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## Mergers and Acquisitions of Investment Managers: Assignment of Investment Advisory Agreements

by Jon S. Rand and Mary C. Carty

*This is Part I of a series addressing the issues arising in these types of transactions. Part II will explore fund governance issues in investment management acquisition transactions.*

**T**his article reviews the situations under which a merger or acquisition involving an investment adviser may result in an “assignment” of an investment advisory agreement under the Investment Company Act of 1940 (1940 Act) and the Investment Advisers Act of 1940 (Advisers Act). An assignment of an investment advisory agreement with a registered investment company (fund) under the 1940 Act results in the automatic termination of the agreement, giving

*Continued on page 8*

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# Form N-6—Welcome News for Variable Life Issuers

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by Michael Berenson and Christopher D. Menconi

**T**he recent adoption of Form N-6<sup>1</sup> by the Securities and Exchange Commission (SEC) is a welcome end to the situation insurance companies faced since they began offering variable life insurance policies—the absence of a registration form specifically designed for variable life insurance policies. Prior to Form N-6, the insurance industry used Form S-6, which was not entirely compatible with the complex disclosures frequently associated with variable life insurance. In addition to not being designed for variable life insurance, Form S-6 had another disadvantage. Unlike the two-part prospectus and statement of additional information (SAI) used by Form N-1A and Form N-4, the registration forms for mutual funds and unit investment trusts offering variable annuities, Form S-6 was a single document. The single document approach forced the prospectus to include information that might generally be of limited interest, such as the insurance company's financial statements.

Through their experience with Form S-6 and the integrated registration forms for other investment companies, the SEC Staff and the insurance industry developed, over time, an almost exclusively unwritten consensus on what was required in a variable life prospectus. This consensus formed the basis for Form N-6. While registrants may not be happy with all the judgment calls reflected in Form N-6, its adoption means that registrants will be able to prepare their registration statements based on clearly stated guidelines. This has the additional advantage, once the transition period is over, of assuring that all prospectuses will be prepared based on a uniform set of rules, eliminating the current situation in which prospectus disclosure may differ depending on when the prospectus was initially reviewed and whether the SEC Staff has reviewed a subsequent amendment to the prospectus.

Several sections of the form are of particular interest because they are new and/or reflect significant policy decisions:

- Risk/Benefit Summary
- Fee Table

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- Illustrations
- Performance Data
- Financial Statements

## Risk/Benefit Summary

The prospectus will begin with a plain English summary of the benefits and risks associated with a policy. This section should address death benefits, withdrawal and surrender benefits, and loan features. The summary also should address the risks of poor performance and policy lapse and the adverse tax consequences that may result from an early surrender. To avoid lengthening the summary unnecessarily, the only required statement about the underlying funds is one advising readers that comprehensive discussions of the risks associated with those funds can be found in their prospectuses.

To the extent information is included in the summary that is required by another form item—it need not be repeated. If the summary takes up more than five pages, however, the fee table must be placed before the summary.

## Fee Table

Form N-6 requires a fee table, just as the mutual fund and variable annuity registration statements

have for the past 13 years. The fee table has three sections covering policyholder transaction fees, annual policyholder charges, and underlying fund expenses.

As issuers of variable products have begun to offer a wide variety of optional features from which the purchaser can choose, the question has been whether to require that charges for all features be reflected in the fee table or limit such disclosure on some basis. Although the SEC Staff agreed with the commenters' concern that the fee table should not be so lengthy as to be unusable, there was no practical way to distinguish between the features that need to be reflected and those that didn't. Accordingly, Form N-6 requires disclosure of the charges for all features.

## Level of Charges

With the exception of the cost of insurance charge, Form N-6 requires that the maximum for any particular charge be disclosed. In response to comments received, registrants also are permitted to disclose the current charge so long as the disclosure is no more prominent than, and does not obscure or impede understanding of, the maximum charge.



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## Cost of Insurance

Finding a totally satisfactory way to provide meaningful fee table disclosure about the cost of insurance charges may be as elusive as reaching agreement on the meaning of life, but philosophers and the SEC Staff continue to try to resolve their respective questions. In addition to the requirement in the proposed form that the minimum and maximum cost of insurance charge be disclosed,<sup>2</sup> the charge for a representative policyholder also must be disclosed. This policyholder should reflect the demographics (*e.g.*, age, sex, and rating class) of actual or expected purchasers.

Form N-6 also requires: (1) disclosure that the cost of insurance charges shown are based on individual characteristics, and (2) an explanation of how a policyholder can obtain information about his or her cost of insurance and other applicable charges.

A registrant also is permitted to add disclosure following the fee table in narrative and/or tabular form. This disclosure could provide more information about the factors that determine the level of the cost of insurance charge and could set forth the cost of insurance for a range of typical policyholders beyond the single representative policyholder whose cost of insurance charge will be shown in the fee table.

