IDENTIFYING THE CHARACTER OF THE SEPARATE ACCOUNT OF THE INVESTMENT-LINKED INSURANCE PRODUCTS IN CHINA FROM THEORETICAL AND COMPARATIVE LAW PERSPECTIVES—A PERMANENT SOLUTION FOR ISSUES OF PRESENT LAWS AND REGULATIONS REGARDING THE ADMINISTRATION OF SUCH PRODUCTS

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A brand new life insurance product, which is known as investment-linked insurance (ILI), was first introduced in China in 2000 by the China Ping, an insurance company in Shanghai after the ILI was approved by the China Insurance Regulatory Commission (CIRC). Due to the reduction of the interest rate on ordinary term deposits that began in 2000, ILI products spread quickly nationwide over a two-to-three year period. ILIs became popular with insurers, because they shift asset management risks to the insured and provide relief for the reverse spread problem facing the insurance companies. They became popular with insureds, because they offer an alternative to investments with a potentially higher yield. Although the market share of investment-linked insurance products in China has been noticeably increasing, laws and regulations regarding the administration of the ILI did not seem to correspond to the rapid growth of sales. In addition to the very limited number of articles in insurance law, the only two existing regulations that address the related supervisory issues are the "Tentative measures for the Administration of Investment-Linked Insurance" announced by the CIRC in 2000, and the "Measures Regulating the Information Disclosure of New Types of Insurance Products" enacted by the CIRC in 2009. Unfortunately, both Measures are inadequate to resolve complex supervisory problems such as asymmetry of information, suitability, or other standard settings for the conduct of ILI business. This paper argues that the root of their inadequacy lies in the failure of these measures to identify the character of the separate account in each ILI policy and its distinction from the life insurance policy to which it attaches. Without distinguishing the nature of the separate account from traditional "insurance", it is virtually impossible to ascertain the category of the

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contract formed between each policyholder and insurer with respect to each such account and to determine which laws and regulations. On the other hand, clarifying the nature of the ILI separate account which requires consumers to bear the investment risk and also helps to decide the essential degree of protection to be given to consumers through laws and regulations. Part I of this paper aims first to clarify the nature of the separate account in the ILI product from a theoretical perspective. Then, Part II will verify the theoretical inference and its implementation from a comparative law perspective through the discussion of the related laws and rules concerning the supervision of ILI products in the United States, Singapore and Taiwan. After affirming the character of the ILI's separate account and how its regulations are designed in other regimes, Part III will examine the present laws and regulations in China and discover the deficiencies of the current Chinese ILI supervisory system. Finally, Part IV proposes recommendations for the reform of the relate d laws and regulations pursuant to the studies in previous parts of this paper.

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INTRODUCTION

A brand new life insurance product, which is known as investment-linked insurance (ILI), was first introduced in China in 2000 by the China Ping, an insurance company in Shanghai after the ILI was approved by the China Insurance Regulatory Commission (CIRC).[1] Due to the reduction of the interest rate on ordinary term deposits that began in 2000, ILI products spread quickly nationwide over a two to three year period. ILIs became popular with insurers, because they shift asset management risks to the insured and provide relief for the reverse spread problem facing the insurance companies. They became popular with insureds, because they offer an alternative to investments with a potentially higher yield.[2] In late 2007, competition in the ILI market was further intensified when Citibank and Sino-US MetLife became the first two foreign institutions permitted to launch RMB-denominated, investment-linked insurance offerings in Beijing, Guangzhou, and Shenzhen.[3]

The ILI is a new insurance product, which combines traditional life insurance coverage with one or more separate investment accounts (a.k.a. separate accounts). Unlike traditional whole life insurance policies, which carry fixed death benefits and cash values, death benefits and cash values of the ILI vary in accordance with the performance of a selected investment portfolio.[4] Hence, the distinguishing feature of an ILI is that premiums may be allocated to one or more investment accounts, known as "separate

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[1] Investment-linked Insurance Emerges in Market, http://english.peopledaily.com.cn/english/200005/16/eng20000516_40933.html (last visited March 12, 2008).

[2] Ginka Sa, New Trends in China's Life Insurance Markets Following WTO Accession 2 (2003) *available at* http://www.nli-research.co.jp/english/socioeconomics/2003/li030902.pdf.

[3] City Bank to Sell Investment-Linked Insurance in China, http://www.chinaretailnews.com/2007/11/23/928-citibank-to-sell-investment-linked-insurance-in-china (last visited February 25, 2008).

[4] James H. Hunt, Variable Universal Life Insurance: Is it Worth it? 1 (2003) *available at* www.consumerfed.org/pdfs/VULReport0203.pdf.

accounts". The policyholder may allocate premiums (net of premium charges) among investment accounts that offer a wide range of choices associated with different risks and opportunities from money market and government bond accounts to domestic and international equity accounts.[5] In addition, the investment risks and returns of the separate accounts are borne by the policyholder, who is free to terminate the policy should he or she become dissatisfied with the rate of return on the ILI policy. Given the very complex nature of the ILI, ordinary consumers have a deplorably inadequate understanding of the ILI products they purchased. The inferior bargaining power and deficiency in professional knowledge makes consumers of the ILI need higher degree of protection through laws and regulations.

Although the market share of investment-linked insurance products in China has been noticeably increasing, laws and regulations regarding the administration of the ILI did not seem to correspond to the rapid growth of sales. In addition to the very limited number of articles in insurance law[6], the only two existing regulations that address the related supervisory issues are the "Tentative Measures for the Administration of Investment-Linked Insurance" (The Tentative Measures) announced by the CIRC in 2000, and the "Measures Regulating the Information Disclosure of New Types of Insurance Products" (Disclosure Measures) enacted by the CIRC in 2009. As for the former, although considered binding and enforceable, these Tentative Measures are not promulgated laws or regulations and contain only twenty-five relatively curtailed articles that are inadequate to resolve complex supervisory problems such as asymmetry of information, suitability, or other standard settings for the conduct of ILI business. The later, although dealt with part of the problems of the asymmetric information, it neither addresses the issue of consumer suitability nor provides restrictions on the marketing. Besides, in case of violation, both measures impose upon the insurer only very slight administrative penalties that can barely produce any deterrence effect and no civil liabilities. This paper argues that the root of their inadequacy lies in the failure of these measures to identify the character of the separate account in each ILI policy and its distinction from the life insurance policy to which it attaches. Without distinguishing the nature of the separate account from traditional

[5] *Id.*

[6] The Insurance Law of People's Republic of China was first promulgated in 1995. It underwent a major amendment in 2002 for the purpose of fulfilling the commitment of China's WTO accession. The full context of the insurance law is *available at* http://www.circ.gov.cn/Portal0/InfoModule_449/21009.htm (last visited March 14, 2008).

"insurance", it is virtually impossible to ascertain the category of the contract formed between each policyholder and insurer with respect to each such account and to determine which laws and regulations, including those related to the supervision of mutual funds and other investment products, are particularly applicable to the administration of each such account. Moreover, clarifying the nature of the ILI separate account which requires consumers to bear the investment risk also helps to decide the essential degree of protection to be given to consumers through laws and regulations.

