STATE OF MINNESOTA
DEPARTMENT OF COMMERCE

In the Matter of Proposed Amendments to the Rules Relating to the Issuance of Variable Life Insurance Policies Pursuant to Minn. Stat. §§ 61A.13 - 61A.21

STATEMENT OF NEED AND REASONABLENESS OF PROPOSED RULES

STATEMENT OF NEED AND AUTHORITY

Variable life insurance is authorized in Minnesota pursuant to Minn. Stat. §§ 61A.13 through 61A.21, enacted by the Laws of 1969 c. 752, authorizing contracts on a variable basis, as subsequently amended by the Laws of 1973, c. 480. The above-captioned amendments to existing rules are proposed by the Commissioner of Commerce (thereinafter "Commissioner") for adoption as permanent rules pursuant to the authority vested in the Commissioner by Minn. Stat. § 61A.20 as appropriate to carry out the purposes and provisions of Minn. Stat. §§ 61A.13 through 61A.21.

In 1981, the Insurance Division of the Department of Commerce adopted Rules 4 MCAR §§ 1.9401 to 1.9415 to govern policies of variable life insurance and the insurers which issue them. The Rules adopted at that time followed the basic format of a model variable life regulation promulgated by the National Association of Insurance Commissioners (NAIC) in 1977. In 1982, the NAIC promulgated an Amended Model Variable Life Regulation.

The amendments broadened the scope of the existing Rule so as to accommodate innovative products. More specifically, the changes permit life insurance companies to offer a product often referred to as flexible premium life insurance. This product is a hybrid of two rather recent innovations -- universal life insurance and existing variable life insurance -- and possesses characteristics of both. In broad overview, the product is conceived of as a flexible premium, separate account product, with the death benefit and cash value varying with investment experience. The flexible premium feature of this new product distinguishes it from current forms of variable life insurance which contemplate a scheduled stream of premium payments. The proposed amendments are designed to permit the Rule to accommodate emerging innovative product designs, such as flexible premium variable life, without compromising the adequacy and comprehensiveness of the basic framework of state regulation of variable life insurance.

As will be more fully shown herein, these proposed rules are intended to more precisely delineate the terms, conditions, and requirements of insurance companies desiring to sell scheduled premium and flexible premium variable life insurance policies in the State of Minnesota. The proposed rules are also intended to implement and make effective the provisions of Minn. Stat. §§ 61A.13 through 61A.21.

In addition, the proposed amendments take cognizance of the regulatory atmosphere prevailing at the time the original NAIC model regulation was adopted. The model regulation was adopted in large part in response to the concerns about dual federal-state regulation of variable life insurance. In 1973, the Securities and Exchange Commission (SEC) adopted Rule 3c-4 under the Investment Company Act of 1940 ("1940 Act"). This rule exempted certain separate accounts funding variable life policies which met certain restrictive design requirements. The original NAIC model and 4 MCAR §§ 1.9401 through 1.9411 were drafted so as to limit their scope to accommodate only those policies which were described in Rule 3c-4. At the same time the SEC determined that variable life insurance policies themselves were subject to the registration and prospective requirements of the Securities Act of 1933 and the antifraud and broker/dealer requirements of the Securities Exchange Act of 1934.

In 1975, the SEC rescinded Rule 3c-4. The NAIC model and 4 MCAR §§ 1.9401 through 1.9411 were never changed to reflect this action by the SEC so that these rules contain many provisions which overlap unnecessarily with the federal securities laws.

The proposed amendments remove those provisions of the existing rules that overlap or duplicate provisions of the 1940 Act. These overlaps were not intended in the original rules adopted in 1981 and serve only to confuse and complicate the regulatory scheme applicable to variable life insurance.

As more fully indicated below, the proposed rules reasonably address the above-stated needs.

The Commissioner has determined that Minn. Stat. § 14.115 is not applicable to the proposed rules.

HISTORY

On March 7, 1983, the Commissioner of Insurance published Notice of Intent to Solicit Outside Information at 7 S.R. 1277 for his consideration in the promulgation of amendments to existing regulations promulgated under Minn. Stat. § 61A.20. In response to the Solicitation, IDS Life Insurance Company submitted a draft of proposed amendments to the regulation governing variable life insurance. This proposal was based on the current Model Variable Life Regulation, as amended by the NAIC in 1982. After review and revision of the proposal, the Commissioner proposed amendments to the rules governing variable life insurance on November 29, 1983 and published the proposed amendments in the State Register on December 12, 1983.

The Commissioner has determined that Minn. Stat. § 14.115 is not applicable to the proposed rules.

FACTS ESTABLISHING REASONABLENESS

As more specifically set forth herein, the proposed amendments to existing rules reasonably address the requirements of Minn. Stat. § 61A.13 through § 61A.21, and constitute a reasonable attempt to further delineate and give effect to the terms, conditions, and requirements for the marketing and sale of variable life insurance in this state.

