual* payments made under each individual policy, compliance could not be prospectively determined unless the sales load deduction could never exceed 9 percent of any payment.

[31] For example, testing compliance on the basis of the payment pattern each individual policyholder contemplates or "targets" would give rise to a Hobson's choice for issuers: (1) adopt only restrictive, and inappropriate, sales load schedules; (2) limit the flexibility of premium payments; or (3) design individual sales load schedules for each policyholder and demostrate compliance on a policy by policy basis.

https://www.loc.gov/item/fr048231/

6e-2 and the proposed rule for equivalent scheduled premium and flexible premium variable life policies, respectively.

This approach to sales load regulation requires further refinement in cases where the actual premiums paid in a policy year exceed the guideline annual premium. In light of the flexibility fundamental to the flexible premium variable life design, it is difficult to project the incidence and level of payments in excess of the guideline annual premium. By limiting the sales load charged with respect to such excess payments to 9 percent, the proposal assures that the aggregate sales load at the end of the lesser of 20 years or the insured's life expectancy mathematically could not exceed (under the assumptions specified above, including the assumed payment of the guideline annual premium) 9 percent of aggregate payments, provided that the sales load schedule with respect to guideline annual premiums complies with the general approach.

The proposed rule further provides that if excess premium is paid, the total sales load charged in that policy year also may not exceed 9 percent of the single premium necessary to pay up the policy until maturity under the above-mentioned actuarial assumptions. The payment of this "guideline single premium" gives rise to the inference that no further payments will be made; therefore, the sales load is appropriately limited in such policy year.[32]

3. *Front-End Sales Loads—Relief From Sections 27(a)(3) and 27(h)(3)*

The proposed rule provides an exemption from Sections 27(a)(3) and 27(h)(3) for flexible premium variable life insurance similar in substance to the relief provided in Rule 27a-2 and Rule 6e-2. In light of the proposed exemptions with respect to the 9 percent requirement, however, separate sales load schedules probably will be common with respect to aggregate annual payments up to the guideline annual premium and payments in excess of that amount. Accordingly, the requirement that sales loads remain level or decline over time as a percentage of payments is separately applied to these respective schedules. This approach neither unduly complicates sales load structures nor compromises the collateral effect of the level load requirement on compliance with the other provisions of Section 27.

4. *Front-End Sales Loads—Relief From Section 27(d)*

The appropriate exemption, if any, from the cash refund requirement of Section 27(d) was among the most important issues in the development of Rule 6e-2. The Commission recognized that expensive insurance-administrative procedures (*e.g.*, the high costs associated with issuance of a policy and the need to subsidize agents' commissions during early policy years) and the nature of scheduled premium variable life insurance justified an exemption from Section 27(d). *See* Investment Company Act Rel. No. 9482, *supra*, at 754. It was also aware that the financial feasibility of variable life insurance in large part depended on the relief provided from this section. *See id.* at 754–755; ALIA Letter Commenting on Proposed Rule 6e-2, SEC Administrative Proceeding File No. S7-554, at 18–27, 64 (March 31, 1976). The Commission ultimately increased the refund period stated in Section 27(d) from 18 to 24 months but reduced the excess sales load required to be refunded to the excess over 30 percent of first-year payments plus 10 percent of second-year payments. An alternative right to convert the policy to a traditional whole life insurance policy was also required. *See* investment Company Act Rel. No. 9482, *supra*, at 755.

The rationale for the exemption from Section 27(d) provided in Rule 6e 2 is equally applicable to flexible premium variable life insurance. Indeed, the consequences of the refund provisions for flexible premium variable life issuers are even more acute. Immediately upon the issuance of a policy, the insurer must subsidize substantial costs, including large first-year sales commissions, which ultimately should be recouped through charges as the policy persists. Because of the flexible payment structure fundamental to this policy design, however, the company will bear these expenses without even the level of assurance present in scheduled premium variable life insurance regarding future payments in early years. This is not to say that the industry anticipates poorer persistency for flexible premium variable life insurance than for scheduled premium variable life insurance. Rather, it is a recognition that some purchasers of either product will cease making payments or, in the case of flexible premium variable life, will make lower premium payments in early years. Scheduled premium variable life insurers can temper that uncertainty by anticipating the precise level of payments to be made if a policy continues in force. In contrast, the flexibility of premium variable life insurance will compound the uncertainty for issuers of these policies.

The import of the relief from Section 27(d) should not be underestimated. Most if not all flexible premium variable life issuers will design their products to avoid, in application, the scope of the requirement; refunds are an extraneous administrative complication in an already complex product, they may inappropriately encourage lapsation, and many companies may not be in a position to fully charge back first-year commissions against sales representatives if excess sales loads are refunded. Therefore, the exemption from Section 27(d) effectively will function as the limitation on sales loads charged during the first 24 months. These lower limits will increase any strain on the issuer's surplus during early policy years. Indeed, the unexpectedly slow proliferation of variable life issuers may be due, in part, to the inability of many companies to tolerate such a strain. As discussed above, this problem may be more acute for flexible premium variable life insurance, and many companies may well determine not to issue this new product if the charges "permitted" under the exemption from Section 27(d) are inadequate. The federal securities laws should not be administered to effectively preclude otherwise qualified companies from marketing insurance products on this ground.

For these reasons, the proposed rule modifies the amount of excess sales loading subject to the refund right from the analogous amount specified in Rule 6e-2. The amount of sales loading to be refunded equals the excess over the sum of (1) the lesser of 30 percent of the guidelines annual premium or 50 per cent of actual first-year premium payments, plus (2) the lesser of 10 percent of the guideline annual premium of 17 percent of actual second-year premium payments, plus (3) 9 percent of payments made in either year in excess of the guideline annual premium. This approach will readily mesh with the sales annual structures suggested by the other proposed exemptions from Section 27. In those cases where equivalent premiums (*i.e.*, the fixed premium for scheduled premium variable life insurance and the guideline annual premium for flexible premium variable life insurance) are paid for equivalent policies, the proposal requires the refund of an amount equal to the amount

[32] For example, if a policyholder chooses to treat a flexible premium variable life insurance policy as a single premium product and pays the guideline single premium in the first policy year, the guideline single premium limitation restricts the sales load to 9 percent of the reasonably anticipated payments (*i.e.*, that single payment), even if the policy generally imposes larger front-end loads.

https://www.loc.gov/item/fr048231/

required by Rule 6e-2. At the same time, the 50 percent and 17 percent limits operate to grade off the amount to be refunded when a policyholder chooses actually to pay less than the guideline annual premium during the first two policy years, and will provide the company with a reasonable level of charge for sales and promotional expense. In this case, the flexible premium variable life policy will reflect a greater pure insurance element than an equivalent scheduled premium variable life insurance policy. In such circumstances, the proposed relief appropriately reflects the front-end life insurance sales and distribution system and the early subsidization of life insurance policy costs (including the fact that a fraction of such costs in the first policy year are fixed per policy sold and are not a function or premium payments). At the same time, when coupled with section 27(a)(2) of the 1940 Act and the proposed exemptions from section 27(a)(1) and 27(h)(1), this refund right preserves the basic investor protections of these provisions while making flexible premium variable life insurance financially feasible for more insurance companies (thereby providing additional investor protection through increased competition in the marketplace.

As a corollary to the basic refund rule, Rule 6e-2 requires during the first 24 months the refund of the present value of any nonforfeiture insurance option then in force to which excess sales loading was applied upon the nonpayment of a premium for a scheduled premium variable life insurance policy. Because of the radically different design of flexible primium variable life insurance with respect to lapsation (notably, the absence of nonforfeiture options with cash value),[33] the proposed rule does not retain this provision.

The proposed rule contains the alternative conversion right prescribed in Rule 6e-2. The proposed rule does not, however, *require* that the flexible premium variable life policy be converted to a conventional whole life policy (*i.e.*, to a policy which provides for "fixed death benefits and cash surrender values"). The proposed rule instead permits the conversion to be made to *any* specified life insurance policy (including term insurance or a conventional whole life policy) other than a fixed premium or flexible premium variable life insurance policy. So long as the policyholder has the right to convert to a fixed benefit policy without providing evidence of current insurability, the purposes apparently underlying the conversion right will be satisfied. Also, because the relationship between the amount of insurance benefit and the net amount at risk may vary significantly with the death benefit option elected, the cash value, and policy design the new policy is permitted to provide *either the same amount of insurance benefit or the same net amount at risk as the converted flexible premium variable life policy.*

5. *Sales Loads Other Than Front-End Loads*

Section 27 of the 1940 Act was drafted with reference to mutual fund contractual plans, which imposed only front-end sales loads. However, as the Commission is aware from other contexts, notably its regulation of variable annuity contracts, other sales load structures are appropriate and, in many cases, desirable in products subject to 1940 Act regulation. These other possible forms include (1) a back-end sales load imposed, if at all, upon a complete or partial surrender or withdrawal of cash value, (2) a periodic sales load charge against cash value, computed as a fixed dollar amount, as a percentage of cash value or on some other basis,[34] and (3) a combination of front-end, back-end, and periodic charges.

In flexible premium variable life insurance products, sales loads other than front-end loads would share the characteristic of deferring the assessment of the charge until some date after the allocation of net premium to the separate account. Because the sales load charge would not be immediately deducted from a payment, a greater percentage of each premium would be allocated to the separate account than if the insurer had imposed a front-end sales load. Accordingly, there would be a relatively larger "investment" upon which investment earnings could compound. The policyholder would realize a greater return, vis a vis a front-end loaded product, from the same positive investment experience applied with respect to the same gross premium.

Moreover, at least under many back-end sales load schedules, the charge would decline gradually to 0 percent over a number of years and, if the policyholder persisted for the required period, no sales load would ever be assessed. This policyholder both would avoid sales loading altogether and would enjoy earnings on a relatively larger net investment. Even if a sales load ultimately were charged (either periodically or upon surrender or withdrawal), the deferral of the charge would confer an economic benefit on the policyholder through investment earnings, up to the time of assessment, on the load charged. The economic effect would be the same as if the insurer had charged a front-end charge at the same rate as the back-end or periodic charge, invested that amount in the separate account for its own benefit, and then credited a portion of that amount plus earnings to the policyholder daily until the day the deferred charge actually is assessed. Thus, the deferral of the sales load, even if the charge ultimately is assessed, would benefit the policyholder.

In addition, the flexible premium variable life policyholder realizes immediate and substantial benefit throughout the life of the policy: The insurance protection fundamental to flexible premium variable life insurance. In effect, the deferred load permits the policyholder to enjoy the primary benefits afforded by flexible premium variable life insurance without incurring a sales load, unless and until the plicy is totally or partially surrendered or otherwise lapses.

It is contemplated that flexible premium variable life insurance policies will be issued with other than front-end loads. In the case of variable annuities, back-end loads have been limited at any time to 9 percent of aggregate purchase payments received under the contract, and deferred sales load percentages have not increased over the duration of the contract.[35] The nature of the relief, however, that is both consistent with the purposes and policies of the 1940 Act and necessary to accommodate deferred sales loads in flexible premium variable life insurance differs from that traditionally accorded variable annuities. The relief must reflect the higher distribution costs characteristic of life insurance products. Absent such relief, insurance companies would be subjected to a substantial financial

[33] For an elaboration of these differences, see pages 21–22, *supra*.

[34] It is intended that the proposal provide all the relief from the 1940 Act necessary to permit sales loads in the form of periodic charges against cash value. No relief from Section 12 or Rule 12b–1 has been proposed, in the belief that these provisions are inapplicable to a charge (in whatever form) to recover sales and distribution expense that complies with the proposed relief from Section 27. Should the Commission take a different view of the application of Section 12, Rule 12b–1, or any other provision of the 1940 Act, additional exemptions will be necessary.