Based upon these considerations, Part II of this paper aims first to clarify the nature of the separate account in the ILI product from a theoretical perspective. Then, Part III and IV will verify the theoretical inference and its implementation from a comparative law perspective through the discussion of the related laws and rules concerning the supervision of ILI products in the United States and Taiwan. After affirming the character of the ILI's separate account and how its regulations are designed in other regimes, Part V will examine the present laws and regulations in China and discover the deficiencies of the current Chinese ILI supervisory system. Finally, Part VI proposes recommendations for the reform of the related laws and regulations pursuant to the studies in previous parts of this paper.

I. THE NATURE OF THE SEPARATE ACCOUNTS OF THE INVESTMENT-LINKED INSURANCE PRODUCTS

A. The Operation of the Separate Account of Investment-linked Insurance Products

Separate accounts are accounts into which a policyholder's life insurance policy cash values are invested.[7] They can be regarded as a trust established by the insurance company on behalf of the ILI product policyholders.[8] These accounts and the funds within them are separate and apart from the insurer's general account.[9] To illustrate, assets in the separate account are held as reserves for specific contracts and that may not be used for other purposes.[10] Separate accounts are an accounting, segregation, and reserving tool, and those assets are insulated from the claims of creditors

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7 Dearborn Financial Services, Variable Universal Life 6 (1999).
8 CLIFFORD E. KIRSCH, VARIABLE ANNUITIES AND VARIABLE LIFE INSURANCE REGULATION 1-7 (2006).
9 *Id*. at 1-8.
10 Joan E. Boros & Randolph Thompson, *A Vocabulary of Variable Insurance Products*, Understanding Securities Products of Insurance Companies 2001, at 14 (2001).

that may arise out of the rest of the insurance company's business.[11] The sole purpose of creating and maintaining separate accounts is for enabling policyholders to participate directly in the account's performance.[12] Thus, the ILI product basically provides death benefits and cash values that vary in accordance with the performance of the investment accounts selected by policyholders.[13]

The most notable element of the separate account is that income, gains and losses from assets in such account are, pursuant to the ILI contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company.[14] Therefore, separate accounts are not insured by the insurer, and the returns on their investments are not guaranteed. "While policyholders enjoy the potential for virtually unlimited growth within their policies, they also bear the risk of any losses."[15] As most ILI products offer a variety of underlying separate accounts for policyholders to select and switch, policyholders are allowed to decrease or increase the amount of risk in accordance with their financial objectives and attitude toward risk.[16] A risk preferring policyholder, for instance, may allocate a large portion of his/her net premiums into higher-risk investments such as a growth common stock fund.[17] Meanwhile, a risk aversion policyholder may select to diversify the risk by allocating cash values among several funds with divergent investment objectives.[18]

Most ILI policies offer premium flexibility.[19] These policies are usually issued "with a minimum scheduled premium based on an initial death benefit amount and the age, gender, and risk of the applicant".[20] The premium is the actuarially calculated amount necessary to supply for the plan, the first year expenses and adequate funding to cover the cost of insurance protection.[21] After the first or second year, if the accumulated cash value is sufficient to cover monthly insurance costs, premium

[11] *Id*.
[12] Dearborn Financial Services, *supra* note 7, at 6.
[13] Hunt, *supra* note 4, at 1.
[14] Clifford E. Kirsch, *Variable Insurance Products*, Investment Company Regulation and Compliance: Ali-Aba Course of Study, at 287 (2000).
[15] Dearborn Financial Services, *supra* note 7, at 7.
[16] *Id*, at 7-8. *Also see* Clifford E. Kirsch, *supra* note 7, at 1-8.
[17] Dearborn Financial Services, *supra* note 7, at 8.
[18] *Id*.
[19] Universal life insurance products and universal variable life insurance products are considered "flexible premium whole life policies". Variable life insurance, though known as the fixed premium policy, its premiums have had much more flexibility in today's market than historically. For details, *see* Hunt, *supra* note 4, at 1.
[20] Dearborn Financial Services, *supra* note 7, at 13.
[21] *Id*.

flexibility is instigated so that policyholders may elect to pay more, less or even no premium.[22] The net premiums (the amount after deducting certain expenses, loads and taxes) are deposited into the separate account and allocated among the funds in accordance with the policyholder's selection.[23] The policyholder not only can change the allocation of premiums but also can transfer sums among the various funds.[24] As mentioned earlier, the flexibility to direct the investment of cash values also impose policyholder the burden of bearing the risk of market loss and managing the allocation of the accounts.[25] Moreover, there are additional expenses for the management and administration of the investments so that any investment returns are earned net after deducting from these expenses.[26]

To sum up, policyholders' risk bearing and premium flexibility are two principal characteristics of the ILI separate account.

B. Primary Features of Insurance

Although a perfectly precise and universally applicable definition of insurance is virtually unavailable, it is commonly recognized that as a contract between the insured and the insurer that states the potential costs of loss the insured transfers to the insurer and articulates the insurer's duty to compensate the loss in exchange for the agreed premium paid by the insured.[27] This description reveals two major features of the "insurance", namely "risk transferring" and "risk poling (distribution)".

With respect to the risk transferring, people's attitude toward risk may vary depending on the probability of loss, the potential magnitude of the loss as well as people's tolerance of absorbing the loss.[28] These factors divide people's into three categories, risk preferring, risk neutral and risk aversion.[29] Given that the primary concern of risk aversion parties includes not only the expected value of losses, but also the magnitude of the losses,

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[22] *Id*. *Also see* Hunt, *supra* note 4, at 1.
[23] Charles L. Ratner, *Practical and Creative Uses of Life Insurance in the Closely Held Business*, Estate Planning for the Family Business Owner: Ali-Aba Course of Study, at 701 (2000).
[24] Dearborn Financial Services, *supra* note 7, at 6.
[25] Ratner, *supra* note 23, at 702.
[26] *Id*.
[27] CONSTANCE M. LUTHARDT & ERIC A. WIENING, PROPERTY AND LIABILITY INSURANCE PRINCIPLES 1.3 (2005); ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES 3 (1988); MALCOLM A. CALRKE, THE LAW OF INSURANCE CONTRACTS 1 (1994). *Also see* California Insurance Code, Sec. 22 (1935).
[28] ROBERT H. JERRY, UNDERSTANDING INSURANCE LAW 15 (2002).
[29] SCOTT E. HARRINGTON & GREGORY R. NIEHAUS, RISK MANAGEMENT AND INSURANCE 147-148 (1999).

they are inclined and willing to pay someone else to assume their risk.[30] Transferring the risk through the purchase of insurance is the main approach for risk averse individuals or businesses to achieve this goal. The formation of the insurance contract allows the insured to partially or completely eliminate the risk by substituting a predictable stream of costs, the insurance premium, for potential larger losses (i.e., catastrophic, disabling…).[31] To illustrate, the insurance premium is the consideration provided by the insured in exchange for the insurer's assumption of the risk transferred and promise to indemnify the insured for a loss or to pay proceeds upon the occurrence of some specified event.[32] Moreover, through the function of the "law of large numbers"[33], the insurance mechanism transfers or shifts risks from individual to a group that contains sufficiently large number of homogeneous exposure units so as to have the losses reasonably predictable.[34] In short, all insurance contracts involve risk transfer.