4 MCAR § 1.9402

4 MCAR § 1.9402 defines certain terms used in the proposed rules. Subdivisions A, D, G, I and J of the proposed amended rule define certain terms necessary to clarify the meaning of the requirements of these rules. Where the definitions are material to a full understanding of the proposed amendments, they will be more fully discussed in the context of the substantive provisions of the amended rule in which they occur.

Subdivision C of the proposed amended rule changes the definition of benefit base to recognize that the benefit base of a flexible premium variable life insurance policy is the policy's cash value and that the concept of "assumed investment rate" is not meaningful in the context of these products. The proposed amended rule changes the definition of "benefit base" so that it is meaningful and applicable to both flexible premium and scheduled premium policies.

Subdivisions E and K of the proposed amended rule distinguish between "flexible premium variable life policies" and "scheduled premium variable life policies". The basic approach has been to define a "schedule premium policy" to include "traditional" variable life insurance policy designs. Accordingly, a "scheduled premium policy" is defined as "any variable life insurance policy under which the amount and timing of premium payments are specified under the terms of the policy". Having established the boundaries of conventional variable life policies, the proposed amended rule defines "flexible premium" policies expansively to encompass all other variable life insurance policy other than a scheduled premium policy as specified in paragraph K of this 4 MCAR § 1.9402". The breadth of this definition is intended to include flexible premium variable life products.

Subdivision L of the proposed amended rule clarifies that the same separate accounts may be utilized to fund a variety of products such as variable annuities. The proposed amended rule is intended to provide insurers with the flexibility needed to manage and market these products.

Subdivision M of the proposed amended rule changes the definition of "variable death benefit" to refer to "any minimum death benefit" instead of "the minimum death benefit". The change reflects the divergent approach to the minimum death benefit that an insurer must afford under scheduled premium and flexible premium variable life insurance policies. The proposed amended rules afford the insurer considerable flexibility in formulating death benefit guarantees for flexible premium products, and a reference to "the minimum death benefit" is inconsistent with other proposed amendments to these rules.

Subdivision N of the proposed amended rule amends the definition of a "variable life insurance policy" to allow for the flexibility inherent in universal life type products. Since insurance coverage under a variable universal policy continues as long as the policy's cash value is sufficient to support charges for the cost of insurance, it may be the duration, rather than the amount, of the variable universal death benefit which varies with the investment experience of the separate account. Accordingly, the amended rule proposes that the definition of "variable life insurance policy" be expanded to include "any individual policy which provides for life insurance the amount or duration of which varies" in accordance with investment experience.

4 MCAR § 1.9403

The existing rule requires that an insurer must, before delivering or issuing for delivery any variable life insurance policy in the state, file with the Insurance Division various documents and items of information not unlike those required to be filed in connection with the sale of a conventional whole life insurance policy.

Paragraph 2 of Subdivision B of the existing rule currently requires a description of the methods of operation of the insurer. The proposed amendment to this paragraph recommends adding to this description the methods of distribution of the variable life insurance policies of the insurer. This suggestion reflects the recognition that the methods of selling flexible premium variable life insurance products may differ from the methods of selling more traditional life insurance products.

Paragraph 4 of Subdivision B of the proposed amended rule is an addition which reflects that, with the flexibility afforded insurers in policy design by the proposed rule, it will be necessary for the insurer to provide a statement by its actuary regarding the mortality and expense risks of the particular policy.

4 MCAR § 1.9404

The proposed amended rule recommends revisions in 4 MCAR § 1.9404 to provide companies with sufficient flexibility to offer flexible premium variable life insurance as well as other variations on more traditional forms of variable life insurance. Many of the proposed amendments to this section consist of deletions from the mandatory Policy Benefit and Design Requirements of Subdivision B.

Paragraph 1 of Subdivision B is being proposed to be amended to delete the requirement that coverage be provided for the lifetime of the insured. This provision is considered to be an unnecessary impediment to the development of innovative flexible product designs. Language has also been added to this paragraph to clarify that the insurer bears the mortality and expense risks under a variable life insurance policy and that the charges for those risks cannot exceed the maximum which the insurer establishes in the policy.

Paragraph 2 of Subdivision B of the existing rule is being deleted to accommodate the flexibility in amount and timing of premium payments which is the cornerstone of the flexible premium variable life product. This deletion will permit flexible premium products while still permitting "traditional" forms of variable life insurance to continue to be written.

Paragraph 2 of Subdivision B of the proposed amended rule was originally adopted to require a minimum death benefit as the initial stated amount of death benefit. This minimum death benefit guarantee could not be required under a product design characterized by non-level premiums which are paid on an irregular basis. The minimum death benefit guarantee was premised on the assumption that the insurer would establish level periodic premiums which would have to be paid by the insured at the times specified by the insurer. Further, the existing rule requires the minimum death benefit only so long as premiums are duly paid. In a flexible premium variable life policy this requirement may not be appropriate where the insured, not the insurer, controls the timing and the amount of each premium payment. Accordingly, the minimum death benefit requirement in the proposed rule would be limited to scheduled premium policies. The minimum death benefit for flexible premium policies would be addressed in the context of a new provision governing grace periods for flexible premium policies (4 MCAR § 1.9404, C. 2. b). This new provision provides that during the grace period the insurer must pay a death benefit equal to the death benefit that was in effect immediately prior to the grace period, less any overdue charges. Thus, this provision in effect prescribes the minimum death benefit payable under a flexible premium policy.

