

**MEMO# 32989**

December 16, 2020

# **SEC Articulates Standards for Relief Under Section 26(c) for Variable Insurance Products Substitution Orders**

[32989]

December 16, 2020 TO: ICI Members

SEC Rules Committee

Variable Insurance Products Advisory Committee SUBJECTS: Fees and Expenses

Investment Advisers

Variable Insurance Products RE: SEC Articulates Standards for Relief Under Section 26(c) for Variable Insurance Products Substitution Orders

On December 4, the Securities and Exchange Commission granted an order (“Order”) approving an application for exemptive relief under sections 26(c) and 17(b) of the Investment Company Act of 1940 to permit the substitution of several mutual funds offered as investment options in variable insurance products and permit certain in-kind transactions in connection with the substitutions.<sup>[1]</sup> The Order was issued for an exemptive application on which a hearing was requested.

While the Order applies only to the applicants listed in the application, it more generally discusses the SEC’s views on the standard of relief under section 26(c), which permits the SEC to grant an order approving a substitution “if the evidence establishes that it is consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.”<sup>[2]</sup> The SEC states that its own history of administering this section as well as the section’s legislative history are consistent in finding that its purposes are to ensure that investors<sup>[3]</sup> should not bear the cost of effecting any substitution, to provide investors with adequate advance notice and an opportunity to switch to another investment option cost-free, and to require that investors receive the benefit of certain expense limitations with respect to the replacement fund.

With these purposes in mind, the SEC explains that the standard for making a determination regarding an application requesting relief under section 26(c):

- Does not require a showing of investor benefit as a result of a substitution. As the SEC explains, determining that a substitution is consistent with the protection of investors entails establishing the absence of harm, which is a different analysis than establishing the presence of a demonstrable benefit.

- Does not require consideration of costs aside from selling charges associated with a redemption and subsequent reinvestment. The SEC explains that selling charges do not include the cost of personal financial advice that an investor may choose to receive regarding a substitution.<sup>[4]</sup>
- Allows the SEC to act upon an application requesting multiple substitutions, regardless of the stated reasons for the substitutions.
- Does not require consideration of protection of investor choice.
- Does not require any finding about differences or similarities between the replaced security and the replacement security.
- Does not require an examination of the effects that a substitution may have on the remaining shareholders of any fund.
- Does not require limiting the approval of substitutions to exceptional or exigent circumstances.
- Does not require an analysis of alternative actions to a substitution.

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#### endnotes

<sup>[1]</sup> See Order under Section 26(c) of the Investment Company Act of 1940 Granting Approval of Substitutions under Section 17(b) of the Act Granting An Exemption from Section 17(a) of the Act (Dec. 4, 2020), Investment Company Act Release No. 34129, available at <https://www.sec.gov/rules/ic/2020/ic-34129.pdf>. The applicants for exemptive relief specifically requested an order pursuant to section 26(c) to approve the substitutions of shares of certain registered open-end management investment companies (“mutual funds”) offered as investment options to certain variable annuity and variable life insurance contracts and held by the separate accounts registered as unit investment trusts with shares of certain other mutual funds. The applicants also requested an order under section 17(b) exempting them from section 17(a) to the extent necessary to permit them to engage in certain in-kind transactions in connection with the substitutions.

<sup>[2]</sup> Investment Company Act Section 26(c).

<sup>[3]</sup> The Order uses both the terms “investors” and “contract holders.” We use the term “investors” in this memorandum.

<sup>[4]</sup> The SEC also explains that because section 26(c) is concerned with the protection of investors, it does not require consideration of the burden on an investor’s financial adviser. Further, section 26(c) does not require consideration of the impact on the value of contract guarantees or potential losses of economies of scale. The SEC believes that the results of any such analyses would be speculative, and their usefulness in determining whether a

substitution is consistent with the protection of investors and the purposes intended by the Investment Company Act would be questionable.

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