In regard of the risk pooling (distribution), in addition to bear the risk transferred from individuals, the insurance mechanism also reduces risk for society as a whole.[35] Insurers accomplish this goal by aggregating the significant number of risks of the same type into a pool in which the increased number of such type of risk will improve the accuracy of estimating the probability of losses.[36] Under the premise that the number of insureds included in the pool is sufficiently large, and the information accumulated concerning the experience of comparable risks in the past is both substantial and precise, the result of the actuary likely will provide predictions on both the number of incidence and the average costs of the harmful experiences with sufficient accuracy to help the insurer to calculate the premium to charge for undertaking the risk transferred.[37] In addition, insurers prefer to include uncorrelated risks and disfavor corrected risks.[38] A property and casualty insurance company, for instance, may favor providing

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[30] AVERY W. KATZ, FOUNDATIONS OF THE ECONOMIC APPROACH TO LAW 210 (1998); Jerry, *supra* note 28, at 16.

[31] Jerry, *supra* note 28, at 17.

[32] *Id*. at 611. *Also see* Keeton & Widiss, *supra* note 27, at 11-12.

[33] The law of large numbers refers to "a theorem in probability that describes the long-term stability of a random variable. Given a sample of independent and identically distributed random variables with a finite expected value, the average of these observations will eventually approach and stay close to the expected value". *See* Law of Large Numbers, http://en.wikipedia.org/wiki/Law_of_large_numbers (last visited March 22th 2008). *Also see* Dictionary of Finance and Investment Terms 316 (John Downes et al. eds., 5th ed., 1998).

[34] EMMETT J. VAUGHAN & THERESE VAUGHAN, FUNDAMENTALS OF RISK AND INSURANCE 33, 41 (2003).

[35] *Id*. at 34.

[36] Keeton & Widiss, *supra* note 27, at 12-13.

[37] *Id*. *Also see* Jerry, *supra* note 28, at 18; Vaughan, *supra* note 34, at 34-39.

[38] EMERIC FISHER ET AL., PRINCIPLES OF INSURANCE LAW 15 (3rd. ed., 2006).

homeowners' insurance service to a million insureds randomly distributed across the entire country than writing the same type of insurance with the same coverage to a million homeowners in a limited geographical area under the threat by a certain type of natural catastrophe as the former case enable the insurer to profitably operate and charge appropriate premiums while the latter case may impair the operation of the insurer.[39] Therefore, establishing a pool of large but uncorrelated policyholders is critical to risk distribution and pooling.

C. The Nature and Characteristics of Mutual Funds

An investment company is a mechanism that pools investors' money for the purpose of investing in securities. The most common type of investment companies is the open-end management company, ordinarily known as "the mutual fund".[40] Mutual funds (a.k.a. open-end funds) are funds that will always sell new shares to investors who intend to invest their capital, or purchase share from investors who wish to have their investments redeemed, at the price according to the net asset value of the fund.[41] Each share represents an investor's proportionate ownership of the fund's holdings (portfolio) and the income those holdings generate.[42] Although recognized as owner of the mutual fund portfolio, mutual fund shareholders rarely assert their ownership rights.[43] This is because first, as mentioned above, mutual fund shares are "redeemable", meaning fund owners, if dissatisfied, have the option to sell their shares back to the fund; and second, fund shareholders rightly focused on their net return, the portfolio return net of fees.[44]

In the mutual fund, the effect of risk diversification is introduced to shareholders' investment portfolio by spreading their investments across a wide range of securities.[45] In addition, by pooling the shareholder's assets with those of other investors, a mutual fund provides the investor with a more diversified portfolio than he/she would probably be able to

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[39] *Id*.
[40] Clifford E. Kirsch, *An Introduction to Mutual Funds*, Nuts and Bolts of Financial Products 2005: Understanding the Evolving World of Capital Market & Investment Management Products, at 369 (2006).
[41] LEE GREMILLION, MUTUAL FUND INDUSTRY HANDBOOK: A COMPARATIVE GUIDE FOR INVESTMENT PROFESSIONALS 3 (2005).
[42] Invest Wisely: An Introduction to Mutual Funds (hereinafter the SEC Guide), http://www.sec.gov/investor/pubs/inwsmf.htm (last visited March 23, 2008).
[43] Barbara Remmers, *Strengthening Mutual Fund Corporate Governance: A Security Design Approach* 1 (2004), *available at* http://ssrn.com/abstract=516102.
[44] *Id*. at 2-3.
[45] Investment Company Institute, A Guide to Understanding Mutual Funds (hereinafter the ICI Guide) 4 (2006), *available at* http://www.ici.org/pdf/bro_understanding_mfs_p.pdf.

comfortably manage individually at a fraction of the cost.[46] However, the advantage of lowering the risk of loss incurred result from the failure of a single company or sector does not necessary mean investors are free from any risk or risks that transferred from investors to the fund itself. Conversely, fund investors may face price uncertainty. Market price of securities can always rise and fall so that depreciation on the investments can always occur.[47] Also, unlike purchasing or selling an individual stock, the price at which mutual fund shareholders purchase or redeem their shares will be based on the fund's net asset value (NAV), which the fund might not calculate until many hours after the placement of investors' order.[48] Typically, the NAV of mutual funds are calculated at least once every business day, but usually after the major U.S. exchanges close.[49] In addition to the fluctuation and uncertainty of price, specific risks are always associated with different types of mutual funds. These potential risks are: inflation risk, interest rate risk, credit risk, liquidity risk, currency risk and political risk.[50] For instance, the bond fund tends to involve interest rate risk and credit risk. "When interest rates rise, a bond's value usually falls, and the longer a bond's maturity, the more its price tends to fluctuate as market interest rates change.[51] Meanwhile, if a bond issuer is unable to repay principal or interest on time, the bond is said to be in default."[52] A decline in an issuer's credit rating or creditworthiness can cause a bond's price to decline so that bond funds holding the bond could then experience a decline in their net asset value.[53]

D. The Separate Accounts of Investment-linked Insurance Products Should be Regarded as Securities Products

Comparing the mutual fund to insurance companies, the former is a company that invests in a diversified portfolio of securities by collecting

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[46] *Id*.
[47] Investment Company Institute, Questions You Should Ask Before You Invest in a Mutual Fund (hereinafter ICI Q & A) 3 (2000), *available at* http://www.ici.org/pdf/bro_questions_p.pdf.
[48] In the case of the purchase or sale of a single stock or bond, investors may acquire real-time (or close to real-time) pricing information with relative ease by checking financial websites or by calling your broker. You can also monitor how a stock's price changes from hour to hour—or even second to second. For details, *see* The SEC Guide, *supra* note 42. *Also see* Laurin B. Kleiman et. al, *Forming, Organizing and Operating a Mutual Fund: Legal and Practical Considerations*, The ABCS of Mutual Funds 2007, at 18 (2007).
[49] The SEC Guide, *id*.
[50] ICI Q & A, *supra* note 47, at 3.
[51] For details, *see* the ICI Guide, *supra* note 45, at 7.
[52] *Id*.
[53] *Id*.