[35] In this respect, the exemptions from Section 27 for variable annuities could be characterized as treating back-end loads as if they were front-end loads.

https://www.loc.gov/item/fr048231/

disincentive to adopt deferred load structures in lieu of front-end structures, to the detriment of policyholders. The relief should also be sufficiently general to allow the diversity of possible combinations of sales load structures involving a complete or partial deferral of charges; that is, the rule should fairly regulate these varying structures while foreseeing and foreclosing any potential abuse each separate structure might entail. Moreover, the relief should recognize the inherent difficulty in applying the 1940 Act regulatory structure to a flexible premium insurance product with a deferred sales load.

The proposed rule accounts for these considerations by providing that a policy imposing a sales load other than a front-end load is exempt from the relevant provisions of Section 27 if the policy is economically as advantageous to the policyholder as would be an otherwise identical front-end loaded policy which complied in all respects with Section 27 and the exemptions contained in the proposed rule. Specifically, under the proposed rule, a flexible premium variable life insurance policy with other than a front-end sales load ("the actual policy") is exempt from Sections 27(a)(1), 27(a)(3), 27(d), [36] 27(h)(1), 27(h)(3), and 27(a)(4) of the 1940 Act if, at all durations through maturity, the cash surrender value, death benefit, and any endowment benefit of the actual policy is not less than the cash surrender value (including the proceeds from any applicable refund right), death benefit, and endowment benefit of a hypothetical policy ("the test policy") that is identical to the actual policy in all respects except that it charges a front-end sales load in any manner satisfying the Act and the proposed exemptive rule.

This approach to the regulation of deferred sales loads offers significant advantages. It recognizes that, at least in this context, the direct application of the strictures of Section 27 to deferred sales charges is at best strained. It also recognizes that companies are free to adopt front-end loads if they choose, and does not penalize, through a strained application of Section 27, issuers which adopt deferred sales load structures benefitting policyholders. Instead, it allows the issuer a *potential* sales load equivalent in value to the sales load it *actually* could have received with a front-end load design. Because this approach is framed in relatively general terms, it can evenhandedly regulate the wide range of possible deferred sales load structures, without a limiting reference to particular designs.

Finally, this approach is highly workable. It lends itself readily to a prospective demonstration of compliance if certain actuarial assumptions are made. In order to test representative payment patterns and to police possible abuses, the proposed rule specifies that; (1) Payments of the guideline annual premium for the actual policy and the guideline single premium at issue for the actual policy must both be tested in the alternative, (2) withdrawals or surrenders are assumed *not* to occur prior to the duration being tested, and (3) a reasonable net annual rate of return such as 4 percent is assumed. Under these actuarial assumptions, the computations necessary for this prospective demonstration are relatively mechanical, and probably in practivc could reduce to a testing of worst case examples. A sample demonstration of the type contemplated is attached as Appendix D. Accordingly, this approach permits both efficient review by the Commission staff of the compliance of individual sales load designs *and* regulation of deferred loads in a rule of general applicability.

This "economic value" approach to the regulation of sales loads other than front-end loads does not preclude the possibility that sales loads would exceed 9 percent of, generally, twenty years' payment.[37] There could be circumstances where the amount of the deferred sales charge would exceed 9 percent of total payments over twenty years, depending on the precise sales load schedule and the investment performance of the separate account. Practical factors tend to reduce the possibility that the 9 percent of payments limit would be exceeded. For example, the 9 percent limit is framed in terms of gross payments, but the cash value of the policy will reflect ongoing deductions of various charges (*e.g.*, cost of insurance and administrative charges) from either gross premiums or the account. Particularly in early policy years, the combination of large front-end administrative charges and the brief period of time during which earnings could compound will tend to reduce the applicable deferred sales load as a percentage of gross payments. Moreover, as discussed above, back-end sales loads in particular often decline to 0 percent over a period of years. Thus, for a deferred sales load to exceed 9 percent of gross payments, the investment performance of the separate account would have to more than compensate for the effect of charges against the policy and any decremental sales load schedule. There is, of course, no assurance that investment performance will be so favorable.

To the extent that deferred sales loads might exceed 9 percent of twenty years' payments, the proposed rule provides an exemption from Sections 27(a)(1) and 27(h)(1) of the 1940 Act. The deferred loading can be viewed as compensating the issuer for the time value of money. Obviously, a dollar amount of sales load received periodically or at surrender would be worth less to an issuer than the same amount received at the time a premium is paid. This is because the issuer would not have had the use of the money for the period between premium payment and assessment of the charge, and would have had to find other ways to pay for the expenses incurred in the sales of the policy. To the extent that favorable investment experience of the separate account would cause the dollar amount of deferred sales charges to exceed the 9 percent limitation, the excess will reflect the future value of the dollar amount of sales load that the issuer had the option of realizing at an earlier date by deducting it as a front-end load from gross premium. In this sense, the excess results from investment earnings on what can be described as the issuer's money.

Additional considerations support the proposal in the case of back-end loads. Flexible premium variable life insurance will be designed to provide insurance protection for the whole of life and to set the level of charges so as to cover expenses expected to be incurred or amortized over a protracted preiod of time. In other words, each time an issuer sells a policy, it will anticipate receiving a stream of income for a period of years, arising from charges for the cost of insurance, for administration, and for mortality and expense risks and other contingencies, that will cover the expenses incurred in selling and administering the policy and paying death claims during that period.[38] A

[36] The required right to convert to a fixed benefit policy is retained, under the proposal.

[37] A deferred charge limited to 9 percent of twenty years' premiums, where the insurance company gives up the economic value of a comparable front-end load, would necessarily comply with the 9 percent of payments restriction. The following discussion therefore pertains only to deferred loads *not* expressly limited to 9 percent of twenty years' payments.

[38] The insurer will bear the risk that policy charges will be insufficient to cover expenses (including death benefits). The insurer will draw down its surplus, or realize contributions to its surplus, to the extent that monies collected from charges are less or more, respectively, than expenses incurred.

https://www.loc.gov/item/fr048231/

back-end sales charge can be viewed, in principle, as the functional equivalent of those revenues that the insurer would have realized from such policy charges if the policyholder had persisted for the requisite period of years rather than surrendered and that would have paid, in whole or in part, for expenses incurred but not yet amortized. The back-end sales charge, generally speaking, thus will compensate the insurer for the future income stream from charges that the insurer anticipated receiving when it sold the policy, but loses as a result of surrender prior to the end of the anticipated life of the policy.

In this regard, a back-end sales charge will roughly balance the interests of surrendering versus persisting policy-holders. The economic effect of having no back-end charge can be viewed as permitting a policyholder to surrender without having paid the expenses incurred in the sale of his policy. In the absence of a back-end sales charge, the unpaid expenses ultimately would have to be borne by persisting policyholders. The back-end sales charge thus operates as a mechanism to shift, from persisting policyholders to a surrendering policy-holder, expenses incurred in the sale of the policy being surrendered.

For all these reasons, the proposed rule does not as a matter of law limit deferred sales loads to 9 percent of twenty years payments.

Finally, the proposed rule provides exemptions from Sections 2(a)(32), 26(a), 27(c), and 27(d) to the extent necessary to permit the assessment of sales loads upon redemption or other than against gross premium.

6. *Sales Loads in the Event of Adjustments in Face Amount*

This petition does not address the appropriate treatment of sales loads charged in connection with or following adjustments in the face amount of insurance after issuance of a flexible premium variable life insurance policy. The proposal with respect to this significant issue remains under consideration. An amendment to the petition detailing the relief necessary in this regard will be filed in the near future.

7. *Relief from Sections 27(c)(1), 27(d) and 2(a)(32)*

Rule 6e–2 provides certain exemptions from the redeemability provisions of Section 27 (an exemption which arguably should be extended to Section 2(a)(32) of the 1940 Act), primarily because the insurance nature of scheduled premium variable life insurance prevents the "redemption" of a pro rata share of the separate account's assets within the strict meaning of the 1940 Act. *See* Investment Company Act Rel. No. 9482, *supra*, at 753; *see also* Rel. No 8888, *supra*, at 592. This is an inherent characteristic of any life insurance product funded by a separate account, and the proposed rule contains a similar exemption, with one modification.

A scheduled premium variable life insurance policy lapses upon nonpayment of a premium before the end of the appropriate grace period. Upon lapsation, the policyholder may elect to receive a nonforfeiture option or, as required by Rule 6e–2, the cash surrender value. Since lapsation of a scheduled premium variable life policy results solely from a failure to pay premiums when due and is in no way dependent on the amount of the policy's cash value, the right to elect to receive the cash surrender value is consistent with the design of the product.

In contrast, as reflected in Article IV, Section 3(b)(2) of the Variable Life Insurance Model Regulation, a flexible premium variable life insurance policy may lapse only when the amounts available under the policy are less than the authorized charges necessary to keep the policy in force until the next policy processing day and the resultant grace period expires. This typically will occur only when the cash surrender value of the policy is minimal. In such a case, the administrative burden and expense to the insurance company of providing a cash "redemption" will be extremely high in relation to the benefit received by the policyholder; the cost could easily exceed the cash surrender value (if any). Moreover, in these circumstances, the application of the cash surrender value to a nonforfeiture option rather than to a cash redemption is equitable to both the policyholder and the insurer. If the amount available under the policy is insufficient to pay current charges and no additional premium is paid, the policyholder will receive at least some free insurance protection during the grace period. It is fair to permit the insurer to recoup some of its cost of such insurance provided to the policyholder, to the extent that the cash surrender value is sufficient to pay part of the authorized charges. Therefore, the proposed exemption from the redeemability requirements permits, during the grace period, the mandatory application of the cash surrender value to the purchase of a nonforfeiture option specified in the policy.

8. *Relief From Section 27(e), Rule 27e–1, Section 27(f), and Rule 27f–1*

The proposed rule substantially retains the exemptions in Rule 6e–2 from the "free look" and notice requirements of Section 27. Certain revisions, however, have been made in these exemptions to reflect industry practice and the nature of flexible premium variable life insurance.

With respect to the notice requirements, three modifications have been made. First, it is a common industry practice to provide notices to policyholders (especially in connection with the issuance of a policy) through personal delivery by sales representatives. The proposed rule permits this practice as an alternative to notice by mail. Because scheduled premium payments are not required by the flexible premium variable life insurance, the obligation to give a follow-up notice of the right of withdrawal and refund cannot be linked to the nonpayment of a premium. In the interest of both simplicity and investor protection, the proposed rule instead requires this notice to be provided within 30 days after each of the first two policy anniversaries (or such other date during the first two policy years as specified by the company). At the same time, the proposed rule provides that the refund right does not expire until 15 days after the final notice is given. Such an approach permits the requisite notices to be provided with the annual statements and reports required by Article IX of the Variable Life Insurance Model Regulation, resulting in improved convenience and economies for both policyholders and companies. Finally, the proposed rule allows companies to design their own notices containing certain information prescribed in the rule (which in certain regards may differ from the content of notices developed for scheduled premium variable life insurance because of the significant differences between the products). Notices tailored by each company to its individual policy design likely will be more understandable to policyholders than a standard form specified by the Commission.[39]

With respect to the "free look" requirement, certain amendments to the Variable Life Insurance Model Regulation are reflected in the proposed rule. Both Rule 6e–2 and, prior to its amendment, the Model Regulation required the refund of *all* payments made upon the exercise of the "free look" right. In contrast, Section 27(f) requires the refund of the value of the account at the time of the refund plus

[39] The Commission has permitted at least one scheduled premium variable life issuer to utilize its own notice of the right of withdrawal and refund. *See* Investment Company Act Rel. Nos. 8888, *supra*.

https://www.loc.gov/item/fr048231/

the difference between gross and net payments. Article IV, Section 3(a)(5) of the Model Regulations was amended by the NAIC in December 1982 to provide an analogous result. The rationale for the amendment was that it was inequitable to impose the entire investment risk on the insurer during the free look period; investment performance, either positive or negative, with respect to *net* premiums should instead be reflected in the amount to be returned.[40] (The insurer would still bear the investment risk with respect to any charges, which must be returned in full.) The proposed rule therefore specifies an amount to be refunded consistent with Section 27(f) and the Model Regulation as amended.

