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Variable Annuity Product and Related Disclosure, Regulatory, and Accounting Pronouncement Developments

By
W. Thomas Conner
Carlton Fields
Washington, D.C.

ETFs in Variable Contracts: Still a Round Peg in a Square Hole?[1]

W. Thomas Conner

ETFs are a cost-effective investment tool for investors to gain exposure to broad markets, particular sectors, geographical regions, or specific investment strategies. Institutional and retail investors alike increasingly turn to them as investment options. U.S. ETF total net assets at year-end 2022 stood at $6.5 trillion.[2]

ETFs generally feature lower expenses and greater tax efficiency than mutual funds, and because ETF shares are listed on stock exchanges, they can be traded through broker-dealers throughout the day. ETFs are available widely through IRAs and retail investor accounts. They are not available as investment options in variable life insurance policies or variable annuity contracts (collectively, "variable contracts").[3] There are economic and regulatory reasons for this.

Congress recently took a swing at erasing one of the regulatory hurdles by directing the Treasury Department to revise its "asset diversification" restrictions. Congress may not have

[1] The author expresses his deep appreciation to his Carlton Fields colleagues Steven Kraus, Ann Furman and Richard Choi for their generous assistance and insights in preparing this conference outline.

[2] *See* INVESTMENT COMPANY FACT BOOK: A REVIEW OF TRENDS AND ACTIVITIES IN THE INVESTMENT COMPANY INDUSTRY (published by the Investment Company Institute), available here.

[3] Some variable contracts do offer underlying funds that in turn invest in ETFs, or "Funds-of-ETFs." *See* 2023 IRI FACT BOOK at 35 (stating that variable annuity owners may choose from a wide range of investment options, each of which generally invests in shares of a single underlying mutual fund, or in some cases, in a "fund of funds," which is a mutual fund that invests in several other mutual funds or in exchange-traded funds) (available to IRI members only).

gone far enough. Additionally, there are economic considerations that may discourage insurers from offering ETFs as investment options in variable contracts.

This outline discusses why ETFs are not currently offered directly in variable contracts and recent Congressional attempts to fix current applicable tax restrictions. The outline also discusses remaining economic and regulatory challenges to offering ETFs as investment options in variable contracts.

I. Why Aren't ETFs Offered in Variable Contracts?

In its seminal 1992 "red book" analysis of investment company regulation, the staff of the Division of Investment Management of the Securities and Exchange Commission concluded that trying to fit variable contracts into the regulatory regime of the Investment Company Act of 1940 (the "Investment Company Act") presents the proverbial "round hole" into which the "square peg" of insurance products is forced.[4] Offering ETFs in variable contracts also presents a "round hole/square peg" dilemma.

Restrictions imposed by Treasury Department regulations that pre-date ETFs prevent their use in variable contracts.[5] This technical gap was created in 1984 (years before the introduction of ETFs) when Congress added certain asset diversification requirements to the Internal Revenue Code to address Congressional concerns that the favorable tax treatment afforded by variable contracts not be abused, for example, by marketing variable contracts as

[4] *See Protecting Investors: A Half Century of Investment Company Regulation,* Division of Investment Management of the United States Securities and Exchange Commission (May 1992), available here.

[5] The first ETF was launched in 1993. *See* "Exchange Traded Funds," Investment Company Act Release No. 333646 (Sept. 25, 2019) (adopting Rule 6c-11 (the "ETF Rule") under the Investment Company Act, which provides certain exemptive relief for ETFs to operate), available here.

"mutual funds with a tax-deferred wrapper." As discussed below, these rules have become known as the "look-through" rules.

Put simply, variable contracts may invest directly only in underlying mutual funds ("underlying funds") created exclusively for such use and that are not offered to "retail investors." As a threshold matter, this would require ETF sponsors to create new "insurance dedicated" versions of their ETF line-up. However, by necessity, even insurance dedicated ETFs would be held during the distribution process by certain institutional "authorized participants" that in effect could be viewed as "retail investors."