capital from shareholders (investors),[54] while the later forms the contract with the insured to indemnify the insured against loss for a certain consideration.[55] From descriptions in the preceding paragraphs, investors who contribute money for the mutual fund to buy securities acquire the ownership or shares of the mutual fund.[56] The sole objective of investors is to profit from the positive performance of the mutual fund through the distribution of dividends or interest to the fund, or the increase of the security value. Shareholders may also suffer losses if the NAV of the fund drops.[57] On the other hand, in an insurance contract, premiums paid by the insured to the insurer are the consideration for the insurer's assumption of risks by the insured whereby the insurer agrees to indemnify the insured for potential losses resulting from certain events.[58] Shares of mutual funds are redeemable, but insurance premiums, as the consideration for providing the coverage, are non-refundable unless the contract is recessed.[59] Furthermore, except for the similar function of risk pooling and distribution, apparent differences exist between the purchase of mutual fund shares and purchase of insurance policies. Earlier discussions reveal that the major feature of the insurance is for the insured to transfer his/her risk to the insurance pool while mutual fund shareholders retain the risk of losses. Therefore, insurance is an instrument of risk management for mitigating the pure risk, but mutual fund is a tool that contains speculative risk.[60]

The separate account of the ILI product, though attaches to the life insurance policy, differs from the insurance but resembles mutual fund in various aspects. First, the insured's risk retention is distinguished from the risk transfer feature of the traditional whole life insurance but very similar to the risk borne by the mutual fund shareholders. Second, albeit that the separate account, pursuant to the law, has no separate existence like a mutual fund, the net premiums deposited into the separate account and policyholders' liberty in the allocation of premiums are analogous to the purchase of mutual fund share and the right of redemption.[61] Third, unlike the risk management function of the insurance, it is the fact that the purpose

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[54] *Id*. at 3.
[55] Griffin Systems, Inc. v. Washburn, 505 N.E 2d. 1121, 1123 (1987).
[56] For details, *see* the ICI Guide, *supra* note 45, at 3.
[57] *Id*.
[58] 505 N.E 2d., at 1123 (1987).
[59] The SEC Guide, *supra* note 42; Keeton & Widiss, *supra* note 27, at 617; Jerry, *supra* note 28, at 611-612.
[60] Speculative risk describes a situation in which there is a possibility of loss, but also a possibility of gain; whereas the risk that the insurer take from the insured is the pure risk referring to the occasion that involves only the probability of loss or no loss. For details, *see* Vaughan, *supra* note 34, at 7, 17.
[61] Boros & Thompson, *supra* note 10, at 14; Ratner, *supra* note 23, at 701.

of the existence of separate accounts is to allow policyholders to participate directly in the account's performance depending on the rise or fall the investment subjects, which is consistent with the emphasis of mutual fund investors.[62] Fourth, same as the mutual fund shareholders, the policyholder of the separate account receives a "pro-rata share of what the portfolio of equity reflect—which may be a lot, a little or nothing".[63] Fifth, additional expenses for the management and administration of the investments caused from the separate account regardless of the negative performance are comparable to the mutual fund whereas the administrative expenses of insurance has included in the gross premium.[64]

From the above comparison and analyses, this paper concludes that the nature of the ILI product's separate account deviates from insurance but corresponds to characters of the mutual fund. Legally, it is more appropriate to treat the separate account like mutual fund or at least a securities product resembling mutual fund.

II. LAWS AND REGULATIONS WITH REGARD TO THE SUPERVISION OF THE INVESTMENT-LINKED INSURANCE PRODUCTS IN THE U.S.

A. *Evolvements of the Regulatory Settings—the Case Law*

Pursuant to the McCarran-Ferguson Act, the power of regulating and taxing the insurance business traditionally belongs to the state as it is the intention of the Congress that such arrangement is in the public interest.[65] In addition, Section 3 (a) (8) of the Securities Act of 1933 explicitly provides that insurance or annuity contracts are immune from the application of all provisions of the Act.[66] Nevertheless, with the appearance of the ILI

[62] Dearborn Financial Services, *supra* note 7, at 6; Remmers, *supra* note 43, at 2.
[63] SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71 (1959).
[64] Ratner, *supra* note 23, at 702; The SEC Guide, *supra* note 42; Jerry, *supra* note 28, at 611; Hunt, *supra* note 4, at 3.
[65] The McCarran-Ferguson Act reads "(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business. (b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance…" 15 U.S.C. § 1012 (1948). *Also see* Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 429 (1986); U.S. Dept. of Treasury v. Fabe, 508 U.S. 491, 499 (1993).
[66] Section 3 (a) (8) of the Securities Act of 1933 provides that any provisions of the such Act shall not apply to "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia". 15 U.S.C. §77c. (a) (8).

products, courts and the Securities Exchange Commission (SEC) has gradually shifted their attitude toward what is included in the scope of "insurance" and "annuity" stated in Section 3 (a) (8) and what is not. Two landmark decisions rendered by the Supreme Court of United States have elaborated the change.

In *SEC v. Variable Annuity Insurance Company*,[67] Justice Douglas articulated the insurance's risk-taking feature of which the annuity contract in issue is in lack:

> Absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interests reflects-which may be a lot, a little, or nothing…[C]ommon knowledge tells us that the forms have greatly changed even in a generation. And we would not undertake to freeze the concepts of "insurance" or "annuity" into the mold they fitted when these Federal Acts were passed. But we conclude that the concept of "insurance" involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense…[W]e deal with a more conventional concept of risk-bearing when we speak of "insurance". For in common understanding "insurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts. The companies…guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities-an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage.[68]

Justice Brennan and Justice Stewart, in their concurring opinion, analyzed the issue from the perspective of the purpose of 1933 Act and concluded that risks associated the variable annuity facing the policyholders falls within the scope of protection Federal legislations aim to provide:

> These exclusions were to take effect where the issuer of the policy or contract was subject to the supervision of the state "insurance commissioner, bank commissioner, or any agency or officer performing like functions" [Securities Act §3 (a) (8)] or where a company classifiable as an "insurance company" was "subject to supervision by the insurance commissioner or a similar official or agency of a State" [Investment Company Act §2 (a) (17)]. The exclusions left these contracts and companies to the sole control of such state officials. Except for these exclusions, there is little doubt that these contracts and the companies issuing them would be subject to the Federal Acts…[B]ut if a brand-new form of investment arrangement emerges which is labeled "insurance"

[67] SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).
[68] *Id*. at 71-73.

> or "annuity" by its promoters, the functional distinction that Congress set up in 1933…must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners. In that inquiry, an analysis of the regulatory and protective purposes of the Federal Acts and of state insurance regulation as it then existed becomes relevant…in a traditional annuity the policyholder bears the investment risk in the sense that he stands the risk of the company's insolvency. The prevention of insolvency and the maintenance of "sound" financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at. The protection of share interests in a fluctuating, managed fund has received the attention of specific federal legislation. Both are "investment risks" in a sense, buy they differ vastly in kind and lend themselves to different regulatory schemes.[69]

Similarly, in *SEC v. Unisted Benefit Life Insurance Company*[70], the "flexible fund annuity" allowed the purchaser, at the maturity to elect to receive the cash value of his policy, measured either by his interest in the fund or by the net premium guarantee, whichever is larger.[71] The policyholder might also choose to convert his interest into a life annuity under conditions specified in such contract.[72] These conditions related future benefits to dollars available at maturity so the dollar benefits to be received would vary with the cash value at maturity.[73] Meanwhile, the net premium guarantee was also a guarantee that a certain amount of fixed-amount payment life annuity will be available at maturity.[74] Justice Harlan distinguished the complete-risk-assumption function of the insurance from the partial risk transferring offered through the guarantee in this contract in issue:

> There is some shifting of risk from policyholder to insurer, but no pooling of risks among policyholders…The policyholder has no direct interest in the fun and the insurer has a dollar target to meet. The "Flexible Fund" program completely reverses the role of the insurer during the accumulation period. Instead of promising to the policyholder an accumulation to a fixed amount of savings at interest, the insurer promises to serve as an investment agency and allow the policyholder to share in its investment experience. The insurer is obligated to produce no more than the guaranteed minimum at maturity, and this amount is substantially less than that guaranteed by the same premiums in a conventional deferred annuity contract…Approaching the accumulation portion of this contract, in this light, we have little difficulty in concluding that it does not fall within the

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[69] *Id*. at 76, 91.
[70] SEC v. United Benefit Life Ins. Co. 387 U.S. 202 (1967).
[71] *Id*. at 205.
[72] *Id*.
[73] *Id*.
[74] *Id*.