In addition, the proposed rule does not link the free look right to the execution of the insurance application. Rule 6e-2 extends the free look right until (among other cumulative dates) 45 days after the execution of the application. This provision was apparently intended to conform the rule to the existing free look provision in the Model Regulation. *See* Investment Company Act Rel. No 8691, *supra*, at 366. Article IV, Section 3(a)(5) of the Model Regulation was amended in 1982 to delete the reference to the execution of the insurance application. The proposed rule conforms to this amendment.

C. Other Provisions

As noted above, the proposed rule generally provides exemptions for flexible premium variable life insurance which correspond in substance to those contained in Rule 6e-2. In addition to the modifications in the definitional and sales load provisions discussed above, however, the proposed rule contains certain other variations from Rule 6e-2.

1. *Custodial Provisions*

With respect to Section 17(f), the proposed rule provides exemptions relief if either Rule 17f-2 or the conditions stated in Rule 6e-2 are satisfied. A separate exemption also is provided from Rule 17f-2 to the extent necessary for compliance with state insurance laws and established insurance company procedures. As the Commission is aware from numerous exemptions granted to issuers of variable annuity contracts,[41] state insurance laws and regulations and the issuer's general procedures may impose technical requirements inconsistent with those contained in Rule 17f-2 regarding, for example, the number of employees of the separate account who may have access to the securities and similar investments of the account, and access by employees of the insurance company (as opposed to employees "of" the separate account) and by employees or representatives of the state insurance department or the NAIC. The purpose of these state laws and company procedures is the protection of policyholders and the safeguarding of the separate account's assets. The insurance company and its operations and procedures, including its safekeeping of investments, are subject to the supervision of the state insurance department, and the company remains liable to policyholders until its obligations have been fully discharged. Accordingly, adequate protections will be afforded policyholders and this exemption is justified.

An additional exemption is provided from Sections 27(c)(2), 26(a)(1) and 26(a)(2) to permit the insurer to hold the securities and similar investments of the separate account in book entry form, subject to the provisions of Section 17(f) and Rule 17f-4, where applicable. Analogous exemptions have been routinely granted to issuers of variable annuity contracts.

2. *Pricing Provisions*

The proposed rule contains technical clarifications of the exemption provided in Rule 6e-2 from Sections 22(d), 22(e), and 27(c)(1) and Rule 22c-1. By requiring daily valuation as of the close of the New York Stock Exchange, the Rule 6e-2 exemption is not fully consistent with Rule 22c-1 in its current form. To rectify this inconsistency, the proposed rule authorizes the board of directors of the separate account annually to specify the daily time for valuation. Furthermore, as was recognized in Rule 6e-2, daily determinations that have no practical import should not be required, in order to avoid unnecessary administrative burdens. The proposed rule refines the Rule 6e-2 exemption in two ways to account for this concern. First, the determination of cash surrender value can readily be made from cash value when relevant, but may require an additional computation. The proposed rule therefore specifies that "cash value" only need be "determinable" daily. In addition, if the terms of the flexible premium variable life policy are such that charges and investment experience do not daily affect the cash value and the death benefit, respectively, then daily determinations taking such factors into account are not required, unless necessary for compliance with state insurance laws.

3. *Shared Funds*

The proposed rule permits a flexible premium variable life insurance separate account organized as a unit investment trust to invest its assets in registered management investment companies which offer their shares to other purchasers as well. This provision is intended to allow insurance companies to utilize the same mutual fund complex as a funding vehicle for variable annuities and for scheduled premium variable life insurance as well as for flexible premium variable life insurance. Although a similar provision in Rule 6e-2 is limited to funds used solely for scheduled premium variable life insurance, increased pooling, diversification, and scale economies in expenses, as well as avoidance of potential conflicts of interest among similar investment portfolios, would result if the same mutual funds were used for all variable contracts. These benefits are important enough to justify this practice. the proposed rule does not impose any conditions on such funding methods, because it is unclear what conditions, if any, would be appropriate. It is intended that any appropriate conditions would be incorporated in the proposed rule.

4. *Definitions*

Certain changes from the definitions contained in Rule 6e-2 are necessary in the proposed rule. The definitions of "incidental insurance benefit," "guaranteed death benefit," and "variable death benefit" reflect the structural differences between scheduled premium and flexible premium variable life insurance discussed elsewhere. In particular, the term "incidental insurance benefit" has been refined to include those insurance benefits lacking discrete cash values that vary with the investment performance of the separate account supporting the policy. Such benefits are treated as "fixed" for purposes of the proposed rule although the *amount* of insurance purchased may change with

[40] *See* Variable Life Insurance Model Regulation, art. IV, § 3(a)(5), commentary at 59-60 (1982).

[41] For examples of these exemptions, see the following 1940 Act releases: Rel. No. 12307 (March 18, 1982) (proposed), Rel. No. 12370 (April 13, 1982) (order); Rel. No. 12276 (March 5, 1982) (proposed), Rel. No. 12410 (April 30, 1982) (order); Rel. No. 12103 (December 14, 1981) (proposed), Rel. No. 12150 (January 8, 1982) (order); Rel. No. 14482 (December 8, 1980) (proposed), Rel. No. 11537 (January 6, 1981) (order); Rel. No. 11083 (March 13, 1980) (proposed), Rel. No. 11123 (April 8, 1980) (order); Rel. No. 9120 (January 12, 1976) (proposed), Rel. No. 9153 (February 11, 1976) (order); Rel. No. 8952 (September 24, 1975) (proposed), Rel. No. 8998 (October 21, 1975) (order).

https://www.loc.gov/item/fr048231/

investment experience.[42] Similarly, a benefit is treated as "incidental" even if its duration might depend on investment experience.

The definition of "payment" has also been modified. As used in Rule 6e–2, the term "payment" excludes charges for substandard risks, incidental insurance benefits, and more frequent than annual payments, for purposes of determining the amount upon which sales loads and refunds are computed. These charges were so excluded to provide consistent sales load regulation for contract with the same variable benefits and to provide additional relief from the refund requirement of Section 27(d). *See* Investment Company Act Rel. No. 9482, *supra*, at 754. To the extent that a flexible premium variable life policy treats such charges in the same manner as a scheduled premium variable life policy—effectively, as separate premiums which are deducted from gross premiums prior to the allocation of net premiums to the separate account—the proposed rule excludes the charges for the above-mentioned purposes. In many cases, however, these enumerated charges probably will be treated in a different manner under flexible premium variable life insurance, because of the flexibility of the product. Fixed premium payments may not be required for these coverages; rather, charge may be periodically deducted from cash value, in the same manner as the cost of insurance charge and certain other charges. In such cases, when a premium payment is received, it will not be possible to allocate a portion of it to these specified charges. Instead, the premium will be treated as paid toward *all* the charges under the policy, any front-end sales load will be computed on the basis of the gross payment received, and the net payment will be transferred to the separate account without earmarking. Under these circumstances, the proposed rule does not exclude the charges enumerated in the definition in Rule 6e–2 from the term "payment."

For the purpose of clarity, precise definitions of "cash value," "cash surrender value," and "net investment earnings" are provided.

Finally, to resolve any possible uncertainty with respect to the status under the 1940 Act of regulated insurance companies the primary and predominant business of which is the issuance of scheduled premium or flexible premium variable life insurance (or of both), the proposed rule provides that such issuers are "insurance companies" within the meaning of Section 2(a)(17) of the 1940 Act.

D. Rule 6c–3

Rule 6c–3 provides that a separate account which meets the requirements of Rule 6e–2 but which registers under the 1940 Act, together with certain related persons, shall nonetheless be entitled to the relief provided in Rule 6e–2, except for the exemptions from Section 7 and 8(a) of the Act. The adoption of this rule at the same time as Rule 6e–2 reflected the fact that the exemptions contained in Rule 6e–2 for unregistered separate accounts merely tailored the provisions of the 1940 Act to scheduled premium variable life insurance without providing unconditional relief from those provisions necessary for investor protection. Such exemptions (other than those from Sections 7 and 8(a)) were not predicated on the registration status of the separate account, and companies might prefer to register such separate accounts for external reasons. *See* Investment Company Act Rel. No. 9482, *supra*, at 756. A rule analogous to Rule 6c–3 is proposed for flexible premium variable life insurance.

V. Text of Proposed Rule Under Section 6(e)

(a) A separate account, and the investiment adviser, principal underwriter and depositor of such separate account, shall, except for the exemptions provided in paragraph (b) of this Rule, be subject to all provisions of the Act and rules and regulations promulgated thereunder as though such separate account were a registered investment company issuing periodic payment plan certificates if:

(1) Such separate account is a separate account within the meaning of Section 2(a)(37) of the Act and is established and maintained by a life insurance company pursuant to the insurance laws or code of: (i) Any state or territory of the United States or the District of Columbia, or (ii) Canada or any province thereof, if it complies to the extent necessary with Rule 7d–1 under the Act;

(2) The assets of the separate account are derived solely from the sale of flexible premium variable life insurace policies as defined in paragraph (c)(1) of this Rule, the sale of variable life insurance contracts as defined in paragraph (c)(1) of Rule 6e–2, funds corresponding to dividend accumulations with respect to such policies or contracts, and advances made by the life insurance company which established and maintains the separate account ("life insurer") in connection with operation of such separate account;

(3) the separate account is not used for variable annuity contracts or contract liabilities not involving life contingencies;

(4) the separate account is legally segregated, and that portion of its assets having a value equal to, or approximately equal to, the reserves and other contract liabilities with respect to such separate account are not chargeable with liabilities arising out of any other business that the life insurer conduct;

(5) the assets of the separate account have, at each time during the year that adjustments in the reserves are made, a value at least equal to the reserves and other contract liabilities with respect to such separate account, and at all other times, except pursuant to an order of the Commission, have a value approximately equal to or in excess of such reserves and liabilities; and

(6) the investment adviser of the separate account is registered under the Investment Advisers Act of 1940.

(b) If a separate account meets the requirements of paragraph (a), then with respect to flexible premium variable life insurance policies funded by such separate account, such separate account and the other persons described in paragraph (a) shall be exempt from the provisions of the Act as follows:

(1) Section 2(a)(35), provided, however, that the term "sales load," as used in the Act and rules and regulations thereunder, shall have the meaning set forth in paragraph (c)(4) of this Rule.

(2) Section 7.

(3) Section 8, to the extent that:

(i) For purposes of paragraph (a) of Section 8, the separate account shall file with the Commission a notification of Form ——— which identifies such separate account; and

(ii) For purposes of paragraph (b) of Section 8, the separate account shall file with the Commission a form to be designated by the Commission within ninety days after filing the notification of Form ———, provided, however, that if the fiscal year of the separate account ends within this ninety day period the form may be filed within ninety days after the end of such fiscal year.

(4) Section 9 to the extent that:

(i) The eligibility restrictions of Section 9(a) of the Act shall not be applicable to those persons who are officers, directors and employees of the

[42] For example, a rider for variable annuity benefits funded by its own variable cash value is not intended to be treated as an incidental insurance benefit. In contrast, an accidental death benefit, the *amount* of which is indexed to the basic death benefit provided under the policy, would be treated as an incidental insurance benefit.

https://www.loc.gov/item/fr048231/

life insurer of its affiliates who do not participate directly in the management or administration of the separate account or in the sale of flexible premium variable life insurance policies funded by such separate account; and

(ii) A life insurer shall be ineligible pursuant to paragraph (3) of Section 9(a) of the Act to serve as investment adviser, depositor of or principal underwriter for a flexible premium variable life insurance separate account only if an affiliated person of such life insurer, ineligible by reason of paragraphs (1) or (2) of Section 9(a) participates directly in the management or administration of the separate account or in the sale of flexible premium variable life insurance policies funded by such separate account.