Paragraph 3 of Subdivision B of the proposed amended rule was changed to modify some of the rigidity of the existing requirement. The amendment deletes the requirement that investment experience be reflected in "the variable death benefit" so that investment experience could, for example, be used to increase cash value or the duration of coverage. In addition, the portion of this paragraph which prescribed the manner in which excess investment performance was to be applied is proposed to be deleted in favor of a provision requiring the insurer to demonstrate that the reflection of investment experience is actuarially sound. It is intended that the demonstration will pay particular attention to the manner in which the policy operates under both favorable and unfavorable investment conditions, and to the matching of current liabilities under the policy to the market value of assets.

Paragraph 6 of Subdivision B of the proposed amended rule requires that the method of computation of cash values and other non-forfeiture benefits rests in all cases on the assumption that at all times during the life of the policy the full net investment return exactly equals the assumed interest rate. The proposed amendment embodies the recognition that flexible premium variable life insurance products might not contain an assumed rate. In that event, the calculation is to be based upon the maximum interest rate permitted under the Standard Nonforfeiture Law (Minn. Stat. § 61A.24).

Paragraph 9 of Subdvision B of the existing rule limited the deductions that could be made in determining net investment return to four of the categories of charges enumerated in 4 MCAR § 1.9406, Subdivision G. The proposed amended rules modify Subdivision G of § 1.9406 so that the specifically enumerated categories no longer limit permissible charges, but merely illustrate charges which must be disclosed in writing prior to or contemporaneously with delivery of the variable life insurance policy. This change makes Paragraph 9 of Subdivision B of § 1.9404 obsolete and it is, therefore, proposed to be deleted.

Subdivision C, Paragraph 1 is proposed to be amended in subparagraphs a. and c. to conform those paragraphs to the amended definition of "variable life insurance" and to the bifurcated approach to the minimum death benefit guarantee for schedule and flexible premium policies. Also subparagraph e. is proposed to be amended to reflect the change in the federal 45 day requirement for securities and to place the rule in compliance with Minnesota law, specifically Minn. Stat. §§ 72A.51 and 72A.52. Further, subparagraphs a. and b. are proposed to be amended by deleting the requirement that these statements be set forth in type at least four points larger than the type size used in the text of any provision on the page. The statements required by these subparagraphs will be adequately distinguishable from the surrounding text since they must, in any event, be set forth either in contrasting color or bold-face type.

Paragraph 2 of Subdivision C is proposed to be amended so as to require different grace periods for scheduled premium and flexible premium policies. Subparagraph a. is to be amended so as to apply only to scheduled premium policies since the concept of "premium due date" is inappropriate to flexible premium policies, and a thirty-one day "standard life insurance policy" grace period is consistent with the longer grace period which is typically required for current general account flexible premium policies. Subparagraph b. is proposed to be added so as to permit a 61 day grace period for flexible premium policies which is now typically required for universal life policies. Further, this new subparagraph requires that the minimum death benefit be provided during the grace period equal to the benefit in effect immediately prior to the grace period.

Paragraph 3 of Subdivision C is proposed to be amended so as to only apply to scheduled premium policies. This is being done since the concept of reinstatement is inappropriate to flexible premium policies since there is nothing to reinstate under a flexible premium policy once the policy's cash value has been depleted by deductions for the cost of insurance and other charges.

Paragraph 5 of Subdivision C is proposed to be amended by deleting subparagraph a. This deletion is intended to provide insurers the flexibility to utilize the same separate account to fund several products, such as variable annuities, in addition to variable life.

To take account of the flexible features of the proposed new product, Subdivision C, Paragraph 7 and Subdivision E, Paragraph 1 of the proposed amended rule provide that the incontestable and suicide provisions of the policy shall apply to new insurance coverages under the policy which have been added at the owner's request, for a two-year period following the date of issue of the increased coverage. This provision would not extend the suicide and incontestable provision for any coverage which had been in effect for longer than two years.

Paragraph 9 of Subdivision C of the proposed amended rule provides that at least one settlement option must be provided on a fixed basis, but permit the insurer to provide variable settlement options. The prior restriction was enacted to avoid SEC regulation. The federal role in the regulation of variable life insurance has eliminated the justification for this limitation.

This prior restriction imposed unnecessary costs on consumers since a person desiring a variable settlement option was required to surrender the variable life insurance policy and purchase a separate variable product and incur the costs associated with the surrender and replacement.