> insurance exemption of §3 (a) of the Securities Act. "Flexible Fund" arrangements…are considered to appeal to the purchaser not on the usual insurance basis of stability and security but on the prospect of "growth" through sound investment management. And while the guarantee of cash value based on net premiums reduces substantially the investment risk of the contract holder, the assumption of an investment risk cannot by itself create an insurance provision under the federal definition. The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized.[75]

Same as Securities Exchange Act of 1933, Section 3 (c) (3) of the Investment Company Act of 1940 (hereinafter the 1940 Act) also literally excluded insurance companies from the regulation of this Act pursuant to the definition provided by Section 2 (a) (17) of the same Act.[76] In 1964, the *Prudential Insurance Company* case created the possibility of applying the 1940 Act to the separate account of the ILI product.[77] In the Prudential case, the variable annuity contracts designed by Prudential provided that the purchaser would make monthly purchase payments of fixed amounts over a period of years, and the proceeds would be invested in a portfolio of securities.[78] The purchaser would receive monthly credits with "units" representing his proportionate interest in this fund, while the value of these units will fluctuate, essentially depending upon the investment results of the

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[75] *Id*. at 207-208.

[76] Section 3 (c) (3) of the Investment Company Act of 1940 provides that "Any bank or insurance company; any savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, or any receiver, conservator, liquidator, liquidating agent, or similar official or person thereof or therefor; or any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian, if—(A) such fund is employed by the bank solely as an aid to the administration of trusts, estates, or other accounts created and maintained for a fiduciary purpose; (B) except in connection with the ordinary advertising of the bank's fiduciary services, interests in such fund are not—(i) advertised; or (ii) offered for sale to the general public; and (C) fees and expenses charged by such fund are not in contravention of fiduciary principles established under applicable Federal or State law". *See* 15 U.S.C. § 80a-3 3 (c) (3) (2004).

The "insurance company" in this Act refers to "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such. "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such". *See* 15 U.S.C. § 80a-2 (a) (17) (2006).

[77] Prudential Ins. Co. v. SEC, 362 F.2d. 383 (1964).

[78] *Id*. at 384.

fund.[79] The court, through reviewing the function and character of Prudential's "Investment Fund" and the purpose of the 1940 Act, determined that the 1940 Act applies to the separate account created by Prudential, and the separate account should be treated as "the issuer" of the contract in this case:

> The legislative history compels the conclusion that Prudential's Investment Fund is a "fund" as that term is used in the statute. As we have previously seen, the Investment Fund is a completely segregated account, devoted to investing in securities. The cash for these investments is derived from payments made by the purchaser of the variable annuity contract. Though the proceeds of the fund are held for the sole benefit of the annuitant, it is this fund, and no other entity, in which he has an interest. Thus, the fund is separable from the insurance company which, as the Supreme Court noted in VALIC, "guarantee(s) nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor…[I]t follows from this that the Investment Fund, and not Prudential, is the 'issuer' of these securities for the purposes of the Investment Company Act of 1940…The Investment Company Act of 1940 contains significant safeguards for the protection of those who, like the purchasers of variable annuities, invest in 'securities'". These safeguards, characterized by the Commission as insuring "corporate democracy", include disclosure of investment policy and operating practices, and the regulation of fees, trading practices, and changes in investment policy. The mere fact that the investment program in the case at bar is under the aegis of an insurance company ought not to negate compliance with these controls in the absence of compelling circumstances.[80]

B. Related Rules under the Securities Act of 1933 & the Investment Company Act of 1940

1. Rule 151 of the 1933 Act

In 1986, the SEC adopted Rule 151 for the purpose of providing criteria to assist issuers of annuity contracts to determine whether the contract is an "annuity contract" or "optional annuity contract".[81] According to Rule 151, section 3 (a) (8) of the 1933 Act is applicable if any annuity contract or optional annuity contract if:

> (1) The annuity or optional annuity contract is issued by a corporation (the "insurer") subject to the supervision of the insurance commissioner, bank

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[79] *Id*.
[80] *Id*. at 385-388.
[81] Christopher S. Petito, *Status of Variable Products Under the Securities Act of 1933*, Variable Annuities and Variable Life Insurance Regulation (Clifford E. Kirsch ed., 2006), at 2-4.

> commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia; (2) The insurer assumes the investment risk under the contract as prescribed in paragraph (b) of this rule; and (3) The contract is not marketed primarily as an investment.[82]

Rule 151 also renders guidance of whether the insurer is regarded to bear the investment risks. An insurer fulfilled the criteria of assuming investment risks if:

> (1) The value of the contract does not vary according to the investment experience of a separate account;
>
> (2) The insurer for the life of the contract:
>
> i. Guarantees the principal amount of purchase payments and interest credited thereto, less any deduction (without regard to its timing) for sales, administrative or other expenses or charges; and
>
> ii. Credits a specified rate of interest [as defined in paragraph (c) of this rule] to net purchase payments and interest credited thereto; and
>
> (3) The insurer guarantees that the rate of any interest to be credited in excess of that described in paragraph (b) (2) (ii) will not be modified more frequently than once per year.[83]

These elements reiterating the language of the *United Benefit* case provide bright guidelines for identifying the status of the separate account. They were properly tested and implemented in *Otto v. Variable Annuity Life Ins. Co.*, in which the U.S. Court of Appeals categorized the fixed annuity issued by Variable Annuity Life Insurance Company (VALIC) as securities product by utilizing the Rule 151 scrutiny and ruled that because the contract actually leaves the investor with an investment risk significant enough to throw its status into doubt, the standards of Rule 151 has not sufficed.[84]

2. Rule 6e-2 and 6e-3 (T) of the 1940 Act

In terms of facilitating the functional regulation, various provisions of the 1940 Act have been adapted to be more feasible for the supervision of ILI products and its separate account.[85] Two principal extensive rules, Rule

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[82] 56 F.R. 20262 (a) (1986).
[83] 56 F.R. 20262 (b) (1986).
[84] For details, *see* Otto v. Variable Annuity Life Ins. Co., 814 F.2d 1127-1142 (1986).
[85] Windell M. Faria, *Status of Insurance Companies and Insurance Company Separate Accounts Under the Investment Company Act*, Variable Annuities and Variable Life Insurance Regulation (Clifford E. Kirsch ed., 2006), at 3-31.