(5) Section 13(a) to the extent that:

(i) An insurance regulatory authority may require pursuant to insurance law or regulation that the separate account make (or refrain from making) certain investments which would result in changes in the sub-classification or investment policies of the separate account;

(ii) Changes in the investment policy of the separate account initiated by policyholders or the board of directors of the separate account may be disapproved by the life insurer, provided that such disapproval is reasonable and is based upon a determination by the life insurer in good faith that:

(A) Such change would be contrary to state law; or

(B) Such change would be inconsistent with the investment objectives of the separate account or would result in the purchase of securities for the separate account which vary from the general quality and nature of investments and investment techniques utilized by other separate accounts of the life insurer or of an affiliated life insurance company, which separate accounts have investment objectives similar to the separate account;

(iii) Any action taken in accordance with paragraph (b)(5) (i) or (ii) and the reasons therefor shall be disclosed in the proxy statement for the next meeting of flexible premium variable life insurance policyholders of the separate account.

(6) Section 14(a), provided that until the separate account has total assets of at least $100,000 the life insurer shall have: (i) A combined capital and surplus, if a stock company, or (ii) an unassigned surplus, if a mutual company, of not less than $1,000,000 as set forth in the balance sheet, of such life insurer contained in the registration statement, or any amendment thereto, relating to flexible premium variable life insurance policies funded by such separate account filed pursuant to the Securities Act of 1933, as amended.

(7)(i) Section 15(a) to the extent this section requires that the initial written contract pursuant to which the investment adviser serves or acts shall have been approved by the vote of a majority of the outstanding voting securities of the registered company, provided that:

(A) Such investment adviser is selected and a written contract is entered into before the effective date of the registration statement under the Securities Act of 1933, as amended, for flexible premium variable life insurance policies which are funded by the separate account, and that the terms of the contract are fully disclosed in such registration statement, and

(B) A written contract is submitted to a vote of flexible premium variable life insurance policyholders at their first meeting after the effective date of the registration statement under the Securities Act of 1933, as amended, on condition that such meeting shall take place within one year after such effective date, unless the time for the holding of such meeting shall be extended by the Commission upon written request for good cause shown;

(ii) Sections 15(a), (b) and (c) to the extent that:

(A) An insurance regulatory authority may disapprove pursuant to insurance law or regulation any contract between the separate account and an investment adviser or principal underwriter;

(B) Changes in the principal underwriter for the separate account initiated by policyholders or the board of directors of the separate account may be disapproved by the life insurer, provided that such disapproval is reasonable;

(C) Changes in the investment adviser of the separate account initiated by policyholders or the board of directors of the separate account may be disapproved by the life insurer, provided that such disapproval is reasonable and is based upon a determination by the life insurer in good faith that:

(1) The rate of the proposed investment advisory fee will exceed the maximum rate that is permitted to be charged against the assets of the separate account for such services as specified by any flexible premium variable life insurance policy funded by such separate account; or

(2) The proposed investment adviser may be expected to employ investment techniques which vary from the general techniques utilized by the current investment adviser to the separate account, or advise the purchase or sale of securities which would be inconsistent with the investment objectives of the separate account or which would vary from the quality and nature of investments made by other separate accounts of the life insurer or of an affiliated life insurance company, which separate accounts have investment objectives similar to the separate account;

(D) Any action taken in accordance with paragraph (b)(7)(ii) (A), (B) or (C) and the reasons therefore shall be disclosed in the proxy statement for the next meeting of flexible premium variable life insurance policyholders of the separate account.

(8) Section 16(a) to the extent that:

(i) Persons serving as directors of the separate account prior to the first meeting of such account's flexible premium variable life insurance policyholders are exempt from the requirement of Section 16(a) of the Act that such persons be elected by the holders of outstanding voting securities of such account at an annual or special meeting called for that purpose, provided that:

(A) Such persons have been appointed directors of such account by the life insurer before the effective date of the registration statement under Securities Act of 1933, as amended, for flexible premium variable life insurance policies which are funded by the separate account and are identified in such registration statement (or are replacements appointed by the life insurer for any such persons who have become unable to serve as directors), and

(B) An election of directors for such account shall be held at the first meeting of flexible premium variable life insurance policyholders after the effective date of the registration statement under the Securities Act of 1933, as amended, relating to policies funded by such account, which meeting shall take place within one year after such effective date, unless the time for holding such meeting shall be extended by the Commission upon written request for good cause shown;

(ii) A member of the board of directors of such separate account may be disapproved or removed by the appropriate insurance regulatory authority if such person is ineligible to serve as a director of the separate account pursuant to insurance law or regulation of the jurisdiction in which the life insurer is domiciled.

(9) Section 17(f) to the extent that the securities and similar investments of a separate account organized as a management investment company may

https://www.loc.gov/item/fr048231/

be maintained in the custody of the life insurer or an insurance company which is an affiliated person of such life insurer, provided that either the provisions of Rule 17f-2 are satisfied or:

(i) The securities and similar investments allocated to such separate account are clearly identified as to ownership by such account and such securities and similar investments are maintained in the vault of an insurance company which meets the qualifications set forth in paragraph (b)(9)(ii), and whose procedures and activities with respect to such safekeeping function are supervised by the insurance regulatory authorities of the jurisdiction in which the securities and similar investments will be held;

(ii) The insurance company maintaining such investments must file with an insurance regulatory authority of a state or territory of the United States or the District of Columbia an annual statement of its financial condition in the form prescribed by the National Association of Insurance Commissioners, must be subject to supervision and inspection by such authority and must be examined periodically as to its financial condition and other affairs by such authority, must hold the securities and similar investments of the separate account in its vault, which vault must be equivalent to that of a bank, which is a member of the Federal Reserve System, and must have a combined capital and surplus, if a stock company, or an unassigned surplus, if a mutual company, of not less than $1,000,000 as set forth in its most recent annual statement filed with such authority;

(iii) Access to such securities and similar investments shall be limited to employees of or agents authorized by the Commission, representatives of insurance regulatory authorities, independent public accountants for the separate account, accountants for the life insurer and to no more than 20 persons authorized pursuant to a resolution of the board of directors of the separate account, which persons shall be directors of the separate account, officers and responsible employees of the life insurer or officers and responsible employees of the affiliated insurance company in whose vault such investments are maintained (if applicable), and access to such securities and similar investment shall be had only by two or more such persons jointly, at least one of whom shall be a director of the separate account or officer of the life insurer;

(iv) The requirement in paragraph (b)(9)(i) that the securities and similar investments of the separate account be maintained in the vault of a qualified insurance company shall not apply to securities deposited with insurance regulatory authorities or deposited in a system for the central handling of securities established by a national securities exchange or national securities association registered with the Commission under the Securities Exchange Act of 1934, as amended, or such person as may be permitted by the Commission, or to securities on loan which are collateralized to the extent of their full market value, or to securities hypothecated, pledged, or placed in escrow for the account of such separate account in connection with a loan or other transaction authorized by specific resolution of the board of directors of the separate account, or to securities in transit in connection with the sale, exchange, redemption, maturity or conversion, the exercise of warrants or rights, assents to changes in terms of the securities, or to other transactions necessary or appropriate in the ordinary course of business relating to the management of securities;

(v) Each person when depositing such securities or similar investments in or withdrawing them from the depository or when ordering their withdrawal and delivery from the custody of the life insurer or affiliated insurance company, shall sign a notation in respect of such deposit, withdrawal or order which shall show: (A) The date and time of the deposit, withdrawal or order, (B) the title and amount of the securities or other investments deposited, withdrawn or ordered to be withdrawn, and an identification thereof by certificate numbers or otherwise, (C) the manner or acquisition of the securities or similar investments deposited or the purpose for which they have been withdrawn, or ordered to be withdrawn, and (D) if withdrawn and delivered to another person the name of such person. Such notation shall be transmitted promptly to an officer or director of the separate account or the life insurer designated by the board of directors of the separate account who shall not be a person designated for the purpose of paragraph (b)(9)(iii). Such notation shall be on serially numbered forms and shall be preserved for at least one year;

(vi) Such securities and similar investments shall be verified by complete examination by an independent public accountant retained by the separate account at least three times during each fiscal year, at least two of which shall be chosen by such accountant without prior notice to such separate account. A certficate of such accountant stating that he has made an examination of such securities and investments and describing the nature and extent of the examination shall be transmitted to the Commission by the accountant promptly after each examination;

(vii) Securities and similar investments of a separate account maintained with a bank or other company whose functions and physical facilities are supervised by federal or state authorities pursuant to any arrangement whereby the directors, officers, employees or agents of the separate account or the life insurer are authorized or permitted to withdraw such investments upon their mere receipt are deemed to be in the custody of the life insurer and shall be exempt from the requirements of Section 17(f) so long as the arrangement complies with all provisions of this paragraph (b)(9), except that such securities will be maintained in the vault of a bank or other company rather than the vault of an insurance company.

(10) Rule 17f-2, to the extent necessary for compliance with insurance laws and regulations of the jurisdiction in which the securities and similar investments allocated to a separate account organized as a management investment company will be held, or with the established procedures of the life insurer.

(11) Section 18(i) to the extent that:

(i) For the purposes of any section of the Act which provides for the vote of securityholders on matters relating to the registered management investment company:

((A) Flexible premium variable life insurance policyholders shall have one vote for each $100 of cash value funded by the separate account with fractional votes allocated for amounts less than $100;

(B) The life insurer shall have one vote for each $100 of assets of the separate account not otherwise attributable to policyholders pursuant to paragraph (b)(11)(i)(A), with fractional votes allocated for amounts less than $100, provided that after the commencement of sales of flexible premium variable life insurance policies fund by the separate account, the life insurer shall cast its votes for and against each matter which may be voted upon by policyholders in the same proportion as the votes cast by policyholders; and

(C) The number of votes to be allocated shall be determined as of a record date not more than 90 days prior to any meeting at which such vote is held, provided that if a quorum is not present at the meeting, the meeting may

https://www.loc.gov/item/fr048231/

be adjourned for up to 60 days without fixing a new record date;

(ii) The requirement of this section that every share of stock issued by a registered management investment company (except a common-law trust of the character described in Section 16(c)) shall be a voting stock and have equal voting rights with every other outstanding voting stock shall not be deemed to be violated by actions specifically permitted by any provisions of this Rule.

(12) Section 19 to the extent that the provisions of this section shall not be applicable to any dividend or similar distribution paid or payable pursuant to provisions of participating flexible premium variable life insurance policies.

(13) Sections 22(d), 22(e) and 27(c)(1) and Rule 22c-1 promulgated under Section 22(c) to the extent:

(i) That the amount payable on death and the cash value of each flexible premium variable life insurance policy shall be determinable on each day during which the New York Stock Exchange is open for trading, not less frequently than once daily as of such specific time during the day as determined at least annually by a majority of the board of directors of the investment company, except that:

(A) To the extent that the calculation of the cash value reflects deductions for the cost of insurance and other insurance benefits or administrative expenses and fees and distribution expenses, such deductions need only be made at such times as specified in the policy or as necessary for compliance with insurance laws and regulations; and

(B) Unless necessary for compliance with insurance laws and regulations, the amount payable on death need not be calculated on a day during which the New York Stock Exchange is open for trading if the provisions of the policy are such that the investment experience of the separate account does not increase or decrease such amount on that day;

(ii) Necessary for compliance with this Rule or with insurance laws and regulations and established administrative procedures of the life insurer with respect to issuance, transfer and redemption procedures for flexible premium variable life insurance policies funded by the separate account including, but not limited to, premium rate structure and premium processing, insurance underwriting standards, and the particular benefit afforded by the policy, provided, however, that any procedure or action shall be reasonable, fair and not discriminatory to the interests of the affected policyholder and to all other holders of policies of the same class or series funded by the separate account, and, further provided that any such action shall be disclosed in the form required to be filed by the separate account with the Commission pursuant to paragraph (b)(3)(ii) of this Rule.