Subdivision C, Paragraph 10 of the proposed amended rule, formerly required that a variable life insurance policy contain a description of "the basis for computing the cash surrender value under the policy" and display such value in the format of a "schedule" of cash values. The function of these schedules was to set out the cash values under the policy at specified durations by $1,000 of variable death benefits then in force, regardless of investment performance. The schedules did not involve assumptions as to what the amount of variable death benefit or cash values would in fact be at the specified future durations. The alternative cash value schedules that were set forth in subparagraphs a. and b. of former paragraph 9 were deleted on the grounds that they might be, at best, meaningless, and, at worst, misleading in the context of flexible premium variable life policies characterized by nonguaranteed cash values which fluctuate in accordance with investment experience. The proposed amended rule will require the insurer to describe the basis for computing the policy's "cash value" in addition to its "cash surrender value". This requirement was added to provide the policyholder with useful information which juxtaposes the two amounts and thereby focuses the policyholder's attention on the costs associated with surrendering the policy.

Paragraph 11 of Subdivision C of the proposed amended rule clarifies that while premiums for incidental death benefits could be paid directly by the policyholder, the cost of such benefits could be paid directly by the policyholder. The cost of such benefits might also be deducted as "charges" from the separate account.

In the existing Rule, 4 MCAR § 1.9404, Subdivision D, Paragraph 1, (which has been renumbered in the proposed amended rule as 4 MCAR § 1.9404, Subdivision C, Paragraph 12) requires that a variable life insurance policy afford at least one non-forfeiture benefit "on a fixed basis from the due date of the premium in default," and prohibits an insurer from offering variable extended term insurance as a non-forfeiture benefit. The proposed amended rule responds to the clear incompatibility between these constraints and rudimentary design characteristics of flexible premium policies. The hallmark of flexible premium products is the latitude and discretion which the policyholder possesses over the amount and timing of premium payments. Thus, the concepts of a discrete, identifiable "premium due date" and of a "premium in default" -- which are readily defined and easily applied in the context of fixed life insurance and "traditional" variable life products --are inadaptable to flexible premium products. Nonpayment of premiums under a flexible premium product would not necessarily result in termination of insurance coverage; instead, coverage continues until the charges necessary to keep the policy in force exceed the amounts allocated to the separate accounts under the policy. In other words, if premium payments are discontinued, the duration of coverage would vary in accordance with investment performance. Thus, the product design which the insurance industry broadly envisions for flexible premium variable life in effect provides variable extended term insurance upon nonpayment of premium.

The existing rule's constraints upon the types of nonforfeiture insurance benefits which may be offered have been deleted because it was felt that they posed unnecessary obstacles to the evolving development of flexible premium products. Moreover, it was felt that sound state regulation of these products did not require that these restrictions be retained. The concluding language of the proposed provision, 4 MCAR § 1.9404, Subdivision C, Paragraph 12 allows an insurer to limit certain nonforfeiture benefits to a reasonable minimum amount. In other words, the regulation recognizes that costs associated in offering certain benefits in minute amounts may be unrelated to the size of the benefit. Therefore, it was thought unreasonable to require an insurer to absorb costs below a reasonable minimum benefit amount.

In the existing rule, 4 MCAR § 1.9404, Subdivision D, Paragraph 2 encompassed partial surrenders and partial withdrawals in addition to policy loans. In the proposed amended rule, Subdivision D, was restructured so that it addresses only policy loans. This was accomplished by deleting references to partial withdrawals and partial surrenders from Subdivision D and inserting instead, in Subdivision E, Paragraph 5 a permissive provision that a variable life insurance policy may contain "a provision allowing the policyholder to make partial withdrawals".

The original rule formulated the loan value by reference to the "cash value" of the policy. The proposed amended rule correlates the loan value to the "cash surrender" value of the policy to accomplish two principal objectives.

First, defining the loan value in terms of the "cash surrender" value conforms the rule to Minn. Stat. 61A.03, Subdivision 7. This provision defines the loan value as the cash surrender value and provides that when total indebtedness equals or exceeds such loan value, the policy may be terminated provided that at least thirty days' prior notice has been given to the policyholder.

Second, relating the loan value to the cash surrender value avoids disparate treatment of a policyholder who takes out a policy loan vis-a-vis a policyholder who surrenders the policy. Specifically, it was felt that if the original language were retained and a policyholder were permitted to borrow the full "cash value" of the policy, he could thereby circumvent imposition of a surrender charge and would be more favorably treated than a surrendering policyholder.

The proposed amended rule also adds an exclusion for term insurance policies and pure endowment policies to the introductory language to Subdivision D to make it clear that a policy loan provision is mandatory only for whole life policy designs. Obviously, it would not make sense to require policy loans provisions in contracts which have no cash values available to be loaned. In addition, because of the unscheduled nature of premium payments characterisitc of flexible premium products, it was felt that the previous introductory language which tied the availability of policy loans to payment of a specified number of "full years' premiums" was inapposite. Accordingly, this language was amended to provide that policy loans would be available after the "policy has been in force" for a specified period of time.

4 MCAR § 1.9404, Subdivision D, Paragraph 1 of the proposed amended rule clarifies the original intent of this provision. There existed some confusion as to whether this provision limited the maximum amount of a policy loan to 75% of the policy's cash surrender value, or whether the insurer was required to make available at least 75% of the cash surrender for a loan. The amendment reflects the original intent of this language which was to require that at least 75% of the cash surrender value be available as a loan.