6e-2 and Rule 6e-3 (T) are adopted to regulate scheduled premium variable life insurance policies and flexible premium life insurance policies respectively.[86]

a. Rule 6e-2

Subsection (a) of this rule provides seven conditions for the establishment and maintenance of the separate account in a schedule premium variable life insurance policy: (1) The separate account is established and maintained by a life insurance company pursuant to the state insurance laws or code, or a Canadian-regulated insurance company; (2) The assets of the separate account can be derived only from the sale of variable life insurance contracts, and advances made by the life insurance company which established and maintains the separate account ("life insurer") in connection with the operation of such separate account; (3) The separate account is barred from being used for variable annuity contracts or for funds corresponding to dividend accumulations or other contract liabilities not involving life contingencies; (4) The income, gains and losses, whether or not realized, from assets allocated to such separate account, should be, in accordance with the applicable variable life insurance contract, credited to or charged against such account without regard to other income, gains or losses of the life insurer; (5) The separate account is required to be legally segregated, and that portion of its assets having a value equal to, or approximately equal to, the reserves and other contract liabilities with respect to such separate account are not chargeable with liabilities arising out of any other business that the life insurer may conduct; (6) The assets of the separate account have, at each time during the year that adjustments in the reserves are made, a value at least equal to the reserves and other contract liabilities with respect to such separate account, and at all other times, except pursuant to an order of the Commission, have a value approximately equal to or in excess of such reserves and liabilities; and (7) The investment adviser of the separate account is registered under the Investment Advisers Act of 1940.[87]

Subsection (b) of this rule provides a series of exceptions to the application of the 1940 Act in scheduled premium variable life insurance. Some of which are considered necessary to ensure that policyholders would not be able to incur unreasonable risk to the insurance company according to such company's guarantee of the minimum death benefit, while others are

[86] *Id*.

[87] 67 FR 43534 (a) (2002).

designed for convenience purpose.[88]

b. Rule 6e-3 (T)

Like Rule 6e-2, subsection (1) of this rule also creates several conditions for the establishment and maintenance of the separate account of the flexible premium insurance product. While these conditions are similar to those in Rule 6e-2, the most significant difference lies in the source of the separate account assets. Pursuant to Subsection (a) (2) of this Rule, the assets of the separate account must be obtained from: (i) the sale of flexible premium variable life insurance contracts, (ii) the sale of scheduled premium variable life insurance contracts, (iii) funds corresponding to dividend accumulations with respect to such contracts, and (iv) advances made by the life insurer in connection with the operation of such separate account.[89] Comparing to Subsection (a) (2) of Rule 6e-2, the source of assets provided in this Rule is broader. In addition to the variation in the element of the separate account, no other major distinction exists between Rule 6e-2 and Rule 6e-3 (T).

C. Rules of Disclosure of the ILI Separate Account

Disclosure requirement aiming to mitigate the asymmetry of information on the market is always an indispensable mechanism of investor protection in the securities regulation.[90] The goals of the disclosure system under the federal securities laws are to promote accurate analysis of securities offered in the market (informative function) and to protect unsophisticated investors from fraud and unfair treatment

[88] With respect to the former, for example, Subsection (b) (5) (ii) of this rule provides that "Changes in the investment policy of the separate account initiated by contract holders or the board of directors of the separate account may be disapproved by the life insurer, provided that such disapproval is reasonable and is based upon a determination by the life insurer in good faith that: A. Such change would be contrary to state law; or B. Such change would be inconsistent with the investment objectives of the separate account or would result in the purchase of securities for the separate account which vary from the general quality and nature of investments and investment techniques utilized by other separate accounts of the life insurer or of an affiliated life insurance company, which separate accounts have investment objectives similar to the separate account." As for the later one, subsection (b) (15) (i) provides that "The eligibility restrictions of section 9 (a) of the Act shall not be applicable to those persons who are officers, directors and employees of the life insurer or its affiliates who do not participate directly in the management or administration of any registered management investment company". *Also see* Faria, *supra* note 85, at 3-32 & 33.

[89] 67 CFR 43536 (a) (2) (2002).

[90] International Organization of Securities Commissions, Objectives and Principle of Securities Regulation 24 (1998) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD82.pdf.

(protective function).[91] The rationale is that "disclosure makes available the information needed for accurate investment analysis, thus promoting efficient securities markets which in turn result in better allocation of the nation's capital resources". [92] In its protective function, disclosure "prevents the kind of defrauding and exploitation of inexperienced investors which depends its success on nondisclosure, or inadequate or misleading disclosure, by securities dealers or corporate insiders".[93] The securities-law disclosure requirements applicable to the issuance and maintenance of variable insurance products are uniquely complex. [94] Prospectus disclosure and delivery are one of the most important approaches to attain the goal of disclosure.[95] The federal securities laws require companies to provide investors with sufficient prospectus information during the period of distribution to allow investors to make rational investment decisions and to provide sufficient legally-binding public disclosure in the full registration statement, annual and semi-annual reports and proxies filed with the SEC to deter unfair and fraudulent business practices.[96]

Present Federal securities laws and regulations and the interpretations of the staff of the SEC require disclosures at two different periods, namely the "point-of-sale disclosure" and "regular on-going disclosure".[97] Issuers of variable insurance products ought to deliver various in such two periods. A customer who purchases the variable products are entitled to receive a current prospectus for the variable product,[98] and a current prospectus for each underlying investment fund ("Fund") to which money is allocated.[99] This arrangement is known as the "two tier system"—the separate account tier and the underlying fund tier in correspondence with the "two tier

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[91] Stephen E. Roth & Mary Jane Wilson-Bilik, *Simplified Disclosure for Mutual Funds and Variable Insurance Products: Variable Insurance Products*, Conference on Life Insurance Company Products: Current Securities, Tax, Erisa, and State Regulatory Issues, at 310 (1998).

[92] ALISON G. ANDERSON, THE DISCLOSURE PROCESS IN FEDERAL SECURITIES REGULATION: A BRIEF REVIEW, 25 Hastings L. J. 311, 314 (1974).

[93] *Id*.

[94] Stewart D. Gregg, *Current and Evolving Disclosure Delivery Practices of Issuers of Variable Insurance Products*, Conference on Life Insurance Company Products: Aba-Ali Course of Study, at 47 (1999).

[95] Roth & Wilson-Bilik, *supra* note 91, at 310.

[96] *Id*. at 310-311.

[97] *Id*. at 49.

[98] 15 U.S.C. §77e (b) (2) (2006).

[99] SEC Release No. IC-14575 text at n. 49 (June 25, 1985) (Form N-4 adopting release) quoting Gregg, *supra* note 91, at 49.

registration system".[100] Typically, these two (or more) disclosure documents are delivered to the customer at or before the point at which a sale occurs; nevertheless, in some instances, the issuer may not convey the prospectus for the Fund(s) or for the contract until the point at which the issuer delivers the confirmation of the transaction, i.e., at the delivery of the contract or policy.[101] With respect to the regular on-going disclosure, after a consumer purchase a variable insurance product, he or she is entitled to receive a series of disclosure documents each year. These may include: (1) an annual report to shareholders for each Fund to which money is allocated as of December 31;[102] (2) an updated prospectus for the variable product;[103] (3) an updated prospectus for each applicable Fund;[104] (4) a semi-annual report to shareholders for each Fund to which money is allocated as of June 30;[105] (5) prospectus supplements for the contract prospectus and each applicable Fund prospectus.[106] In addition, while not legally required, some variable product issuers deliver to customers an "annual report" for the product which consists largely of financial statements for the separate account.[107]

D. The NAIC Model Laws

As previously mentioned, each individual state possesses the authority to regulate and tax the insurance business. The mission of the NAIC is to assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members. State insurance regulators created the NAIC in 1871 to address the need to coordinate regulation of multistate insurers. The first major step in that process was the development of

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[100] A life insurance company separate account, holding purchase payments made under a variable annuity contract ("VA") or variable life insurance policy ("VLI") (collectively, "variable insurance contracts"), is deemed to be a registerable investment company under the 1940 Act. Units of interest, or other participations in the separate account, (collectively, units of interest) under the variable insurance contracts are deemed to be registerable securities under the 1933 Act. *See* Gary O. Cohen, *Prospectus Delivery Issues Under the Securities Act of 1933 for Life Insurance Company Issuers of Variable Insurance Products and for Underlying Mutual Funds*, Conference on Life Insurance Company Products: Aba-Ali Course of Study, at 4 (1999). *Also see* Gary O. Cohen, Discourse Delivery by Life Insurance Company Issuers of Variable Insurance Contracts and Underlying Mutual Funds in the 40 Act Institute 2000: PLI Order No. B0-00KD, at 91 (2000).