(14) Section 27 to the following extent:

(i) Sections 27(a)(1), 27(h)(1), and 27(h)(4) to the extent that the sales load, as defined in paragraph (c)(4), charged during the policy periods equal to the lesser of 20 years or the anticipated life expectancy of the insured named in the policy based on the 1958 Commissioners Standard Ordinary Mortality Table on any flexible premium variable life insurance policy which is funded by the separate account shall not exceed 9 per centum of the sum of the guideline annual premiums that would be paid thereon during such policy periods: Provided, that the sales load, as defined in paragraph (c)(4), charged during any policy period in which the payments exceed the guideline annual premium shall not exceed the lesser of 9 per centum of the guideline single premium payable in such policy period, or the sum of the sales load charged during such policy period assuming the payment of exactly the guideline annual premium and 9 per centum of the excess of the payments made during such policy period over the guideline annual premium;

(ii) Sections 27(a)(3) and 27(h)(3), provided that the ratio with respect to each payment treated under paragraph (d)(1) of this Rule as made for the guideline annual premium and for amounts in excess of the guideline annual premium, respectively, of

(1) the amount by which the sales load charged during the policy period is increased by reason of the making of a payment, to

(2) The amount of such payment shall not exceed such ratio for any prior corresponding payment, unless an increase in any such ratio is caused by the grading of cash surrender values into reserves, or reductions in the annual cost of insurance.

(iii) Sections 27(c)(2), 26(a)(1) and 26(a)(2) provided that the life insurer complies, to the extent applicable, with all other provisions of Section 26 as if it were a trustee, depositor or custodian for the separate account, and:

(A) Files with the insurance regulatory authority of a state or territory of the United States or of the District of Columbia an annual statement of its financial condition in the form prescribed by the National Association of Insurance Commissioners, which most recent statement indicates that it has a combined capital and surplus, if a stock company, or an unassigned surplus, if a mutual company, of not less than $1,000,000;

(B) Is examined from time to time by the insurance regulatory authority of such state, territory of District of Columbia as to its financial condition and other affairs and is subject to supervision and inspection with respect to its separate account operations; and

(C) Limits the fees for administrative services to amounts that are reasonable in relation to services rendered and expenses incurred. The Commission shall retain jurisdiction regarding the determination of such fees; and

Provided further, that such life insurer may hold securities and similar property in which the funds of the separate account are invested in book entry form, subject to the provisions of Section 17(f) and Rule 17f-4, where applicable;

(iv) Section 27(c)(2) and 26(a), to the extent that charges under the policies may be imposed for administrative expense, taxes, sales and distribution expense, and similar expenses, provided that charges for administrative services are reasonable in relation to services rendered and expenses incurred;

(v) Section 27(c)(1), Section 27(d), and Section 2(a)(32), to the extent that

(A) Such sections require that the flexible premium variable life insurance policy be redeemable or provide for a refund in cash, provided that such policy provides for election by the policyholder of a cash surrender value or certain non-forfeiture and settlement options which are required or permitted by the insurance law or regulation of the jurisdiction in which the policy is offered, and further provided that unless required by the insurance law or regulation of the jurisdiction in which the policy is offered or unless elected by the policyholder, such policy shall not provide for the automatic imposition of any option, including, but not limited to, an automatic premium loan, which would involve the accrual or payment of an additional interest or similar charge;

(B) Sales loads may be charged upon a complete or partial surrender or withdrawal.

Notwithstanding the provisions of paragraph (b)(14)(v)(A), the policy may provide that, 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 date, the cash surrender value shall be applied to purchase a non-forfeiture option specified by the insurer in such policy;

https://www.loc.gov/item/fr048231/

(vi) Section 27(d), provided that the flexible premium variable life insurance policy gives the holder thereof the right to:

(A) Surrender the policy at any time during the first 24 months after issuance and receive in cash an amount not less than the sum of the present value of his policy which is the cash surrender value next computed after receipt by the life insurer of the request for surrender in proper form, plus, depending upon the period over which such policy has been retained by the policyholder, an amount which is a refund of any excess paid for sales loading prior to or in connection with the surrender. The amount of sales loading to be refunded shall be equal to that part of the sales loading in excess of the sum of: (1) The lesser of 30 per centum of the guideline annual premium or 50 per centum of the actual payments made during the first policy period, plus (2) the lesser of 10 per centum of the guideline annual premium or 17 per centum of the actual payments made during the second policy period, plus (3) 9 per centum of the payments made during the first or the second policy period after such payments exceed the guideline annual premium.

(B) Convert the policy at any time during the first 24 months after issuance so long as the policy is in force to a life insurance policy on the life of the insured pursuant to a plan of insurance (other than a plan involving a flexible premium variable life insurance policy as defined in paragraph (c)(1) of this Rule or a variable life insurance contract as defined in paragraph (c)(1) of Rule 6e–2) specified in the policy issued by the life insurer, or by a life insurance company affiliated with such insurer, which provides for either the same amount payable by reason of the death of the insured or the same net amount at risk as the flexible premium variable life insurance policy at the time of conversion and premiums which are based on the same issue age and risk classification of the insured as the flexible premium variable life insurance policy, which conversion shall be subject to an equitable adjustment in payments and cash values to reflect variances, if any, in the payments and cash values under the original policy and the new policy, provided that the method of computing such adjustment shall be filed with the Commission as an exhibit to the form required pursuant to paragraph (b)(3)(ii) of this Rule;

(vii) A depositor or principal underwriter for a flexible premium variable life insurance policy sold subject to Section 27(d) or Section 27(f) of the Act, or both, shall be exempt from the requirements of Rule 27d–1 if an insurance company undertakes in writing to guarantee the performance of all obligations of such depositor or principal underwriter under Sections 27(d) and 27(f) of the Act to refund charges and such insurance company, depositor and principal underwriter comply with all provisions of Rule 27d–2;

(viii) Section 27(e) and Rule 27e–1 thereunder to the extent that the separate account and the depositor and principal underwriter therefor, when such persons are subject to paragraph (b)(14)(vi)(A) of this Rule, are required to provide a notice of right of withdrawal and refund to holders of flexible premium variable life insurance policies, if the life insurer or a duly authorized agent provides a notice of withdrawal and refund rights to the holder of any flexible premium variable life insurance policy under which a refund may be available, provided that such notice shall be sent by first class mail or personal delivery to the policyholder:

(A) At issuance of the flexible premium variable life insurance policy, which notice may be sent together with the issued policy and an illustration, in a form appropriate for inclusion in the prospectus for the flexible premium variable life insurance policy, of guideline annual premiums, death benefits and cash surrender values applicable to the age, sex and underwriting classification of the insured; and

(B) Within thirty days after the first and second anniversaries of the policy, or within thirty days after a specified date in the first and second policy years, provided, however, that the right of withdrawal and refund provided by paragraph (b)(14)(vi)(A) of this Rule shall not expire until not less than 15 days after the mailing or personal delivery of the last notice referred to in this paragraph (b)(14)(viii)(B).

(ix) Section 27(f) and Rule 27f–1, provided that:

(A) The policy holder may elect to return the policy within 10 days after receipt of the issued policy by the policyholder, or within 10 days after mailing or personal delivery of the notice of the right of withdrawal referred to in paragraph (b)(14)(ix)(C), whichever is later, and receive a refund equal to the sum of (1) 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 (2) 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, provided, however, that if state law or the policy so require, the redeeming policyholder shall receive a refund of all payments made for such policy;

(B) A refund in accordance with paragraph (b)(14)(ix)(A) to redeeming policyholders will not in any way affect the interests in the separate account or the benefits of other flexible premium variable life insurance policyholders;

(C) Notice of such withdrawal right and a statement of charges is sent by first class mail or personal delivery to the policyholder. Such notice and statement shall inform the policyholder of the right of withdrawal as set forth in paragraph (b)(14)(ix)(A) and shall summarize the deductions for sales load and for administrative expenses as specified in the prospectus for the flexible premium variable life insurance policy. Such notice and statement may be accompanied by the flexible premium variable life insurance policy, and an illustration, in a form appropriate for inclusion in the prospectus for the flexible premium variable life insurance policy, of guideline annual premiums, death benefits and cash surrender values applicable to the age, sex and underwriting classification of the insured;

(D) The policyholder, in conjunction with the notice of withdrawal right referred to in paragraph (b)(14)(ix)(C) is provided with a form of request for refund of the amount computed in accordance with paragraph (b)(14)(ix)(A), which form shall set forth

(1) Instructions as to the manner in which a refund may be obtained including the address to which the request form should be mailed; and

(2) Spaces necessary to indicate the date of such request, the policy number and the signature of the policyholder; and

(E) Within 7 days from the receipt of such duly executed timely request for refund, the life insurer will refund in cash to the policyholder the amount computed in accordance with paragraph (b)(14)(ix)(A);

(x) Solely for purposes of paragraphs (b)(14)(vi) and (b)(14)(ix) of this Rule, the postmark date on the envelope containing the flexible premium variable life insurance policy shall determine whether such policy has been submitted for surrender or conversion within the designated period.

(15) Section 32(a)(2), provided that:

(i) The independent public accountant is selected before the effective date of the registration statement under the Securities Act of 1933, as amended, for

https://www.loc.gov/item/fr048231/

flexible premium variable life insurance policies which are funded by the separate account, and the identity of such accountant is disclosed in such registration statement, and

(ii) The selection of such accountant is submitted for ratification or rejection to flexible premium variable life insurance policyholders at their first meeting after the effective date of the registration statement under the Securities Act of 1933, as amended, on condition that such meeting shall take place within one year after such effective date, unless the time for the holding of such meeting shall be extended by the Commission upon written request for good cause shown.

(16) If the separate account is organized as a unit investment trust, all the assets of which consist of the shares of one or more registered management investment companies:

(i) The eligibility restrictions of Section 9(a) of the Act shall not be applicable to those persons who are officers, directors and employees of the life insurer or its affiliates who do not participate directly in the management or administration of any registered management investment company described above;

(ii) The life insurer shall be ineligible pursuant to paragraph (3) of Section 9(a) of the Act to serve as investment adviser of or principal underwriter for any registered management investment company described in this paragraph (b)(16) only if an affiliated person of such life insurer, ineligible by reason of paragraphs (1) or (2) of Section 9(a), participates in the management or administration of such company;

(iii) The life insurer may vote shares of the registered management investment companies held by the separate account without regard to instructions from policyholders of the separate account if such instructions would require such shares to be voted:

(A) To cause such companies to make (or refrain from making) certain investments which would result in changes in the sub-classification or investment objectives of such companies or to approve or disapprove any contract between such companies and an investment adviser when required to do so by an insurance regulatory authority subject to the provisions of paragraphs (b)(5)(i) and (b)(7)(ii)(A); or

(B) In favor of changes in investment objectives, investment adviser of or principal underwriter for such companies subject to the provisions of paragraphs (b)(5)(ii) and (b)(7)(ii) (B) and (C);

(iv) Any action taken in accordance with paragraph (b)(16)(iii) (A) or (B) and the reasons therefor shall be disclosed in the next report to policyholders made pursuant to Section 30(d) and Rule 30d-2 thereunder.