4 MCAR § 1.9404, Subdivision D, Paragraph 2, Subparagraph b of the existing rule has been deleted, based upon the fact that no premium is required to be paid under a flexible premium policy. This deletion would not affect scheduled premium policies, either, since, by definition, the timing and amount of those payments are fixed at the time of issue. 4 MCAR § 1.9404, Subdivision D, Paragraph 2 of the proposed amended rule amends former subparagraph c to replace the reference to a maximum permissible interest rate with language which would permit insurers to charge a variable interest rate on policy loans where permitted by state law.

Subdivision D, Paragraph 5 of the proposed rule amends former subparagraph f to apply it only to scheduled premium policies because notices under flexible premium policies will now be governed by 4 MCAR § 1.9409, Subdivision C, which is mirrored in a new sentence which was added at the end of 4 MCAR § 1.9404, Subdivision D, Paragraph 5. Based upon the reasons expressed previously, the thirty-one day notice of intention to cancel is triggered when the indebtedness exceeds the "cash surrender value" of the policy, rather than the policy's "cash value".

Subdivision E of rule 4 MCAR § 1.9404 pertains to optional policy provisions. These provisions need not be included in any variable life policy, but if they are, the provisions must meet the minimum standards set forth in this Subdivision. Paragraph 1 of this Subdivision provides the same treatment for increases in insurance coverage, in the event of a suicide, that was earlier provided for incontestability situations, by 1.9404, Subdivision C, Paragraph 7. Paragraph 2 of this Subdivision now provides that if incidental benefits are offered they may be offered on either a fixed or variable basis. Although variable incidental benefits were originally felt to be impractical, the recent development of the necessary computer hardware and software to handle such benefits, the consumers' increasing interest in multiple-person coverage under one policy, and the increased consumer interest in variable life insurance contracts all make such benefits more attractive.

Subparagraphs 3 b. and c. of this Subdivision have been amended, combined and renumbered to eliminate a requirement that certain forms of life insurance which are purchased under dividend options be "paid up". In addition, the amendment permits forms of fixed benefit life insurance besides "whole life". New Subparagraph 3 e. was added to allow the dividend to be deposited as a variable deposit in a separate account. These changes were made to add needed flexibility to permissible dividend options.

Paragraph 5 was added to provide for optional partial withdrawal rights. This addition was necessitated by the deletion of the partial withdrawal provisions from § 1.9404, Subdivision D.

Paragraph 6 was added to clarify that any other policy provision may be included in a variable life policy so long as it is not inconsistent with these rules or Minnesota law.

4 MCAR § 1.9405

This section in the current rule delineates the requirements for determining reserve liabilities for variable life insurance. The proposed amended rule amends the current minimum death benefit guarantee reserve requirement to limit it to scheduled premium policies. It then adds new Subdivision C which is designed to deal with reserves for any minimum death benefit guarantee under a flexible premium policy. The minimum reserve proposed is a term reserve equivalent to that defined in 4 MCAR § 1.9405, Subdivision B, Paragraph 1 for scheduled premium policies. Because the timing of future premium payments is uncertain, an "attained age level" reserve cannot be calculated for a flexible premium policy.

Some changes are made to the existing Section 4 MCAR § 1.9405, Subdivision C (which is renumbered 4 MCAR § 1.9405, Subdivision D in the proposed amended rule). This subdivision in the current rule requires that reserve liabilities for all fixed incidental insurance benefits must be maintained in the separate account in amounts determined in accordance with the actuarial procedures appropriate to such benefits. The proposed amended rule simply adds to the current requirements the requirement that reserve liabilities for all variable incidental insurance benefits may be maintained in a separate account.

4 MCAR § 1.9406

Existing rule 4 MCAR § 1.9406 delineates the requirements for the establishment and administration of the variable life insurance separate accounts. The introductory language to Subdivision A has been modified to make clear that the domiciliary state has exclusive jurisdiction over the establishment of separate accounts and to clarify that a Commissioner may not require foreign insurers to establish separate accounts in his state. Corresponding changes are made to Subdivision A in order to be consistent with this concept.

This change makes the provision consistent with Minn. Stat. § 61A.14 (which provides that "any domestic life insurance company may . . . establish and operate one or more separate accounts") and Minn. Stat. § 61A.19. The authority given to the Commissioner by Minn. Stat. § 61A.19, subsection C, and sections 1.9403, Subdivision B, and section 1.9410 of these rules, assure that the Commissioner could refuse to approve, or subsequently could disapprove, any policy funded by an improperly established or maintained separate account, regardless of whether that separate account was established in Minnesota or elsewhere.

Subdivision A, Paragraph 2 of the existing rule requires that an insurer desiring to establish more than one separate account for variable life insurance must file with the Commissioner a justification and must obtain the Commissioner's approval for the establihsment of each additional separate account. The paragraph also prohibits the creation of additional separate account for the purpose of avoiding lower maximum charges against the separate account. This paragraph has been deleted because flexible

premium variable life products would be registered with the SEC under the 1940 Act, which regulates permissible charges against a separate account. By deleting this section, unnecessary dual regulation at the state and federal levels would be eliminated. Also, the schedule of maximum charges contained in 1.9406, Subdivision G which had been a part of the previous Rule has been deleted, and thus the basis for this limitation no longer exists.