[101] Gregg, *supra* note 91, at 49.

[102] Investment Company Act Rule 30a-1 (2003).

[103] Gregg, *supra* note 91, at 49.

[104] *Id.*

[105] Investment Company Act Rule 30e-2 (2001).

[106] Gregg, *supra* note 91, at 49.

[107] *Id.*

uniform financial reporting by insurance companies. Since then, new legislative concepts, new levels of expertise in data collection and delivery, and a commitment to even greater technological capability have moved the NAIC forward into its role as a multidimensional, regulatory support organization. Therefore, the NAIC model laws do generate significant influences on state insurance regulations.[108]

The Variable Life Insurance Model Regulation (VLIR) is the model law that provides for regulating the ILI products. While the VLIR did not offer a clear-cut definition for "separate account", it defines the "variable life insurance policy" as "an individual policy that provides for life insurance the amount or duration of which varies according to the investment experience of any separate account or accounts established and maintained by the insurer as to the policy".[109] Section 6 and 7 of the VLIR were provided particularly for the separate account of the Variable Life Insurance. Section 6 requires a domestic insurer issuing variable life insurance to establish one or more separate accounts in which the assets should be maintained at the amount at least equal to the greater of the valuation reserves for the variable portion of the variable life insurance policies or the benefit base for these policies.[110] It further mandates an insurer intending to enter into the variable life insurance business to adopt by formal action of its board of directors a written statement specifying the standards of conduct of the insurer, its officers, directors, employees and affiliates with respect to the purchase or sale of investments of separate accounts.[111] A code of ethic which meets the requirements of Section 17j under the Investment Company Act of 1940 and its applicable rules and regulations are deemed to fulfill this requirement.[112] It can be inferred that the provision requiring an insurer engaging in variable life insurance business to have in place the same code of ethics same as an investment company implies that the separate account is an investment account rather than a general account of insurance in nature.

As for the restrictions imposed to the management of the separate account, no insurer is allowed to sell, transfer or exchange assets between any of its separate accounts except in the case that the transfer is made, in cash or other assets approved by the commissioner, for the sole purpose of establishment of the account or supporting the operation of the policies with

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[108] The NAIC's History and Background, http://www.naic.org/index_about.htm (last visited May 11, 2013).
[109] VLIR Sec. 2 (P) & (S) (1996).
[110] VLIR Sec. 6 (A) & (B) (1996).
[111] VLIR Sec. 6 (H) (1996).
[112] *Id.*

respect to the separate account to which transfer is made.[113] In addition, the initial investment policy of the separate account as well as any subsequent changes is subject to the approval of the commissioner.[114] An insurer is not permitted to contract with any person to furnish investment advice unless such contractual party is a registered investment adviser under the Investment Advice Act of 1940.[115] This provision offers a concrete proof that the separate account resembles a mutual fund, otherwise, it doesn't need to be managed by a registered investment adviser as mutual funds do.

Section 7 of the VLIR requires the insurer to furnish the applicants with information in the prospectus which fulfills the requirements of the Securities Act of 1933 and which was declared effective by the Securities and Exchange Commission.[116] Information to be provided to the applicant should contain the following:

> A. Summary explanation, in non-technical teams, of the principal features of the policy, including a description of the manner in wrier the variable benefits will reflect the investment experience of the separate account and the factors that affect the variation.
>
> B. Statement of the investment policy of the separate account, including:
>
> (1) A description of the investment objectives intended for the separate account and principal types of investments intended to be made; and
>
> (2) Restrictions or limitations on the manner in which the operations of the separate account are intended to be conducted;
>
> C. A statement of the net investment return of the separate account for each of the last ten years or such lesser period as the separate account has been in existence;
>
> D. Statement of the Charges levied against the separate account during the previous year;
>
> E. Summary of the method to be used in valuing assets held by the separate account;
>
> F. A summary of the federal income tax aspects of the policy applicable to the insured, the policyholder and the beneficiary; and
>
> G. Illustrations of benefits payable under the variable life insurance contract. The illustrations shall be prepared by the insurer and shall not include projections of past investment experience into the future or attempted predictions of future investments experience, provided that nothing contained Herein prohibits use of

113 VLIR Sec. 6 (C) (1996).
114 VLIR Sec. 6 (F) (1996).
115 VLIR Sec. 6 (J) (1996).
116 VLIR Sec. 7 (1996).

hypothetical assumed rates of return to illustrate possible levels of benefits if it is made clear that the assumed rates are hypothetical only.[117]

Within thirty days after each anniversary of the policy, an insurer delivering or issuing a variable life insurance policy shall mail to each variable life insurance policyholder at his or her last known address the reports containing the statement or statements the cash surrender value, death benefit, any partial withdrawal or policy loan, any interest charge, any optional payments allowed under the policy.[118] An annual statement should also include the following information:

(1) A summary of the financial Statement of the separate account based on the last annual statement filed with the Commissioner;

(2) Net investment return of the separate account for the last year and, for each year abet the first, a comparison of investment rate of the separate account during the last year with the investment rate during prior years, up to a total of not less than five years when available;

(3) A list of investments held by the separate amount as of a date not edgier than the end of the last year for which an annual statement was filed with the commissioner;

(4) Charges levied against the separate account during the previous year; and

(5) Statement Of any change, since the last report, in the investment objective and orientation of the separate account, in any investment restriction or material quantitative or qualitative investment requirement applicable to tee separate account or in the investment advisor of the separate account.[119]

E. Brief Conclusion

Case law and related rules under the 1933 Act (Rule 151) and the 1940 Act [Rule 6e-2 and 6e-3 (T)] have all demonstrated the crystal clear factor, the assumption of investment risk, for distinguishing the genuine insurance product from the insurance securities product to which the separate account attaches. The NAIC Model Laws further endorsed this view. An insurance product will be treated as securities product and thus be subject to the regulation of securities laws and rules under the circumstance that the investment risk is borne by insureds (policyholders). As the fact that policyholders of ILI products assume the investment risk of the separate account has been affirmed by American case law and statutory laws and

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[117] *Id.*
[118] VLIR Sec. 9A (1996).
[119] VLIR Sec. 9B (1996).

rules[120], the theoretical conclusion that the separate account is a securities product analogous to mutual fund that can therefore be authenticated. Scholarly opinions further indicate that the assumption of mortality risk does not appear to be the single important factor in determining the insurance product under the 1933 Act.[121] It is claimed that SEC erred in construing the *United Benefit* case due to failing to consider the mortality risk pooling feature of the insurance product.[122] Thus, "[a]s long as insurance protection and mortality consideration are dominant, principal, and central, and investment aspect are subordinate, secondary and auxiliary, a product will not be a 'security'".[123] As inferred in the second part of this paper, "risk pooling" is one of the fundamental elements of the insurance, this paper consider such argument convincing.