(c) When used in this Rule:

(1) "Flexible premium variable life insurance policy" means a policy of life insurance, subject to regulation under the insurance laws or code of every jurisdiction in which it is offered, funded by a separate account of a life insurer, which provides for:

(i) The payment of one or more premiums which are not fixed by the life insurer as to both timing and amount;

(ii) A death benefit the amount or duration of which may vary to reflect the investment experience of the separate account;

(iii) A cash surrender value which varies to reflect the investment experience of the separate account; and

(iv) Assumption of mortality and expense risks thereunder by the life insurer for which a charge may be assessed. Such charge shall be disclosed in the prospectus.

Provided, however, that "flexible premium variable life insurance policy" shall not include that portion of any policy which is treated under state law as providing any annuity benefits other than as a settlement option.

(2) "Incidental insurance benefits" means insurance benefits provided pursuant to the flexible premium variable life insurance policy, other than any guaranteed and variable death benefit, which do not have discrete cash values that may vary in accordance with the investment performance of the separate account, including, but not limited to, accidental death dismemberment benefits, disability income benefits, guaranteed insurability options, and family income or fixed benefit term riders.

(3) "Guaranteed death benefit" is the amount, if any, guaranteed by the life insurer to be paid pursuant to a flexible premium variable life insurance policy in the event of the death of the insured without regard to the investment performance of the separate account funding the flexible premium variable life insurance policy, if there are no outstanding loans, partial withdrawals or partial surrenders, but does not include any incidental insurance benefits.

(4) "Sales load" charged during a policy period is the excess of the payments made during such period over the sum of the following:

(i) The amount of the increase in the cash surrender value for such period not attributable to net investment earnings for such period:

(ii) The cost of insurance for such period based on the 1958 Commissioners Standard Ordinary Mortality Table and net interest at an annual effective rate of 4 percent;

(iii) If the policy provides for a guaranteed death benefit, a reasonable charge necessary to cover the risk assumed by the life insurer that the variable death benefit will be less than the guaranteed death benefit;

(iv) Any administrative expenses or fees which are reasonable and in amounts not exceeding anticipated administrative expenses and fees not properly chargeable to sales or promotional activities;

(v) Any deduction approximately equal to state premium taxes;

(vi) Any additional charges assessed if the insured does not meet standard underwriting requirements;

(vii) Any additional charge assessed specifically for any incidental insurance benefits;

(viii) Any additional charge assessed specifically for any mortality or administrative expense risk or interest rate guarantees, to the extent that such charges are not reflected in net investment earnings;

(ix) Any additional charge, in the nature of an interest or service charge or administrative fee, assessed when payments are made more frequently than annually;

(x) Any amounts paid out of the cash surrender value to the policyholder upon a complete or partial surrender or withhdawal or to the beneficiary upon the death of the insured which are not attributable to net investment earnings for such period;

(xi) For a participating flexible premium variable life insurance policy, a deduction for dividends to be paid or credited in accordance with the dividend scale in effect on the issue date of the policy assuming a net investment earnings rate for the separate account which funds such policy of 4 percent. The deduction may be determined pursuant to either of the following methods, provided that the same method must be applied with respect to each policy period:

(A) The actuarial level annual equivalent of dividends to be paid or credited over the policy periods described in paragraph (b)(14)(i) of this Rule, based upon the mortality, interest and lapse assumptions used in computing the dividend scale for such policy and the assumption that the guideline annual premium will be paid in each such policy period, multiplied by

https://www.loc.gov/item/fr048231/

the fraction of the policy year represented by the policy period; or

(B) That portion of the dividend to be paid for the policy year which does not depend on the making of payments in addition to those made during such period; and

(xii) Any other fees or charges that are not properly chargeable to sales or promotional activity, to the extent that such fees or charges are reasonable in relation to expenses incurred and are not reflected in net investment earnings.

(5) "Policy period" means the period from a policy anniversary date to the earlier of the next following anniversary date (or, if later, the last day of any grace period commencing before such next following anniversary date) or the termination date of the policy.

(6) "Variable death benefit" is the amount of death benefit, other than incidental insurance benefits, payable under a flexible premium variable life insurance policy which varies to reflect the investment performance of the separate account, and which would be payable in the absence of any guaranteed death benefit.

(7) "Payment" as used in paragraph (b)(14)(i), (b)(14)(ii), and (b)(14)(vi)(A) of this Rule and in sections 27(a)(e) and 27(h)(2) solely with respect to flexible premium variable life insurance policies, means for a policy period the gross premium payments made less any portion of such gross premium payments charged prior to the allocation of net premiums to the separate account for the items specified in paragraphs (c)(4)(vi), (c)(4)(vii), and (c)(4)(ix) of this Rule. "Payment," as used in any other section of the Rule, means the gross premiums paid or payable for the flexible premium variable life insurance policy.

(8)(A) "Guideline annual premium" means the level annual amount that would be payable over the longest period permitted under the policy for the future benefits under the policy, if, subject to the provisions of paragraph (c)(8)(B):

(i) The premiums were fixed by the insurer as to both timing and amount, and

(ii) The premiums were based on the 1958 Commissioners Standard Ordinary Mortality Table, net investment earnings at an annual effective rate of 1 percent, the sales load under the policy, and the charges associated with the policy specified in paragraphs (c)(4)(iii), (c)(4)(iv), (c)(4)(v), (c)(4)(vi), (c)(4)(vii), (c)(4)(viii), (c)(4)(ix), (c)(4)(xi) and (c)(4)(xii) if this Rule.

(B) In computing the guideline annual premium:

(i) The excess of the amount payable by reason of the death of the insured (determined without regard to any incidential insurance benefits) over the cash value of the policy shall be deemed to be not greater than such excess at the time the policy was issued.

(ii) The maturity date shall be the lastest maturity date permitted under the policy but not less than 20 years after the date of issue or (if earlier) age 95, and

(iii) The amount of any endowment benefit (or sum of endowment benefits) shall be deemed not to exceed the least amount payable by reason of the death of the insured (determined without regard to any incidental insurance benefits) at any time under the policy.

(9) "Guideline single premium" means the single amount payable at a specified time which would provide the future benefits under the policy until the maturity date specified in paragraph (c)(8)(B)(ii) and which otherwise is computed on the same basis as the guideline annual premium.

(10) "Cash value" means the amount that would be available in cash upon voluntary termination of a policy by its owner before it becomes payable by death or maturity, without regard to any charges that may be assessed upon such termination and before deduction of any outstanding policy loan.

(11) "Cash surrender value" means the amount available in cash upon voluntary termination of a policy by its owner before it becomes payable by death or maturity, after any charges assessed in connection with such termination have been deducted and before deduction of any outstanding policy loan.

(12) "Net investment earnings" means investment earnings in the separate account after any asset charges, including but not limited to such charges for income tax, investment expense, investment advice, interest rate guarantees, and expense and mortality risk, but not including asset charges properly chargeable to sales or promotional activity.

(d) The following computational rules shall be used in applying this Rule:

(1) Payments made during each policy period shall be deemed to be paid first, for the guideline annual premium, and second, for amounts in excess of the guideline annual premium.

(2) Paragraphs (b)(14)(i), (b)(14)(ii), and (b)(14(vi)(A) of this Rule shall be deemed to be satisfied with respect to any flexible premium variable life insurance policy under which sales load may be deducted other than from gross premiums prior to the allocation of net premiums to the separate account (the "actual policy") if during each policy period through the maturity date specified in paragraph (c)(8)(B)(ii) of this Rule, the cash surrender value, the death benefit, and any endowment benefit provided under such policy is not less than the cash surrender value (including any amounts that would be refunded under paragraph (b)(14)(vi)(A) of this Rule), death benefit, and endowment benefit, respectively, that would be provided under a flexible premium variable life insurance policy (the "test policy") that is identical to the actual policy except that sales load may be deducted only from gross premiums prior to the allocation of net premiums to the separate account in any manner satisfying the provisions of the Act and this Rule, assuming that:

(A) Premiums for both the actual policy and the test policy are paid in each of the following alternative amounts:

(i) Level annual premiums equal to the guideline annual premium for the actual policy, and

(ii) A single premium paid at issue equal to the guideline single premium at issue for the actual policy,

(B) Net investment earnings are earned at an annual effective rate of 4 percent, and

(C) No partial withdrawals or surrenders are effected under the actual and test policies.

(e) The term "insurance company," as used in the Act and the rules and regulations thereunder, shall have the meaning set forth in Section 2(a)(17) of the Act, provided that the phrase "the writing of insurance" as used therein shall include the writing of flexible premium variable life insurance policies as defined in paragraph (c)(1) of this Rule or of variable life insurance contracts as defined in paragraph (c)(1) of Rule 6e-2. A company that is an insurance company within the meaning of this paragraph (e) shall be exempt from Section 2(a)(17) of the Act.

VI. Text of Proposed Rule under Section 6(c)

A separate account which meets the requirements of paragraph (a) of Rule 6e– and registered as an investment company under section 8(a) of the Act, and the investment advisor, principal underwriter and depositor of such separate account, shall be exempt from the provisions of the act specificed in paragraph (b) of Rule 6e–, except for sections 7 and 8(a) of the Act, under the same terms and conditions as a separate account claiming exemption under Rule 6e—.

https://www.loc.gov/item/fr048231/

September 15, 1983 Supplement to Petition

Table of Contents

I. Adjustments in Insurance Benefits
II. Basis for Exemption From the 1940 Act
III. Analysis of the Proposed Exemption From the 1940 Act
IV. Text of Additional Paragraph for Proposed Rule Under Section 6(e)
V. Conclusion

Amendment to Petition for Issuance of Rules and Rulemaking Proceeding Therefore

This amendment to the petition for issuance of rules and for a rulemaking proceeding therefore is submitted by the American Council of Life Insurance, and supplements the petition filed June 29, 1983 (hereinafter referred to as "the Petition") with respect to flexible premium variable life insurance separate accounts. This amendment discusses the proposed treatment of sales loads charged upon adjustments in insurance benefits provided under flexible premium variable life insurance policies, which was not addressed in the Petition. This amendment reflects the joint efforts of the Council and the law firm of Sutherland, Asbill & Brennan.

The interest of the petitioner, the statutory authority for the Petition and the issuance of the proposed rule, and the background to and general characteristics of flexible premium variable life insurance are discussed in the Petition, which discussion is incorporated herein by reference.

I. Adjustments in Insurance Benefits

As more fully described at pages 8–22 of the Petition, flexible premium variable life insurance is a new class of insurance policy offering a unique combination of insurance and investment elements. Like scheduled premium variable life insurance—the first life insurance product subjected to the Investment Company Act of 1940 (" the 1940 Act")—flexible premium variable life insurance will provide a death benefit and cash value that may vary in certain respects to reflect the investment performance of one or more insurance company separate accounts. Like universal life insurance issued out of insurance company general accounts, flexible premium variable life insurance will permit unscheduled premium payments and adjustment of the face amount of insurance or incidental insurance benefits by the policyholder.

The ability for the policyholder independently to adjust the face amount of insurance or insurance riders under the policy is unprecedented in a product registered under the 1940 Act. While existing scheduled premium variable life insurance provides an immediate insurance benefit to purchasers, it generally does not permit adjustment of that benefit by the policy holder.[1] Rather, the design of such policy inherently reflects a structured relationship between premiums, cash value, and insurance benefits. That is, the policy prescribes scheduled premiums and predetermined tabular cash values resulting from those premiums, which are calculated to provide a specified face amount of insurance. (The amount of insurance additions resulting from earnings in excess of the assumed investment rate is also prescribed.) Existing variable life insurance does not permit the policyholder readily to adjust the face amount of the policy, because such increased benefits would exceed the benefit preordained by the premiums required and cash values accumulated to date. Policyholders may obtain such *additional* insurance protection only by purchasing a second policy. A *reduction* in the face amount of insurance can be accomplished (if at all) only by a partial surrender of the policy, which also involves a pro rata reduction in the cash value.