## Underlying Fund Expenses

Form N-6 requires disclosure of the range of underlying fund expenses rather than separate disclosure of the expenses for each fund.<sup>3</sup> In this connection, the minimum and maximum level of each charge and expense of the underlying funds will be disclosed. For example, assume Fund A has the highest level of other expenses, as well as the highest total expenses. Assume further that Fund B's management fee is higher than all available underlying funds and that Fund C has the highest distribution fee. In this situation, Fund B's management fee would be disclosed under the caption "Maximum Management Fee." Fund C's distribution charge would be disclosed under the caption "Maximum Distribution Fees." Fund A's other expenses would be disclosed under the caption "Maximum Other Expenses" and its total expenses would be disclosed under the caption "Maximum Total Annual Operating Expenses." Note that the sum of the minimum and maximum amounts disclosed for the individual items in the underlying fund fee table will rarely equal the amounts disclosed as Minimum and Maximum Total Annual Operating Expenses.

Registrants are permitted to include the fees and expenses for each underlying fund, in addition to the required range of expenses. One glaring difference

between Form N-6 and its counterparts, Form N-1A and Form N-4, is the absence of an expense example. As noted in the release proposing Form N-6,<sup>4</sup> the SEC believed that it would be difficult to design a single example or small number of examples that would provide a useful comparison tool for investors considering different variable life insurance policies because of the individualized nature of fees and charges associated with variable life insurance, particularly the cost of insurance.

***One glaring difference between Form N-6 and its counterparts, Form N-1A and Form N-4, is the absence of an expense example.***

Consistent with the Form N-1A treatment of fund expenses, Form N-6 requires fees and expenses to be disclosed gross of any waiver or reimbursement. Expenses net of any reimbursement or waiver can be disclosed in a footnote.

### **Amendment to Form N-1A Fee Table**

The SEC also adopted an amendment to Form N-1A that requires underlying fund prospectuses to include a fee table and an expense example. Prior to this amendment, underlying funds that were sold exclusively to insurance company separate accounts were not required to include these disclosures. This amendment dovetails with the manner in which underlying fund expenses are required to be shown in the Form N-6 and, as proposed, the Form N-4 prospectus (*i.e.*, as a range). Form N-6 will provide the range of underlying fund fees and expenses with a particular fund's expenses now included in its own prospectus.

### **Illustrations**

Form N-6 permits, but does not require, hypothetical illustrations that can be included in either the prospectus or the SAI. If included, Form N-6 imposes certain requirements, including:

- An illustration must be preceded by a narrative that includes a description of the expenses reflected, a statement covering the assumptions made about investment returns and poli-

cyholder characteristics, a description of the circumstances under which actual results for a particular policyholder would differ from the illustrations, and whether personalized illustrations are available and, if so, how they may be obtained.

- Form N-6 requires values to be based on gross rates of return of 0 percent, 6 percent, and one other rate not greater than 12 percent, consistent with prevailing industry practice. Additional gross rates of return no greater than 12 percent also may be used.
- The rating classification used should be the one used in the greatest number of policies outstanding, unless that classification is not fairly representative of policy sales, in which case a rating classification that is fairly representative of policy sales should be used.
- Values shown must reflect an arithmetic average of the total expenses of all available underlying funds.

Although the SEC expressly disapproved the use of a weighted average of underlying fund expenses in hypothetical illustrations, it clarified that it would not object to the use in personalized illustrations of a weighted average of expenses of the underlying funds in which a policyowner invests or expects to invest provided the illustrations are not misleading. In addition, Form N-6 requires hypothetical illustrations to be based on underlying fund expenses before fee waivers or expense reimbursements. The SEC, however, advised the Staff to construe this requirement consistent with the approach it has taken with the expense example of Form N-1A. That is, the Staff should permit illustrations to reflect underlying fund expenses after taking account of contractual limitations that require reimbursement or waiver of expenses, but only for the period of the contractual limitation. Although the SEC continues to have a number of concerns about the use of hypothetical historical illustrations (*i.e.*, illustrations based on the actual historical performance of the underlying funds), it did not prohibit their use in the Form N-6 registration statement provided that they are not incomplete, inaccurate, or misleading and do not obscure or impede understanding of the information required to be included.

### **Performance Data**

For years, insurers and regulators alike have struggled to come up with an effective and meaningful approach for variable life performance presentations.

The challenge has always been whether and how to reflect certain charges associated with a policy. Cost of insurance and surrender charges are particularly problematic because they vary from insured to insured. In order to reflect these charges in a performance presentation, an insurer would have to, in effect, create a hypothetical policyowner by making certain assumptions about age, gender, and other factors that affect the level of the charges. Consequently, if these charges were reflected in performance, the presentation's relevance would be limited to contract owners who fit the hypothetical profile. On the other hand, failing to include these charges would overstate performance.