II. Investor Control Restrictions

Like other investment companies, an ETF pools the assets of multiple investors and invests those assets according to its investment objective and principal investment strategies. Similar to mutual funds, ETFs continuously offer their shares for sale. Unlike mutual funds, however, ETFs do not sell or redeem individual shares. Instead, specialized financial institutional firms, generally broker-dealers that are a member or participant in a clearing agency, have contractual arrangements with the ETF (or its distributor) to purchase and redeem ETF shares directly from or to the ETF in relatively large blocks called "creation units." An authorized participant may act as a principal for its own account when purchasing or redeeming creation units from or to the ETF or may act as agent for other investors, such as market makers, proprietary trading firms, hedge funds or other institutional investors.

An authorized participant that purchases a creation unit of ETF shares directly from the ETF deposits with the ETF a "basket" of securities and other assets identified by the ETF that day, and then receives the creation unit of ETF shares in return for those assets. After

purchasing a creation unit, the authorized participant may hold the individual ETF shares, or sell some or all of them in secondary market transactions.

Importantly, because ETFs only issue shares to and redeem shares from authorized participants in large baskets, most investors purchase and sell individual ETF shares in the secondary market. This is where certain diversification requirements under the Federal tax code (the "Code") become important.

Under certain statutory criteria under the Code, all or part of the amounts received for the contract (*i.e.*, premiums) must be allocated to a segregated asset account (*i.e.*, a separate account) of the insurer. The contract must reflect the investment return and the market value of the segregated asset account, or in the case of a life insurance contract, the amount of the death benefit or period of coverage must be adjusted on the basis of the investment return and the market value of the segregated asset account. The segregated asset accounts for variable contracts generally are invested in a variety of underlying funds.

The investment assets held in the segregated asset account for a variable contract must be adequately diversified. If the assets are not adequately diversified, the variable contract is not treated as an annuity or life insurance contract for tax purposes. As a result, otherwise tax-deferred or excluded income on the contract is treated as ordinary income received or accrued by the contract holder during the taxable year.

When the diversification requirement for variable contracts was added by Congress in 1984, the Conference Report stated, "[i]n authorizing Treasury to prescribe diversification standards, the conferees intend that standards be designed to deny annuity or life insurance

treatment for investments that are publicly available to investors and investments that are made, in effect, at the direction of the investor."[6]

The regulatory diversification requirements impose investment concentration limits based on percentages of the total value of the assets in the segregated asset account. A safe harbor is provided for a segregated asset account holding shares of a regulated investment company ("mutual fund") that is at least as diversified as is required under the Code.

The diversification rules for a two-tiered investment product like a variable contract present a dilemma – if the diversification rules are applied at the underlying fund level, the separate account/subaccount investing in the fund would be viewed as investing solely in one investment. Accordingly, the diversification requirements provide a look-through rule for assets held through, among other things, an underlying mutual fund. This look-through rule provides that the mutual fund is not treated as a single investment of the separate account/subaccount, but rather, a pro rata look-through portion of each of the fund's assets is treated as an asset of the separate account subaccount.

The look-through rule, however, imposes requirements. All the beneficial interests in an underlying mutual fund generally must be held by a separate account. Access to the fund must generally be available exclusively through the purchase of a variable contract.

[6] H.R. Conf. Rep. No. 861, 98th Cong., 2d Sess. (1984), page 1055. Another part of the legislative history notes that diversification requirements were enacted "to discourage the use of tax-preferred variable annuities and variable life insurance primarily as investment vehicles. Congress believed that a limitation on a customer's ability to select specific investments underlying a variable contract will help ensure that a customer's primary motivation in purchasing the contract is more likely to be the traditional economic protections provided by annuities and life insurance." Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, JCS-41-84, December 31, 1984, page 607.

Now, back to the authorized participants that are involved in the ETF distribution system. Even if ETF sponsors were to register and offer insurance-dedicated ETFs, if an ETF's shares are held by an authorized participant that, as a participant in a clearing agency, is permitted to purchase and redeem shares directly from and to the fund and sell them to third parties, the ETF fund does not satisfy the requirement of the look-through rule that access to the ETF be available exclusively through the purchase of a variable contract.