In contrast, flexible premium variable life insurance generally will allow policyholders to increase or decrease their insurance benefits at their option. Policyholders usually will be allowed to adjust the "face amount of insurance" under the policy.[2] Policyholders may also be able to increase, decrease, or add incidental insurance benefits. Decreases typically will be permitted subject to a prescribed minimum face or benefit amount. Increases or additions usually will be permitted subject only to evidence of current insurability. Because of the flexible premium structure characteristic of this new product, an adjustment in insurance benefits will have no necessary, immediate consequence for premiums or cash values under the policy. To the extent that an adjustment in insurance benefits alters the net amount at risk or (if a new incidental insurance benefit rider is added) adds a risk, the periodic cost of insurance or incidental insurance benefit charge to the policyholder will increase or decrease. In addition, some companies may choose to require a minimum premium upon an increase or addition.

This feature of flexible premium variable life insurance will be of significant benefit to policyholders. Each policyholder can purchase a single policy, obtain an immediate insurance benefit in a suitable amount and type, and thereafter independently adapt that level and type of insurance benefit as economic conditions and personal circumstances change. Policyholders usually will realize greater convenience and cost savings by avoiding the need to purchase and maintain a new policy each time their insurance needs change. For example, the administrative charge under a single policy with occasional adjustments in benefits likely will be less than the administrative charges under two or more separate policies. It may be financially feasible for some companies to offer lower sales loads or even lower cost of insurance charges under a single, adjusted policy than under multiple separate policies. Moreover, the ability to adjust benefits will allow companies to meet more precisely their customers' insurance needs within the companies' cost constraints. For example, insurers may permit relatively small increases in face amount under an existing policy in circumstances where a separate policy would not be written because of cost considerations. Likewise, policyholders probably will more readily decrease their insurance benefits in appropriate circumstances if such an adjustment is easily accomplished. A single, adjusted policy in lieu of two or more separate policies simplifies the policyholder's dealings with the insurer: he need write only one premium check or complete only one beneficiary designation form, and policy loans or loan repayments need not be allocated among several policies. Policyholders may also realize greater flexibility in investment allocations among any options made available by the insurer. A single, adjusted policy with a single cash value is less likely to be subject to allocation restrictions than would two or more separate policies with separate smaller cash values. The policyholder's understanding and supervision of his policy should also be improved.

II. Basis for Exemption From the 1940 Act

It is respectfully proposed that the Commission, pursuant to its authority under Sections 6(c), 6(e) and 37(a) of the 1940 Act, include, in a rule exempting

[1] Incidental insurance benefits provided under a scheduled premium variable life insurance policy may be adjustable by the policyholder (depending on individual policy design), but charges in connection with such adjustments are not regulated by Rule 6e–2 or the 1940 Act.

[2] If a policyholder elects an Option I or "level" death benefit under a flexible premium variable life insurance policy (described at pages 13–14 and in Appendix B of the Petition), the face amount of insurance generally is the death benefit payable while the policy remains in force. Under an Option II or "increasing" death benefit election, the face amount of insurance is the level net amount at risk under the policy, to which cash value is added to determine the amount of current death benefit.

https://www.loc.gov/item/fr048231/

flexable premium variable life insurance separate accounts from certain provisions of the 1940 Act, the relief described herein with respect to sales loads charged in connection with or after an adjustment of insurance benefits. The basis for such exemption is stated at page 23-31 of the Petition and in this Amendment.

III. Analysis of the Proposed Exemption From the 1940 Act

As was the case in Rule 6e-2, the accommodation of the investor protections contained in Section 27 of the 1940 Act with the features of life insurance policies subject to that statute is among the most necessary exemptions proposed in the Petition and this Amendment. Section 27 was enacted to regulate a specific security—contractual plans—within the context of the practices and characteristics of a specific industry—the mutual fund industry. The capability to adjust insurance benefits is, of course, totally foreign to mutual funds. That capability arises solely from the insurance features of flexible premium variable life insurance.

The relatively high front-end sales and distribution costs characteristic of life insurance generally will be incurred with respect to increases in the face amount of insurance, or increases in or additions of incidental insurance benefits. (The significant economies of adjustments typically will lie in the ongoing administration of one policy instead of two, not in the implementation of an increase or addition.) In particular, it is expected that an increase or addition usually will involve additional sales effort on the part of the sale representative, including periodic contacts with policyholders to remind them of the availability of increases and additions, and examination and development of various alternative increases or additions with interested customers. This effort will approach, and in some cases may be equivalent to, the sales effort required for a new sale of a flexible premium variable life insurance policy. Accordingly, companies generally will pay sales commissions on increases in our additions of insurance benefits at or near the accustomed rate for new sales, in order to appropriately encourage such adjustments. If the commission on increases or additions does not approximate the commission on new sales, sales personnel could approach existing policyholders and suggest the purchase of a second policy where an increase or addition would be suitable, thereby earning the higher commission. The advantages to policyholders derived from their ability to adjust insurance benefits thus would effectively be compromised. If the design of flexible premium variable life insurance is to be implemented in a manner feasible for insurance companies, the economics of life insurance sales practices dictate that, in most cases, commissions will be paid on increases and additions approximately equal to commissions on new sales. In contrast, decreases in face amount (which are in the nature of partial surrenders) or in incidental insurance benefits likely will not involve sales expense. In particular, sales commissions generally will not be paid.

In circumstances analogous to increases in or additions of insurance benefits, additional sales loads may be charged under other products regulated by the 1940 Act. In the case of scheduled premium variable life insurance, Section 27 and Rule 6e-2 permit assessment of additional sales load upon the acquisition of additional insurance benefits through the only existing means—the purchase of a second policy.

The relief from Section 27 proposed in the Petition did not address, and thus made no provision for, sales loads upon adjustments in face amount or incidental insurance benefits. Such relief is, however, necessary and justified. Sections 27(a)(1), 27(a)(3), 27(h)(1), 27(h)(3), and 27(h)(4) of the 1940 Act (and the exemptions from those sections proposed in the Petition) can be read to require the continued charging of sales loads under a flexible premium variable life insurance policy according to the renewal year schedule established at issue, without additional loading at the time of the increase or addition to compensate for the additional sales and distribution expense incurred, simply because the adjustment of the face amount of insurance or incidental insurance benefits[3] does not formally require the purchase of a new policy. This stricture on sales load would result solely from the innovative insurance design of this new policy, and in all likelihood would cause many insurers not to provide policyholders the right to adjust insurance benefits. Such a result is not required to preserve the investor protections of the 1940 Act, as evidenced by additional sales loads permitted upon corresponding transactions under other types of products.

Accordingly, if flexible premium variable life insurance is to be a viable product for the industry, relief from Section 27 consistent with the purposes and policies of the 1940 Act should be promulgated to permit companies to receive sales loads upon adjustments in insurance benefits, in recognition of the sales and distribution costs incurred in such transactions. Such relief should also satisfy the additional criteria noted in the Petition: (1) it should facilitate prospective demonstrations of compliance, (2) it should not limit the diversity of sales load forms (*i.e.*, a front-end load, a back-end load, a charge against cash value, or a combination thereof) suitable for this product, but instead should foreclose any potential abuses possible under the various forms, and (3) it should recognize the inherent difficulty of applying the 1940 Act regulatory structure to these circumstances.

The proposed rule accommodates these considerations by providing that a flexible premium variable life insurance policy imposing a sales load in connection with or after an increase in the face amount of insurance or an increase in or addition of incidental insurance benefits requested by the policyholder is exempt from Sections 27(a)(1), 27(a)(3), 27(d), 27(h)(1), 27(h)(3), and 27(h)(4) of the 1940 Act if the policy satisfies *both* an "economic value" test *and* a "cumulative sales load" test. This relief pertains only to adjustments in insurance protection requested by the policyholder after issuance of the policy. A policyholder could request such an adjustment in one of two ways: by affirmatively applying for an adjustment or, if the policy by its terms schedules adjustments which the policyholder has the option to decline,[4] by not exercising

[3] As explained at page 46, footnote 29, and at pages 75-76 of the Petition, and in contrast to Rule 6e-2, the proposed rule treats incidental insurance benefits as a part of the policy for sales load purposes, unless premiums for the rider are separately stated and required. In particular, the proposed rule generally cannot exclude amounts attributable to incidental riders from the definitions of "payment" and, indirectly, of "sales load." (Any specific benefit charges for such riders are not treated as sales load and thus are unregulated, as in Rule 6e-2.) That sales load is, however, tested against a "guideline annual premium" which also takes account of incidental insurance benefits. Thus, to the extent that any additional charges on an increase or addition of an incidental insurance benefit will be treated as sales load, relief necessary to allow such charges (with reference to an appropriately adjusted guideline annual premium) is required.

[4] For example, a policy might provide that, subject to the policyholder's option to request that the adjustment not be made, the face amount of insurance would be adjusted in a fixed manner (*e.g.*, it would double on the tenth policy anniversary) or in a determinable manner (*e.g.*, it would be annually adjusted to reflect changes in the Consumer Price Index).

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such an option and thus implicitly requesting that the adjustment be made. In contrast, the proposed relief would be inapplicable to adjustments after issuance not requested by the policyholder, such as increases in the death benefit resulting from positive investment performance or automatic adjustments scheduled in the policy which the policyholder may not decline.

The proposed relief is also limited to adjustments in the insurance protection provided by the insurer to the policyholder. Adjustments in insurance benefits within the scope of the proposed rule thus include:

1. An increase in the face amount of insurance provided under an Option I death benefit election;

2. An increase in the face amount of insurance (that is, the level net amount at risk) provided under an Option II death benefit election;

3. A switch from Option I to Option II. The effect of this adjustment generally is to maintain the same net amount at risk at the time of the change in election but to increase, relative to the prior option, the future net amount at risk for the insurance company;

4. An increase in the amount of an incidental insurance benefit; and

5. An addition of an incidental insurance benefit. If the policyholder switches from Option II to Option I, maintaining the same net amount at risk, there is no increase in insurance benefits even though there is a change in the face amount of insurance.[5] The relief requested would not apply in this case.

The "economic value test" corresponds to the test for sales loads other than front-end loads proposed in the Petition. This test is satisfied if, during each policy period through maturity, the cash surrender value, death benefit, and any incidental insurance or endowment benefit under the actual policy (taking account of increases or additions) are not less than, respectively, the aggregate cash surrender values, death benefits, incidental insurance benefits and endowment benefits of a "base test policy" and an "incremental test policy." [6] The base test policy is identical to the actual policy in all respects except that the increase or addition is assumed not to occur. The "incremental test policy" is a flexible premium variable life insurance policy issued at the time of the increase or addition which provides only the incremental change in the insurance benefits and assesses sales load (without requiring any sales load to be refundable upon surrender in the first 24 months) in any manner permitted by the 1940 Act and the proposed rule.

The "cumulative sales load test" is satisfied if, during each policy period through maturity, the cumulative sales load charged to date under the actual policy does not exceed the sum of the cumulative sales loads under the base test and incremental test policies.

In applying these tests, the proposed rule specifies certain actuarial assumptions. Consistent with the approach to sales load regulation generally taken in the proposal, payments of both guidelines annual premiums and guideline single premiums are assumed and tested. For example, payments for the actual policy are assumed to be the guideline annual premium adjusted at the time of increase or addition. Payments for the base test policy are assumed to be the guideline annual premium at issue, while payments equal to the difference in the guideline annual premium for the actual policy before and after the increase or addition are deemed to be made under the incremental test policy. Corresponding assumptions as to the alternative payment of the guideline single premium are also required.[7] Net investment earnings at an effective annual rate of 4 percent are assumed. Finally, withdrawals or surrenders are assumed not to occur prior to the duration being tested.