In the existing Rule, 4 MCAR § 1.9406, Subdivision A, Paragraph 4 provides that a separate account, exempt from regulation under the 1940 Investment Company Act pursuant to Section 3(c)(11) of that Act because of the tax qualified status of the policies funded thereby, shall not be used to fund other variable life insurance policies. This paragraph was included in the existing rule in order to prohibit companies from jeopardizing the exempt status under the 1940 Act of Section 3(c)(11) separate accounts by placing in those accounts assets from non-exempt policies. This paragraph was made a part of the original rule because the NAIC intended to prevent dual SEC-State jurisdiction over these accounts by this prohibition. The proposed amended rule deletes this provision on the grounds that the management of the insurer would be best able to decide whether there are economies or benefits to be gained from pooling 3(c)(11) assets with non-exempt assets in one separate account that offset any costs or inconvenience incurred in complying with the 1940 Act for that account. Also, Section 3(c)(11) of the 1940 Act is a permissible exemption from the definition of an "investment company". The 1940 Act does not require that a company use that exemption if it decides to subject the account to the Act's provisions.

Similarly, Subdivision A, Paragraph 5 of the existing rule states that except for separate accounts exempt pursuant to Section 3(c)(11) of the Investment Company Act, variable life insurance separate accounts shall not be used for variable annuities or the investment of funds corresponding to dividend accumulations or other policyholder liabilities not involving life contingencies. This provision was included in the existing rule to assure that insurers not jeopardize the partially exempt 1940 Act status of variable life insurance separate accounts by pooling them with assets funding variable annuities when variable annuity separate accounts were subject to full 1940 Act regulation. Again, the proposed amended rule deletes this provision on the grounds that the management of the insurer will be best able to decide whether it is more advantageous to its policyholders to maintain, on the one hand, two separate accounts, one a 1940 Act regulated variable annuity separate account, and the other a variable life insurance separate account that is partially exempt from certain 1940 Act provisions, or, on the other hand, to pool the assets into one 1940 Act regulated account.

In 4 MCAR § 1.9404, Subdivision B, Paragraphs 3, 4 and 6 of the proposed amended rule it is required that the policy design reflect investment experience in an actuarially sound manner, the full net investment return be credited to the benefit base, and the method of computation of nonforfeiture benefits be consistent with the Standard Nonforfeiture Law. 4 MCAR § 1.9405, Subdivision A of the proposed amended rule requires reserves to be established under the Standard Valuation Law. These provisions ensure that the benefit base will be soundly defined and the benefits generated will be adequately reserved for. Accordingly, the existing provisions in 4 MCAR § 1.9406, Subdivision B, Paragraphs 2, 3 and 4 of the current Rule, which define the minimum benefit base, are unnecessary and have been deleted.

Subdivision C, Paragraph 1 of the existing Rule requires that assets allocated to variable life insurance separate accounts be held in cash or investments having a "reasonably ascertainable market value", and sets forth restricted categories of investments fulfilling this standard. The suggested revisions to this paragraph set forth a standard which will provide adequate safety and liquidity for separate accounts while also providing greater investment flexibility than is provided under the current provision. The proposal would delete the requirement that the entire portfolio of the separate account be composed of the specified types of assets designated by the rule as having a "reasonably ascertainable market value", and would substitute a requirement that the account maintain in its portfolio readily marketable assets and assets producing investment income such that the total of such assets and income are sufficient to meet anticipated withdrawals under policies funded by such account. In other words, to determine liquidity of the account, the net income from investment plus the aggregate amount of publicly traded securities, cash items and other readily marketable assets will be compared with anticipated withdrawals to meet obligations under the policies. In this way, the proposed standard for liquidity would focus upon the entire separate account rather than individual assets in the separate account. Paragraph 1 also has been amended to include a requirement that the separate account be registered under the Investment Company Act of 1940. This requirement is consistent with the other amendments of the Rule which provide relief from insurance regulation in certain areas because the product is regulated under the federal securities laws.

Paragraph 2 of Subdivision C of the existing Rule precludes certain separate account investments because they were considered to be either incapable of uniform valuation or unreasonably speculative. The proposed Rule would delete this paragraph in order to permit separate accounts to hold a wider range of investments. Deletion of this subsection is consistent with the concept of the proposed revision of Paragraph 1 of Subdivision C which permits a determination of liquidity by reference to the aggregate account rather than requiring that every investment in the account meet conservative liquidity standards. With this deletion, separate accounts would be permitted to acquire certain currently attractive forms of investment (e.g., options for hedging and realestate) while maintaining safety and liquidity. Finally, these changes comport with the nearly unlimited flexibility allowed separate account investments by Minn. Stat. § 61A.14, Subd. 3.