III. Section 203 of the Secure 2.0 Act – Congress Rides to the Rescue

So as to allow ETFs under the diversification requirements applicable to variable insurance contracts, Section 203 of the Secure 2.0 Act directs the Treasury Department to amend its regulations interpreting those diversification requirements.[7] In the legislative history, Congress explained that it intends that under the amended regulatory interpretation of the diversification requirements, the look-through rule available to mutual funds also be available to ETFs, notwithstanding that shares of the ETF are held by authorized participants that are not permissible investors under the Code.

Section 203 imposes several requirements. ETFs funding variable contracts must be registered with the SEC as an open-end investment company or unit investment trust. The shares of the ETF may be purchased or redeemed directly from the fund only by an authorized participant. The shares of the ETF must be traded throughout the day on a national stock exchange at market prices that may or may not be the same as the net asset value of the shares.

[7] *See* H.R. 2954 – Securing a Strong Retirement Act of 2022 (Secure 2.0). The Secure 2.0 Act was passed as part of H.R. 2617 – Consolidated Appropriations Act, 2023, in Division T, Title II. The specific history for the Secure 2.0 Act is available here.

An authorized participant must be a financial institution that is a member or participant in a clearing agency registered under Section 17A(b) of the Securities Exchange Act of 1934. The authorized participant must enter into a contract with an ETF that permits the financial institution to purchase or redeem shares of the ETF and to sell the shares to third parties, provided that the financial institution is precluded from purchasing the shares for its own investment purposes and from selling the shares to persons that are not market makers. A market maker is a financial institution that is a registered broker or dealer under Section 15(b) of the Securities Exchange Act of 1934 and that maintains liquidity for an ETF on a national stock exchange by always being ready to buy and sell shares, provided that the financial institution is precluded from buying from or selling shares to persons who are not authorized participants or who are persons not permitted to buy or sell shares under the look-through rule in the regulations.

The Treasury Department has seven years to amend its regulations. However, the amendments could be adopted sooner – the extended adoption period reportedly was provided for certain revenue and cost "scoring" purposes. Another timing factor is that SEC rules governing ETFs may also need to be amended.

IV. ETFs in Variable Contracts – Still a Square Peg in a Round Hole?

Congress appears to have provided the variable contracts and ETF industries with half of a solution. That is, Section 203 will permit authorized participants and market makers to hold the shares of a variable contract insurance-dedicated fund without jeopardizing the application of the look-through tax rules. Implicit in this solution is that current mutual fund or ETF sponsors or insurance companies offering proprietary underlying funds will register and offer insurance-dedicated ETFs to be used solely as investment options in variable contracts. This may be

attractive because variable annuity total net assets currently stand at close to 1.8 trillion.[8] Development and registration costs could be lower than usual in some cases because existing ETFs could be "cloned."

A significant hurdle remains, however -- informal discussions with representatives of one national stock exchange indicate that the exchange does not have the systems capabilities to restrict purchases of *any* ETFs to a particular category of purchasers. The exchange also indicated that Regulation NMS may prevent the exchange from excluding retail public investors from purchasing or selling shares of an insurance-dedicated ETF on the exchange.[9] This means that exchange-listed insurance dedicated ETFs could be purchased by any type of investor, not just variable contract investors.

Theoretically, insurance dedicated ETFs could include restrictions in their agreements with authorized participants that the authorized participants, in the initial distribution of a creation basket, could sell only to market makers that have agreed to sell only to insurance company separate accounts funding variable contracts. With respect to secondary market sales, as discussed below insurance companies would in most, if not virtually all, instances purchase and redeem shares of insurance-dedicated ETFs through a limited network of broker-dealers rather than with the ETFs. Again, theoretically, insurers could include provisions in their brokerage agreements prohibiting broker-dealers from transacting in shares of an insurance dedicated ETF except with authorized participants, market makers and insurance companies.

[8] *See* 2023 IRI RETIREMENT FACT BOOK – 2023 (available to IRI members only).

[9] Regulation NMS consists of Rule 600-614 of the SEC's Market Regulations.

Interestingly, informal discussions with another national exchange were more encouraging in this regard. This exchange indicated that eight years ago it partnered with an insurance company to develop an insurance dedicated ETF. The plan was for the insurer to obtain a private letter ruling ("PLR") to address tax issues and to work with the exchange to obtain necessary SEC regulatory approvals for the insurance dedicated ETF.[10] According to representatives from the exchange, a PLR ultimately was not issued, but significant progress had been made to contractually restrict broker-dealers from entering non-insurance company orders for the insurance dedicated ETF. The exchange noted that other types of restrictions are regularly placed on broker-dealers with respect to certain types of orders.

