MEMORANDUM

TO: Proposed Rule: Safeguarding Advisory Client Assets
(IA-6240; File No. S7-04-23)

FROM: Janet Jun
Senior Counsel, Division of Investment Management

RE: Supplement to the Memorandum from the Division of Investment Management regarding a June 13, 2023 videoconference with representatives of the Committee of Annuity Insurers

DATE: October 6, 2023

This memorandum is a supplement to the Memorandum from the Division of Investment Management regarding a June 13, 2023 videoconference with representatives of the Committee of Annuity Insurers, where the staff from the U.S. Securities and Exchange Commission ("SEC") and representatives of the Committee of Annuity Insurers discussed, among other things, the SEC's proposal titled "Safeguarding Advisory Client Assets," set forth in Release No. IA-6240 (Feb. 15, 2023). Attached as Appendix A hereto is a copy of a document that the SEC received from the Committee of Annuity Insurers as a follow-up to the discussion held in the June 13, 2023 videoconference.

Appendix A

Committee of Annuity Insurers- 9/29/23

We are adopting an exception to the Safeguarding Rule today in addition to those that we proposed. Rule 223-1(b)(2) would allow assets supporting variable annuity contracts and variable life insurance policies funded by separate accounts established and maintained by an insurance company to be maintained with the insurance company issuing the variable annuity contract or variable life insurance policy, rather than with a qualified custodian. The exception is intended to mirror an exception codified in Rule 223-1(b)(1) that permits mutual fund shares to be maintained with the fund's transfer agent in lieu of a qualified custodian. In our Proposing Release, we noted that "in our experience, [the mutual fund] exception has not raised similar types of investor protection concerns that we are seeking to address in this proposal."

Similarly, Rule 223-1(b)(2) would codify and expand on a no-action letter that our staff issued in 2005.[1] In that letter, our staff indicated it would not recommend enforcement action when an insurance company served a particular role with respect to variable annuity contracts similar to the role of a transfer agent with respect to mutual fund shares. Since that letter was issued, neither the Commission nor our staff has encountered the types of investor protection concerns that we have sought to address in this rulemaking. Moreover, the manner in which variable insurance contracts are issued is not compatible with a regime that either would require them to be maintained with a qualified custodian or that would deem the issuing insurance company to be a qualified custodian within the meaning of Rule 223-1(d)(10).

First, we note that once an insurance company issues a variable insurance contract, the insurance company generally is required under state insurance law to send the contract itself to the owner of the contract. Therefore, the owner of the contract maintains custody of the contract itself. State insurance "free look rights" (which give the owner a limited period of time in which to return the contract for a full refund) generally are triggered by delivery of the contract to the owner.[2] Our staff previously has taken the position that it is the variable insurance contract that is the client security.[3]

While the owner maintains custody of the contract, the owner's initial and any subsequent purchase payments are generally invested in one or more investment options underlying a separate account of the insurance company. Owners may apply the value of their payments to the various investment options available in the separate account according to their desired allocation. The investment options underlying variable insurance contracts typically consist of shares of open-end management investment companies that are themselves registered with the Commission under the Company Act. Variable insurance contracts give their owners the ability to change their investment allocations among the investment options (on a tax-free basis), subject to certain limitations. Unlike other types of securities, the assets underlying the variable insurance contracts, and any resulting appreciation, are legally owned by the issuing insurance company and not the contract owners. As a result, a variable contract owner cannot instruct the

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[1] American Skandia Life Assurance Corporation, (pub. avail. May 16, 2005) ("Skandia").

[2] *See*, *e.g.*, N.J. Admin. Code § 11:4-44.3(c); 28 Tex. Admin. Code § 3.9711; Iowa Admin. Code r. 191-15.9.

[3] Skandia, supra note __.

issuing insurance company to redeem the assets underlying the variable insurance contracts in-kind, deliver those assets to the contract owner and reregister those assets in the name of the contract owner.

Accordingly, unlike a typical investment adviser relationship in which funds or securities owned by clients are managed or advised on by investment advisers, the funds managed or advised on with respect to variable insurance contracts are not legally owned by contract owners (but by the insurance company). The assets in the insurance company separate accounts, while legally owned by the insurance company under state insurance law, are legally segregated from the insurance company's other assets, and are insulated from the claims of the insurer's general creditors. The insurance company is the legal owner of the underlying insurance fund shares held in the separate account (in uncertificated or "book entry" form). However, we believe that, notwithstanding the fact that the contract owner does not own the underlying assets in the insurance company separate account, our definition of "assets" – namely, "funds, securities, or other positions held in a client's account" – is broad enough to encompass assets that are subject to the advisory relationship between the adviser and the client, regardless of whether the client is the legal owner of those assets. Consequently, we believe that the Safeguarding Rule must explicitly address separate account assets supporting a variable insurance contract.

While we believe that the scope of the Safeguarding Rule encompasses separate account assets supporting variable contracts, we are cognizant of the differences between the manner in which these assets are issued, maintained and safeguarded and the manner in which funds and securities typically are maintained and safeguarded. Through administrative systems, insurance companies maintain records concerning contract owner purchases of variable insurance contracts. Such systems typically record, among other things, the timing and amount of purchase payments and withdrawals, contract owner allocations, loans, cash values, and death benefit values and designate for each concerning contract owner an "account" in the contract owner's name. Each transaction associated with a variable insurance contract is entered or fed through a systematic feed and updates a variety of supporting tables that record variable insurance contracts values (such as cash value or death benefit value) and data at the variable insurance contract level. Variable insurance contract data typically includes owner/annuitant name, social security number, date of birth, owner type and addresses.