Paragraph 3 of Subdivision D was expanded to make clear that Paragraph 1 was not intended to prevent separate accounts from acquiring interests in other pools of investment assets, such as interests in a pool of real estate assets, which may not be registered under the Investment Company Act. Any such investments would also have to substantially comply with the investment restrictions of § 1.9406, Subdivision C and other applicable provisions of the Rule.

Subdivision E of the current Rule requires that investments of the separate account shall be valued at market value on the date of valuation. The proposed Rule would also permit investments to be valued at their amortized cost if it approximates market value. This change permits valuation consistent with the current SEC position on the amortized cost method of valuation.

Subparagraphs 1a, 1b, and 1c, of this Subdivision currently define the term "market value" for purposes of this section. The proposed amended rule recommends deletion of these subsections because the valuation of portfolio assets is comprehensibly regulated by the SEC in the 1940 Act and the rules and regulations thereunder. Minn. Stat. § 61A.14, Subd. 7 also regulates separate account asset valuation. Since it is intended that variable life insurance products sold to the general public would be registered with the SEC, the separate account portfolio assets will be uniformly regulated by the SEC pursuant to specific and detailed regulations. Similarly, 4 MCAR § 1.9406, Subdivision E, Paragraphs 2 and 3 which delineate the valuation of investments which cease to be traded, and require a notice to the Commissioner, are recommended for deletion because the 1940 Act and the rules and regulations thereunder also cover the valuation of assets under those circumstances.

Subdivision F of the current Rule provides that separate account investment policy shall not be changed without the approval of the insurance commissioner, and sets forth administrative procedures for such approval. The proposed amended Rule proposes to modify this Subdivision to provide that a change in investment policy shall not occur until the insurer files the change with the Commissioner. The proposed Rule eliminates the requirement for a mandatory public hearing to consider any proposed material changes in investment policy. The public hearing requirement is deleted because the federal securities laws grant shareholders the right to vote upon changes in investment policy. Further, the SEC reviews the proxy material which is required for shareholder voting. The information provided to the policyholder for any public hearing would be identical to that which had been received in connection with the shareholder's vote. The modifications were intended to eliminate duplicative state administrative and regulatory procedures.

Consistent with the modifications recommended for 4 MCAR § 1.9406, Subdivision F, paragraph 2, the proposed amended Rule proposes that paragraphs 3 and 4 pertaining to hearing procedures be deleted.

Subdivision F, paragraph 5 of the existing Rule, which permits shareholders objecting to material changes in investment policy to convert to a general account life insurance policy, is deleted. At the time the original NAIC model regulation was drafted, it was hoped that variable life insurance could avoid SEC regulation, and the conversion right of objecting shareholders was viewed as a substitute for the voting procedures mandated under the securities laws. Under the federal securities laws, shareholders have the right to vote upon proposed changes in investment policy. This right, together with the SEC oversight review of changes in investment policy, provides adequate policyholder protection from undesirable changes in investment policy.

Subdivision G of existing 4 MCAR § 1.9406 limits charges against the separate account to specifically enumerated categories. The proposed amended Rule recommends modification of the Subdivision to provide that the insurer must disclose in the policy all charges that may be made against the separate account including, but not limited to, the charges currently enumerated in the Subdivision. Flexible premium variable life products issued to the general public will be registered under the 1940 Act which limits the charges which may be levied against separate accounts. As a result, the limitations

in the state law are unnecessary. Policyholders will be adequately protected by the SEC statutes and regulations. In addition, it does not appear reasonable to restrict separate account charges to specific categories and thereby limit future product design. The proposed modifications would expand the enumerated charges to permit administrative expenses and charges for incidental insurance benefits to be charged against the separate account of the flexible premium products.

The proposed Rule deletes the limits in Paragraph 1, subparagraph d. on investment management expenses as a percentage of average net asset value. The 1940 Act regulates the amount that can be charged for investment management expense.

The proposed Rule modifies Paragraph 1, subparagraph e. to remove the limits on charges for mortality and expense guarantees. This revision is proposed in the interest of regulatory consistency, because regulations under the Investment Company Act stipulate that mortality and expense risk charges must be disclosed in the prospectus and shall not be less than 50% of the maximum charge for risk assumption as disclosed in the prospectus and as provided for in the contract.

4 MCAR § 1.9406, Subdivision G, Paragraph 2 is also deleted in the proposed Rule. The prohibition against performance fees for investment advisers is regulated by the 1940 Act and the Investment Advisers Act, making these regulations superfluous.

4 MCAR § 1.9407

Existing rule 4 MCAR § 1.9407 specifies the information that must be furnished to applicants for variable life insurance.

Subdivision D of the existing rule requires that a statement be furnished to the applicant regarding the level of commissions or equivalent payments to be paid to agents as a result of the proposed sale. The proposed amended Rule deletes Subdivision D which requires a statement describing, as an approximate percentage of an annual gross premium for each year and for the life of the policy, all commissions or equivalent payments for each year of the policy for which such payments are to be made. Due to the flexibility inherent in the product's premium payments, no such calculation can be made for a flexible premium product. Also, no other life insurance product requires the disclosure of an agent's commission to a policyholder, thus, there is no overriding insurance regulatory concern which should require such a disclosure for this one product.

