CARLTON FIELDS

New Era for Variable Product Fund Substitutions: SEC Removes Obstacles

May 05, 2021

About 20 years ago, the SEC began scrutinizing variable product fund "substitution" applications in ways that increased both the time required to obtain SEC approval and the conditions necessary to obtain such approval. The Investment Company Act of 1940 ("1940 Act") generally prohibits an insurance company from substituting one fund supporting its SEC-registered variable products (an "underlying fund") for another, unless and until the SEC approves the substitution.

In the past few years, investment advisers to some underlying funds have strenuously objected when insurance companies have proposed to replace those funds. In some cases, this has resulted in costs and delays, cancellation of planned substitutions, and, in one case, a formal SEC hearing on the proposed substitution.

In one welcome development, however, the SEC recently published an industrywide no-action position that allows an insurer to substitute underlying funds without obtaining SEC approval if the substitution is substantially similar to an earlier substitution for which the insurer obtained such approval. For more information, see our recent client alert "SEC Limits Need for Substitution Applications."

In another welcome development, the SEC in December issued an order (Release No. IC-34129) approving certain contested substitutions by two Allianz insurance companies. The order followed an SEC hearing requested by the investment advisers — who were unrelated to Allianz — to some of the funds that Allianz proposed to replace. Because of the hearing, the order was issued by the SEC itself (rather than by the SEC staff pursuant to delegated authority) and made findings favorable to Allianz on a number of matters that are not normally discussed in substitution orders or applications. For these reasons, the SEC's issuance of this order is of great interest to insurance companies contemplating substitutions, as well as to any persons contemplating opposing them.

Among other things, the order:

- States the SEC's view that, in the variable insurance context, the 1940 Act's standard for approving a substitution is met if "the substitution complies with certain terms and conditions set forth in the substitution application that have been developed over several decades of the [SEC's] administration" of that standard.
- Recognizes that, contrary to the challengers' assertions, those "terms and conditions are not merely 'representations' of the Applicants; they are substantive requirements to which the Applicants must adhere in order to rely" on a substitution order.
- Gives significant weight to the large number of applications and circumstances the SEC and its staff have considered in developing those terms and conditions.
- Rejects the challengers' assertions that the 1940 Act "requires a substitution to demonstrably benefit investors" or requires the SEC to "examine the effects that a substitution may or may not have on the remaining shareholders" of any replaced fund.
- Holds that SEC approval of substitutions is not limited to "exceptional or exigent circumstances."

These recent developments should facilitate appropriate future substitution transactions that will redound to the benefit of both insurers and variable contract owners.

Carlton Fields represented Allianz in obtaining the above-discussed order.

Authored By

Thomas C. Lauerman

Related Practices

Financial Services Regulatory
Life, Annuity, and Retirement Solutions

Related Industries

Securities & Investment Companies
Life, Annuity, and Retirement Solutions
Life, Annuity, and Retirement Solutions