In addition, the insurance company typically sends contract owners quarterly account statements that identify the assets in their accounts at the end of the period and all transactions in the account during that period, including payments to any third parties. These statements permit contract owners to monitor the amount of payments to investment advisers that are servicing their accounts and the allocation of their purchase payments and cash values in the separate account. In particular, these statements allow contract owners: (i) that have authorized fee deduction from their variable insurance contract values to determine if their investment advisers have appropriately charged for their advisory services; (ii) to determine whether the adviser or another party has engaged in any transactions with respect to the account; and (iii) that have provided their advisers with authority to make transfers among variable account options to monitor these transactions.

These market practices stand in stark contrast to the market practices associated with securities that are at the heart of the Commission's concerns in adopting the Safeguarding Rule. Unlike the overwhelming majority of securities the Commission is addressing with the Safeguarding Rule, variable insurance contracts themselves are not uncertificated and neither the investment adviser nor any of its related persons takes possession of the variable insurance contract. Moreover, while the vast majority of securities may be held in street name by the legal owner for the benefit of the beneficial owner, this does not represent the nature of the division of ownership of variable insurance contracts (for which both legal and beneficial ownership inhere in the contract owners) and the assets held in the separate accounts supporting the variable contracts (for which the insurance company is the legal owner and over which a contract owner is able to exercise only limited rights). Therefore, requiring a qualified custodian to hold the contract would not provide any investor protection benefits with respect to the assets in the separate account. Similarly, requiring a qualified custodian to hold the separate account assets is not possible without violating state insurance law and would interfere with the proper functioning of the separate account.

Moreover, separate account assets are already more than adequately protected by provisions under: (1) state insurance law,[4] (2) the Company Act (with respect to variable insurance contracts registered under the Company Act),[5] (3) the Securities Act of 1933, as amended (the "Securities Act"), (4) the Securities Exchange Act of 1934, as amended (the "Exchange Act"),[6] and (5) the Sarbanes-Oxley Act ("Sarbanes-Oxley")[7] – protections that do not apply to a typical security held in street name.

These protections similarly obviate the need to expand the definition of qualified custodian to encompass insurance companies maintaining separate accounts holding assets supporting variable insurance contracts. In particular, we believe that the requirements that investment advisers enter into agreements with qualified custodians with required provisions as well as the requirement that investment advisers obtain reasonable assurances from qualified custodians regarding required client protections would provide minimal, if any, incremental investor protection benefits in light of the panoply of protections and practices that already apply to assets held in insurance company separate accounts.

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[4] In addition to the separate account segregation requirements described above, the Commission notes that state insurance regulatory authorities are charged with overseeing insurance companies domiciled or operating in their states and regularly examine the operations and books and records of insurance company separate accounts to ensure they are in compliance with applicable state insurance laws. An insurance company issuing a contract is also required to file quarterly and annual reports regarding its financial condition, as well as annual reports on the financial condition of any separate accounts the company maintains in connection with VA Contracts.

[5] In addition to the separate account registration requirements under the Company Act, Item 23 of Form N-4 mandates that financial statements prepared in accordance with generally accepted accounting principles must be filed and audited. Moreover, independent auditors must provide their consent to include their audit opinion on audited financial statements in Form N-4 filings. And finally, pursuant to Rule 38a-1 under the Company Act, a registered separate account is required to adopt, implement and annually review written compliance policies and procedures reasonably designed to prevent violations of the federal securities laws, and must designate a chief compliance officer to administer such policies and procedures.

[6] Although not directly discussed above, it should be noted that anti-fraud provisions under both the Securities Act and the Exchange Act impose liability in connection with a separate account registration statement. Together, these provisions effectively require a registration statement to be free of any material misstatements or omissions.

[7] Sarbanes-Oxley imposes a number of audit and other requirements on separate accounts, since such accounts are considered "issuers" under Sarbanes-Oxley and "audit clients" under Regulation S-X. The audit requirements further assure the safety and soundness of assets maintained in an insurance company's separate account.

For example, Rule 223-1(a)(1)(i) will require that an investment adviser's agreement with a qualified custodian to include provisions that would require the custodian to provide records relating to client assets to an independent accountant engaged in a required surprise audit, and to provide written internal report reports from an independent accountant that assess, among other things, whether the controls are suitably designed, and are operating effectively to meet control objectives relating to custodial services (including the safeguarding of the client assets held by that qualified custodian during the year). These requirements would raise a host of difficult interpretive issues while providing almost no investor protection benefits (and, to the extent that the requirements create unnecessary costs that are passed on to investors, would harm the very investors that the Safeguarding Rule is intended to protect). Similarly, the requirements in Rule 223-1(a)(1)(ii) that an investment adviser obtain reasonable assurances that that the qualified custodian clearly identify the client's assets as such, hold them in a custodial account, segregate all client assets from the qualified custodian's proprietary assets and liabilities, and subject client assets to any right, charge, security interest, lien, or claim in favor of the qualified custodian or its related persons or creditors, except to the extent agreed to or authorized in writing by the client would prove to be impracticable or duplicative of already-existing protections.

We believe that any attempt to expand the definition of "qualified custodian" to encompass insurance companies maintaining separate accounts holding assets supporting variable insurance contracts is unwarranted Consequently, we are adopting new Rule 223-1(b)(2).