***Unlike Form S-6, the Form N-6 prospectus will not contain financial statements.***

Noting the difficulties inherent in measuring variable life performance, the SEC reasoned that, at the present time, no method of measuring variable life performance has been devised that is useful enough that its disclosure should be required. Accordingly, Form N-6 neither requires nor prohibits the presentation of historical performance information in the prospectus.<sup>5</sup> The SEC identified three types of performance information that have been included in variable life registration statements: (1) underlying fund performance adjusted for separate account asset based charges; (2) illustrations of cash values and death benefits based on actual performance of underlying funds that reflect all fees and charges at the separate account level and the individual policyholder level; and (3) underlying fund performance not adjusted for separate account or policy charges. Although the SEC did not prohibit the use of the last category of performance, the SEC is not enamored with this format, believing that such information is most appropriately presented in the underlying fund's prospectus. The SEC admonished insurers to bear this in mind when determining whether to include underlying fund performance in a Form N-6 prospectus.

If performance is advertised, the Form N-6 SAI must explain how the registrant calculates the data, including how charges are reflected, and include a quotation of performance for each subaccount for which performance data are advertised.

## Financial Statements

Unlike Form S-6, the Form N-6 prospectus will not contain financial statements. The full financial statements of the separate account will be included in the SAI and the insurer's comparative balance sheets for the last two fiscal years (and, in certain cases, an interim balance sheet covering a more recent period) also will appear in the SAI. The remainder of the insurer's financial statements are permitted to be included in Part C, which, like the financial statements included in the SAI, must be made available to investors on request—free of charge.

The insurer's financial statements are permitted to be prepared in accordance with statutory requirements unless the insurer otherwise is required to prepare financials in accordance with generally accepted accounting principles (GAAP) for use in other of its SEC filings or SEC filings of its parent company, in which case Form N-6 would require GAAP financial statements. This requirement is consistent with the treatment of depositor financial statements in variable annuity registration statements on Form N-4. In addition, the SEC clarified that insurers are not required to file GAAP financial statements when GAAP financial statements are prepared solely for internal purposes.

Prior to Form N-6, insurers were required to file interim financial statements in accordance with Rule 3-12(a) of Regulation S-X, which provides, in essence, that financial statements must be updated if they are as of a date 135 days or more prior to the date the filing is expected to become effective. Thus, whenever an insurer filed an amendment to its Form S-6 that was expected to become effective sometime after mid-May, the financial statements were required to be updated with unaudited stubs. Form N-6 supersedes Rule 3-12(a) by allowing insurer financial statements that are not more current than the end of the most recent fiscal year. This is consistent with the treatment of insurer financial statements in variable annuity registration statements on Form N-4.

## Compliance Dates

All new registration statements and annual update post-effective amendments filed on or after December 1, 2002, must comply with Form N-6. The final compliance date for filing amendments to effective registration statements to conform with Form N-6 is December 1, 2003. A registrant may, at its option, comply with the requirements of Form N-6 at any time after the effective date, which is June 1, 2002.

Post-effective amendments should be filed pursuant to Rule 485(a), rather than Rule 485(b), under the Securities Act of 1933.

With respect to the policies that are no longer being sold, the SEC is not requiring insurers to conform registration statements to Form N-6. It encourages registrants to do so because the format may be beneficial to both registrants and continuing investors.

Registrants on Form N-1A must comply with the amendment to Form N-1A with respect to all new registration statements, and post-effective amendments that are annual updates to effective registration statements, filed on or after September 1, 2002. Registrants may file their first annual update complying with the Form N-1A amendment pursuant to Rule 485(b), provided that the post-effective amendment otherwise meets the conditions for immediate effectiveness under the rule.

## NOTES

1. Investment Company Act Release No. 25522 (April 12, 2002).
2. The release does not address what minimum and maximum charges are expected to be disclosed (*e.g.*, the charge for a perfectly healthy 20 year old female as the minimum and the charge for an 80 year old terminally ill male as the maximum).
3. The SEC has proposed amendments to Form N-4 that would, among other things, conform the underlying fund fee table to the Form N-6 fee table. Investment Company Act Release No. 25521 (Apr. 12, 2002). The proposed amendments to Form N-4 also would modify the expense example to conform to the presentation of underlying fund expenses in the fee table.
4. Investment Company Act Release No. 23066 (March 13, 1998).
5. National Association of Securities Dealer Regulation, Inc. (NASDR) recently announced a new standard for the presentation of variable life performance data in supplemental sales literature (*i.e.*, materials preceded or accompanied by a prospectus). NASDR explained that a performance presentation that does not reflect the deduction of separate account or contract level charges would nevertheless comply with Conduct Rule 2210, NASDR's advertising rule, provided it satisfies certain guidelines. *See* NASDR Winter 2001 Regulatory and Compliance Alert ([www.nasdr.com/rca\\_winter01.htm](http://www.nasdr.com/rca_winter01.htm)).