V. Industry Business and Economic Considerations

Assuming for the sake of argument that the public access issue could be resolved, there are significant business and economic factors that could cause insurance companies to pause when considering whether to offer ETFs in their variable contracts. These market and economic factors, at least in part, will drive decision making by ETF sponsors and insurance companies considering partnerships to create and offer insurance dedicated ETFs in variable products. The business and economic pros and cons of offering ETFs in variable contracts are discussed below.

Pros

Potentially lower expenses. The administrative costs of managing ETFs are often lower than those of mutual funds. For example, ETFs generally are bought and sold in the secondary market through brokerage houses so that the ETF does not bear the costs of maintaining

[10] Necessary SEC approvals would be needed, for example, for the exchange to list a new product type and conceivably, to the extent necessary, for exemptive relief from Regulation NMS.

shareholder accounts or executing individual investor buy and sell transactions. Additionally, creation and redemption basket transactions with ETFs often are executed "in-kind" so that an ETF avoids the brokerage and other expenses associated with buying and selling portfolio investments through intermediaries. Finally, ETFs do not have sales loads or 12b-1 fees.

Access to guaranteed lifetime income features. As baby boomers retire in droves, converting their retirement assets into guaranteed lifetime income has become a priority. Investors seeking guaranteed lifetime income, and that have grown to prefer ETFs as opposed to conventional mutual funds, may be drawn to variable annuity contracts that can provide both guaranteed lifetime income and the opportunity to invest in ETFs.

Cons

To the extent that insurers offer actively managed ETFs in their variable products, these ETFs may not experience some of the cost savings of passively managed index-based ETFs. In these situations there may not be a significant cost differential between insurance-dedicated mutual funds versus ETFs. Additionally, mutual fund and ETF sponsors and insurers offering proprietary underlying funds that do not currently offer ETFs will incur the considerable expenses associated with either registering new ETFs or converting existing mutual funds to ETFs.

From an operational perspective, lessons learned by insurers offering ETFs directly in variable annuities that are sold only in the qualified plan market are instructive.[11]

[11] There are several variable annuity products sold only in the qualified plan market that invest directly in retail ETFs. These variable annuity products can do this because tax deferral is provided by the status of the qualified plans rather than by the variable contract itself. *See, e.g.,* the prospectus for the "Variable Annuity for Roll Over Money"

- Insurance-dedicated ETF sponsors may be challenged to transform daily fluctuating secondary market ETF share prices into a defined, repeatable, formulaic and nondiscretionary process required for a separate account to qualify as a unit investment trust under the Investment Company Act.

- As discussed above, unlike mutual fund shares, ETF shares cannot be purchased or redeemed by an insurance company directly from the ETF issuer at net asset value. ETF shares must instead be purchased and sold through broker-dealers in the secondary market at market determined prices that may be above or below net asset value. Mismatches between net asset value of an ETF versus its daily closing prices and various requirements of the Investment Company Act imposed on unit investment trusts will require creative solutions. One solution has reportedly been for an insurance company to enter an agreement with a financial institution that will take on the breakage risk by guaranteeing the insurer 4:00 p.m. NAV prices, even though the firm will be required to wait until the morning of the next business day to purchase or sell those shares.

- In considering cost-benefit analyses, insurers and insurance dedicated ETF sponsors also will need to grapple with a different business and economic model – ETFs generally do not charge 12b-1 fees and platform agreements are still the exception for ETF sponsors.

(Varoom), a variable annuity contract issued by Integrity Life Insurance Company, a subsidiary of Western and Southern Life Insurance Company, available here.

VI. Conclusion

The thought of offering ETFs directly in variable contracts is alluring. While regulatory hurdles currently prohibit such offerings (outside of the qualified plan market), Congress has directed the Treasury Department to amend its regulations to remove one of the primary hurdles. However, other regulatory hurdles appear to remain. Even if all regulatory hurdles can be cleared, there are significant economic and business factors for industry participants to consider.

W.T.C.