The principle underlying the proposal is that, upon or after an increase or addition, the insurance company should be permitted to charge a sales load equivalent to the load it could have charged had the policyholder instead been required to purchase a second policy to obtain the enhanced insurance benefit. Accordingly, the proposal serves the purposes and policies of the 1940 Act by limiting the sales load in these unique circumstances to the amount permitted in more familiar cases. By imposing the requirements of Section 27 indirectly, however, the proposal avoids the inapt direct application of these limitations.[8] Insurers are not penalized for extending to policyholders the right to adjust the face amount or riders, or for adopting sales loads on increases or additions other than front-end loads.[9] By permitting additional sales loads reflecting increases in face amount, or increases in or additions of incidental benefits, the proposal also allows companies to structure sales loads to prevent policyholder from initially buying a small policy and then requesting a substantial increase in the face amount of insurance or in incidental insurance benefits, thereby unfairly requiring other policyholders or the insurer to bear a significant share of the sales expense attributable to such a policyholder. The generality of this approach allows a diversity of sales load structures. By reason of the specified actuarial assumptions, prospective demonstrations of compliance can be mechanically produced.

Finally, it is believed that the economic value and cumulative sales load tests together test representative payment patterns and otherwise police abuses contrary to the purposes and policies of the 1940 Act. In particular, if administrative charges or certain other charges are lower for a single, adjusted policy than for the separate policies, the economic value test alone would allow

[5] The described effect of both switches in death benefit options on the insurance benefits provided to the policyholder assumes a continuing positive accumulation of cash value under the policy.

[6] In order to clarify a possible ambiguity, the statement of the economic value test in the rule provisions proposed in this amendment differs slightly from the statement of the economic value test in the rule provisions proposed in the Petition. It would seem appropriate to conform paragraph (d)(2) proposed in the Petition to paragraph (d)(3)(A)(i) proposed in this amendment.

[7] In addition, the payments assumed for the incremental test policy are specified to be the guideline annual and guideline single premiums for such policy, for purposes of determining its compliance with the 1940 Act and the proposed rule. (Compliance with these authorities is of course a prerequisite to the use of a given incremental test policy in the proposed tests.) This approach avoids certain technical complications which could arise if the guideline premiums for the incremental test policy were computed strictly with reference to the definitions of "guideline annual premium" and "guideline single premium" contained in paragraphs (c)(8) and (c)(9) of the proposed rule. The amounts specified above generally are less than or equal to the guideline premiums that would be independently computed for the incremental test policy under the principles of paragraphs (c)(8) and (c)(9). In the limited circumstance where the policyholder switches from Option I to Option II, the specified guideline premiums for the incremental test policy would, for years immediately after such switch, exceed the corresponding independently computed guideline premiums. Over the life of the policy, however, the independently computed guideline premiums would annually increase and would eventually exceed the corresponding specified guideline premiums. The sum of the specified guideline premiums would be less than or equal to the sum of the independently computed guideline premiums.

[8] A consequence of this approach is that, for example, the 20-year period for complying with the 9 percent sales load limit and the rule that sales loads as a percentage of payments may not increase over time are not *directly* applied to the policy upon an increase. Instead, the policy is tested *to maturity* against hypothetical policies which do comply with these and all other provisions of the Act and the proposed rule.

[9] As explained at pages 57–66 of the Petition, such loads are beneficial to policyholders and should be permitted.

https://www.loc.gov/item/fr048231/

the amount of that reduction to be charged as sales load: for example, the cash value of the various policies would comply with the test because an amount charged as sales load under the actual policy would be matched by an assumed full administrative charge under the incremental test policy. Such a result is simply a methematical quirk of the economic value test.[10] By examining sales loads rather than cash values, the cumulative sales load test precludes this unintended, and possibly abusive, result.[12]

Illustrations of the sales loads permitted by the proposed rule and sample demonstrations of the type contemplated are attached as Appendix A.[12] An explanation in mathematical notation of the computations discussed in the Petition and in this document is attached as Appendix B.[12]

As was the case with the economic value test proposed in the Petition, this economic value and cumulative sales load approach to the regulation of sales loads on increases or additions does not preclude the possiblilty that such sales loads would exceed 9 percent payments over a specified period. To keep the policy in force, additional premiums equal to the guideline single or annual premium after adjustment (or actuarially equivalent to such amount if payments are not made upon the adjustment or at regular annual intervals) will be necessary, under the actuarial assumptions specified above. If such premiums are paid, the sales load charged on the adjusted policies will ultimately average 9 percent of payments. The policyholder may, however, let the policy as adjusted lapse, either by surrendering the policy or by paying premiums less than the guideline amount allowing the cash value to be depleted by authorized policy charges.

Nonetheless, the proposal accommodates in a fair manner the principles of the 1940 Act with the life insurance features of this product. Flexible premium variable life insurance will be designed to provide insurance protection for the whole of life and to set the level of charges so as to cover expenses expected to be incurred or amortized over a protracted period of time. In other words, each time an issuer sells a policy of a certain amount, it will anticipate receiving a stream of income for a period of years, arising from charges for the cost of insurance, for administration, and for mortality and expenses risks and other contingencies the policy and paying death claims during that period. If more insurance protection is added, additional charges will be required for the increase or addition. The remaining stream of income from the original issue does not provide for increased coverage.

In this regard, a sales load on increases or additions will roughly balance the interest of policyholders with the without increases or additions. The economic effect of having no additional sales charge on increases or additions can be viewed as permitting a policyholder to purchase coverage without having paid the expenses incurred in that sale. In the absence of an additional sales charge on increases or additions, the unpaid expenses ultimately would have to be borne by policyholders without increases or additions. (Such a result, by possibly diluting the interests of policyholders without increases or additions, could be viewed as inconsistent with the principles underlying Section 22(d) of the Act.) The sales charge on increases thus operates as a mechanism to shift, from policyholders without adjustments to policyholders with adjustments, expenses incurred in the sale of the policy with increases or additions.

The proposal also permits additional sales load to be deducted from cash value, without regard to whether the increase or addition is accompanied by the payment of additional premium. This practice is consistent with the flexible character of flexible premium variable life insurance. If premium were required upon an increase or addition, a policyholder could simply borrow or withdraw cash value from the policy, and endorse the check back to the company as "new" premium. This practice would not be inconsistent with the 1940 Act; for example, funds may be used to purchase a scheduled premium variable life insurance policy subject to a sales load, and then the same funds may be borrowed through a policy loan and again be subject to sales load when used to pay later premiums or to purchase another such policy providing additional insurance protection. The result should not differ simply because flexible premium variable life insurance permits the addition of insurance benefits without the purchase of a new policy, or may not require the policyholder to submit to the meaningless formalism of withdrawing cash value (and possibly incurring a back-end sales load) so that "new" premium may be paid upon an adjustment.

Upon an increase or addition, the proposal does not reimpose the "refund," "conversion," and "free look" requirements of the rule proposed in the Petition, and further assumes that Section 27(a)(2) of the Act is inapplicable as well. By limiting first-year sales loads, requiring a "free look" period after a policy is issued, and ensuring on early surrender either a refund of certain sales loads or the availability of an alternative policy without evidence of current insurability, these requirements protect a policyholder who finds a newly purchased product unsuitable during this initial experience with it. An increase in or addition of insurance benefits, however, does not involve the purchase of an unfamiliar product. It instead involves an adjustment to an existing policy with which the policyholder is presumably experienced and satisfied. In these circumstances, the various rules applicable in early years after issue need not be directly reapplied after an increase in face amount. The requirements of Section 27(a)(2) and the refund rule are made indirectly applicable through the test policies, under the proposed economic value and cumulative sales load tests. In particular, the cumulative sales load test in effect limits the sales load on an icrease or addition to the sales load chargeable under a new policy without triggering the potential application of the refund rule. (The possibility of an increase or addition does not of course relieve a policy from compliance with these various provisions at issue.)

Finally, the proposal does not require the refund of sales loads upon a decrease in insurance benefits under a flexible premium variable life insurance policy. A decrease is analogous to a partial surrender of the policy. In the case of a surrender, the purposes and policies of the 1940 Act require refund of excess sales loads only during the first two policy years. For the reasons discussed above, such a refund right should not be indefinitely extended to any decrease. Moreover, if refunds of sales loads were required on decreases, policyholders contemplating a surrender could instead decrease the insurance benefits, receive a refund of sales load, and then surrender the policy. Accordingly, a refund rule for decreases

[10] This quirk cannot occur under the economic value test proposed in the Petition for sales loads at issue other than front-end loads, because that test does not involve two different test policies; the administrative charges in the actual and test policies are assumed to be identical.

[11] In practice, the cumulative sales load test will be as rigorous or more rigorous for front-end loaded policies than the economic value test, and the latter test could br dispensed with in such cases. In order to avoid the complication of imposing different tests for different sales load designs, however, the proposal subjects all policies to both tests.

[12] Appendix A and B not included in the Attachment B.

https://www.loc.gov/item/fr048231/

would allow policyholders to inequitably shift sales expense to other policyholders or the insurer.

IV. Text of Additional Paragraph for Proposed Rule Under Section 6(e)

It is proposed that the following paragraph (d)(3) be added to the rule proposed in the Petition:

(d)(3)(A) Solely with respect to increases in or additions of insurance benefits requested by a policyholder after issuance of a flexible premium variable life insurance policy, such policy shall be deemed to satisfy paragraphs (b)(14)(i), (b)(14)(ii), and (b)(14)(vi) of this Rule provided that during each policy period through the maturity date specified in paragraph (c)(8)(B)(ii) of this Rule:

(i) The cash surrender value, the death benefit, any incidental insurance benefit, and any endowment benefit provided under the actual policy are not less than the respective sums of the cash surrender values (including any amounts that would be refunded under paragraph (b)(14)(vi)(A) of this Rule), death benefits, incidental insurance benefits and endowment benefits that would be provided under the base test policy and the incremental test policy, and

(ii) The sum of the sales loads charged in such policy period and all preceding policy periods shall not exceed the sum of the corresponding sales loads under the base test policy and the incremental test policy.

(B) The following assumptions shall be used in applying paragraph (d)(3)(A):

(i) Premiums for the actual policy and the test policies are paid in each of the following alternative amounts:

(a) Level annual premiums for the base test policy equal to the guideline annual premium for such policy, commencing upon issuance; level annual premiums for the incremental test policy equal to the difference between the guideline annual premium for the actual policy after the increase in or addition of insurance benefits and before such increase or addition, commencing upon such increase or addition; and level annual premiums for the actual policy equal to the guideline annual premium for such policy, commencing upon issuance and addjusted for such increase or addition as of the date of such increase or addition; and

(b) A single premium at issue for the base test policy and for the actual policy in an amount equal to the guideline single premium for the actual policy at issue; and a single premium for the actual policy and the incremental test policy equal to the additional guideline single premium needed for the actual policy upon the increase in or addition of insurance benefits, as of the date of such increase or addition;

(ii) Net investment earnings are earned at an annual effective rate of four percent; and

(iii) No partial withdrawals or surrenders are effected under the actual and test policies.

(C) For purposes of this paragraph (d)(3):

(i) "Actual policy" shall mean the flexible premium variable life insurance policy issued to the policyholder, and adjusted for the increase in or addition of insurance benefits, as of the date of such increase or addition.

(ii) "Base test policy" shall mean the actual policy had the increase or addition not occurred.

(iii) "Incremental test policy" shall mean a flexible premium variable life insurance policy that is issued on the date of the increase or addition, provides insurance benefits identical to the incremental change in insurance benefits under the actual policy upon such increase or addition, and charges sales load in any manner, without requiring any sales load to be refundable under paragraph (b)(14)(vi)(A) of this Rule, satisfying the provisions of the Act and this Rule. For purposes of satisfying the provisions of the Act and this Rule, the amounts specified in paragraph (d)(3)(B)(1) (a) and (b) as paid for the incremental test policy shall be treated as the guideline annual premium and guideline single premium, respectively, for such policy.

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