

## ETFs on the Horizon for Variable Products?

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On May 13, 2019, Sens. Rob Portman (R. Ohio) and Ben Cardin (D. Md.) introduced the Retirement Security and Savings Act of 2019. Among other things, that bill would allow separate accounts supporting variable insurance products to directly hold insurance-dedicated exchange-traded funds as investment options under insurance products and still get tax “look-through” treatment. Importantly, however, the proposed legislation would not allow such look-through treatment if separate accounts directly hold regular retail ETFs. The bill was referred to the Senate Committee on Finance, where it remains as of this writing.

### The Legislation

The proposed legislation would allow separate accounts to invest in insurance-dedicated ETFs by designating certain authorized participants (clearing agencies) and market makers (broker-dealers) as “eligible investors” in insurance-dedicated ETFs, subject to certain limitations. This relief is necessary because, in order to fulfill their functions, which are essential to an ETF, authorized participants and market makers must own shares of the insurance-dedicated ETF — which currently would preclude look-through treatment.

The proposed legislation would limit the activities of an insurance-dedicated ETF’s authorized participants and market makers to ensure that retail investors do not have access to insurance-dedicated ETF shares. Specifically, look-through treatment would not be available if: (1) any authorized participant sells the insurance-dedicated ETF’s shares to anyone other than market makers or other eligible investors under the Internal Revenue Code Section 817 asset diversification regulations; or (2) any market maker sells the insurance-dedicated ETF’s shares to anyone other than authorized participants or other eligible investors under those regulations.

### Practical Considerations

Currently, separate accounts purchase and redeem insurance-dedicated mutual fund shares at a set price established by the fund (e.g., as of 4 p.m. each business day) regardless of the size of the separate account’s net purchase or redemption orders. However, it is unclear how a separate account would allocate purchases and redemptions of insurance-dedicated ETF shares among contract owners if the separate account were not able to fulfill all of its orders at the same price.

One of the popular features of an ETF is that investors on the exchange can effect transactions at any time during the trading day at market prices that, in theory, generally track closely to net asset value. Thus, funding a variable insurance product with an insurance-dedicated ETF would in theory permit an insurer to offer variable insurance product owners the opportunity to effect purchases, redemptions, transfers, etc., at different unit values throughout the trading day, in each case based on then-current market prices of the insurance-dedicated ETF’s shares on an exchange. It could be costly for insurers to develop or modify, and thereafter operate, their systems and relationships with distributors and underlying funds in order to accommodate the additional complexity that this would entail.

Moreover, ETFs must achieve a certain level of assets and trading volume to be viable. Insurers would need to consider the pros, cons, and feasibility of using proprietary versus third-party insurance-dedicated ETFs as variable insurance product investment options.

Finally, insurers would have to consider any additional costs, such as those mentioned above, against any possible advantages of using insurance-dedicated ETFs as investment options. For example, insurers might consider: (1) how many variable insurance product purchasers are interested in intraday trading, given the long-term nature of such products; and (2) whether some variable insurance product purchasers would be deterred from choosing insurance-dedicated ETFs by the risk that the arbitrage market may at times be illiquid and that, for that or other reasons, share prices on an exchange may at times deviate substantially from the net asset value.

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