The proposed amended Rule also deletes Subdivision I of this Section which currently requires a prominent statement in contrasting color or in bold-faced type at least four point larger than the type size of the largest type used in the text of any provision on the page, providing:

> "The purpose of this variable life insurance policy is to provide insurance protection for the beneficiary named therein.
>
> No claim is made that this variable life insurance policy is in any way similar or comparable to a systematic investment plan of a mutual fund."

These required disclosures were included in the original Rule as part of the effort to assure that the variable life insurance product would be considered to be insurance not involving an investment company subject to SEC regulation. Because the insurance and securities aspects of future products will be considered on the merits of the product and not on the basis of self-serving statements furnished to applicants, it was felt that these paragraphs could be deleted. The first required statement appears to be superfluous and the second statement may not be true in that certain policy design provisions may be "similar to or comparable to a systematic investment plan of a mutual fund".

The proposed amended Rule also simplifies existing Subdivision E (which is renumbered Subdivision D in the proposed amended Rule) of this Section to require simply a statement of the charges levied against the separate account during the previous year. This disclosure requirement will provide for disclosure of the charges levied against separate accounts without specifying particular charges and thereby creating the possible negative inference that disclosure of others is not required.

4 MCAR § 1.9409

Existing rule 4 MCAR § 1.9409 requires annual reporting to existing variable life insurance policyholders. The new policies which will be authorized for sale by this new Rule will require a greater disclosure of information to the policyholder.

The flexibility in amount and timing of premium payment which is the hallmark of the universal life concept, and the fluctuation of cash value in accordance with investment experience which characterizes variable life insurance, converge in the flexible premium variable product. This highlights the policyholder's need to be provided with current, reliable information concerning the status of his insurance coverage.

The principal proposed amendments to 4 MCAR § 1.9409 attempt to satisfy this need. The expansion of the information that must be included in an annual report in the case of flexible premium policies in proposed Subdivision A, and the notice of impending expiration of coverage which is envisioned by new Subdivision C, are both designed to alert the policyholder to the possible insufficiency of the policy's cash value and the corresponding need to make additional premium payments to keep the flexible premium policy in force.

Thus, the proposed amendment to Subdivision A is designed to provide the policyholder of a flexible premium variable life insurance policy with a long-range warning that his policy may terminate without value if additional premium is not paid. In addition to setting forth information concerning changes in the policy's net cash value and cash surrender value during the preceding policy year, the proposed expanded annual report would also contain a projection, based upon specified assumptions, of net cash value and cash surrender value as of the next policy anniversary. If the projected value is less than zero, the annual report would include a warning message stating that the variable universal policy "may be in danger of terminating without value in the next twelve months unless additional premium is paid".

Although the long-range warning notice contemplated by Subdivision A provides the policyholder with important information concerning the possible insufficiency of the cash value to keep the policy in force, the proposed amendment recognizes the need for an additional, immediate notice if the cash value is in fact sufficient to keep the policy in effect without payment of additional premium. Accordingly, as already mentioned above in discussing the proposed amendments to 4 MCAR § 1.9402 and § 1.9404, proposed new Subdivision C of § 1.9409 requires an insurer to send a report to the policyholder in the event that the "cash value on any policy processing day is equal to or less than the amount necessary to keep the policy in force until the next following policy processing day". The mailing of this report triggers the sixty-one day grace period for flexible premium policies in 4 MCAR § 1.9404, Subdivision C, Paragraph 2, Subparagraph b.

4 MCAR § 1.9409, Subdivision C requires that the report indicate "the minimum payment required under the terms of the policy to keep it in force until the next following policy processing day". Thus, the policyholder is provided with prompt notice of the possible impending expiration of his coverage and of the correlative need to take immediate action to assure that the policy continues in effect.

The proposed rule also proposes several other amendments to 4 MCAR § 1.9409. In Subdivision A, the current requirement that the information contained in reports to policyholders be computed as of forty-five days prior to mailing would be changed to sixty to be consistent with the corresponding time period under current SEC regulations. The portion of Subdivision A which requires the use of "contrasting color or distinctive type" to highlight the variable nature of the cash value and death benefit would be deleted on the rationale that the principal function of a policyholder report, unlike a policy application, is to report, rather than highlight, information.

The proposed rule also proposes amendments to the required contents of the annual statement contemplated by Subdivision B. First, the proposed amendment to paragraph 2 of Subdivision B is intended to permit an insurer, as a matter of state law, to furnish comparisons of the investment rate of the separate account for more than a five-year period. In addition, the requirements embodied in paragraphs 6 and 7 of Subdivision B, that the statement include information concerning the insurer's principal executive officer, directors, parent companies and ten percent beneficial owners have been deleted. This information will be provided to the policyholder of registered products pursuant to the federal securities laws. Also, it is not directly relevant to the more material information contained in the report concerning the policyholder's status with regard to his policy. Finally, a conforming amendment is added in Subdivision B, Paragraph 4 to be consistent with the proposed deletion of the limitations on the types of charges that may be levied against the separate account.