III. LAWS AND REGULATIONS WITH REGARD TO THE SUPERVISION OF THE INVESTMENT-LINKED INSURANCE PRODUCTS IN TAIWAN

The ILI was first introduced in Taiwan in 2001.[124] In response to the supervisory demand of the ILI market, Taiwan has gradually amended its insurance act and related regulations since then. On June 3, 2011, Taiwan even became the first East Asian nation who pass singular legislation protecting consumers who use financial services. The Financial Consumer Protection Act (FCPA) imposes various obligations upon financial service industries in the process of marketing and selling financial products.

A. The Insurance Act

Article 146 of the Insurance Act requires an insurer that engages in ILI business or labor pension annuity insurance business to create a separate account to record the value of the assets in which it invests. The Financial Service Commission (FSC) shall prescribe regulations governing administration and custody of separate account, allocation of investment assets, and other compliance matters pertaining to ILI business, which are not subject to the restrictions applies to the investment of the general

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[120] *See* Prudential Ins. Co. v. Benjamin, 328 U.S. 408 (1986); Rule 6e-2 & 6e-3 (T) of the 1940 Act & Rule 151 of the 1933 Act.
[121] Jeffery S. Puretz, *Insurance Products as Securities*, Understanding Securities Products of Insurance 2001, at 117-118.
[122] *Id.*
[123] Kroll & Cohen, *The Insurance-Securities Identity Crisis*, 46 GEO. WASH. L. REV.790, 793 (1978).
[124] Taiwan Insurance Institute, http://pivot.tii.org.tw/lifesta/pivomoninvnew1.htm (last visited May 29, 2013).

account.[125] With respect to assets of a separate account, if a proposer retains an insurance enterprise by means of an insurance contract to exercise discretionary allocation of the assets and those assets are allocated to the purchase of the securities defined in the Securities and Exchange Act, application for concurrent operation of discretionary investment services shall be made in accordance with the Securities Investment Trust and Consulting Act.[126]

As for the definition, the one given in Article 14 of the Rules Implementing the Insurance Act unequivocally indicates main features of the ILI. It defines the ILI as a life insurance under which the insurer, after deducting all necessary fees, allocates the premium into investment account(s) for certain subjects in accordance with the applicant's instruction and the applicant bear all or part of the investment risks.[127]

B. Regulations Governing Investment of Investment-linked Insurance

Regulations Governing Investment of Investment-linked Insurance (hereinafter the ILI Regulation) first reiterates the insurer's obligation to make out a separate account to record the values of investment assets.[128] The assets in the separate account shall be individually managed.[129] Unless otherwise provided, it is mandatory for an insurer to periodically valuate the assets in the separate account, calculate the benefiting assets value in the separate account in accordance with the approved life insurance accounting template, and inform the insurance applicant of the value according to the method agreed in the insurance contract.[130] The assets in the separate account shall be utilized in conformity to the investment method and objective agreed or specified by the applicant.[131]

In managing the assets in the separate account, the insurer may designate the professionals in possession of financial, securities or other investment experience in managing the assets in the separate account.[132] However, in the event that the applicant plans to discretionarily invest in the securities regulated in the Securities and Exchange Law, the insurer shall separately apply for concurrently engaging in discretionary investment

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[125] Insurance Act, Article 146V (2012).
[126] Insurance Act, Article 146VII (2012).
[127] Rules Implementing the Insurance Act, Article 14 (2008).
[128] ILI Regulation, Article 4 (I) (2008).
[129] ILI Regulation, Article 4 (II) (2008).
[130] *Id.*
[131] *Id.*
[132] ILI Regulation, Article 5 (I) (2008).

services in accordance with investment business with Securities Investment Trust and Consulting Act.[133] ILI Regulation also addresses on fiduciary duty of the insurer and its director and officer. The directors, supervisors, managers and the persons in charge of managing the assets in the separate account are of the duty to act as good fiduciaries to carefully and loyally take care of investment and management of the assets in the separate account.[134] They are prohibited from conducting self-interested investment, making transactions for persons beyond the policyholder of the separate account through the information learned in their posts, or revealing the related information to others.[135] In the case of the bankruptcy of the issuer or agency of the linked investment subjects provided in the ILI contract, the insurer is obliged to aggressively claim for the redemption in line with the best interests of the applicant and beneficiary.[136]

C. Rules Governing the Disclosure of Investment-linked Insurance

Insurers carrying ILI are required by the Disclosure Rule to follow the following principles: (1) All disclosed information and data need to be accurate and latest, and statements or charts made should be presented in a fair manner without misleading or concealment; (2) Documents related to sale should use plain Mandarin, and further explanation need to be added to the professional terminologies; (3) Characters using to express warning and guarantees should not be smaller than other policy clauses; and (4) No language indicating the tax deduction function and the protection provided by the Insurance Security Fund is permitted.[137]

The following information is required to be included in the insurance plan attached to the product description: (1) information regarding subjects of investment (i.e. issuer, nature of the subject, and risks associated with it); (2) arrangement on premium payment and the consequence of default; (3) benefits and methods of calculating the returns; and (4) penalties of contract rescission.[138] Insurers are also obliged to provide warning on the risks associated with the separate account particularly to stress on the fact that the past performance of a subject does not translate into the further rate of return.[139] Section 11 of the disclosure rule further provides detailed matters

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[133] *Id.*
[134] ILI Regulation, Article 9 (I) (2008).
[135] ILI Regulation, Article 9 (II) (2008).
[136] *Id.*
[137] Disclosure Rule, §2 (2013).
[138] Disclosure Rule, §8 (2013).
[139] Disclosure Rule, §8 (2013).

of different categories of investment subjects that should be disclosed. For example, in the case that structured products are the subject, the name of the product, its credit rating, the name of the issuer, the name of the guarantor, the quantity of issuance, the underlying assets, the date of issuance and maturity date, the observation date, the currency, the cash settlement amount, the name of the secondary market and the associated risks.[140]

An insurer also bears the duty to furnish the applicants the quarterly report and annual report which contains information concerning the investment portfolio, difference on the unit price of the subject in the reporting period, variations on the number of units, premiums paid during the reporting period, list of fees incurred, the death benefit, the surrender value, and the amount of the policy loan plus interests.[141]

D. The Financial Consumer Protection Act

Considering the complex nature of today's financial products and the relatively limited knowledge of retail customers about them, the FCPA enhances consumer protection by requiring financial service providers to fulfill duties, including fair dealing, true representation, truthful advertising and solicitation and suitability for customers.

1. Duty of Good Faith and Fair Dealing

The FCPA requires that financial service providers act in conformance with the principles of fairness, reasonableness, equality, reciprocity, and good faith when entering into a contract with a financial consumer for the provision of financial products or services.[142] This provision resembles the general good faith clause in the civil code.[143] As good faith is often seen as the highest norm of contract law and all other private laws, many provisions in the code that make no explicit reference to good faith that are nevertheless said to be based on it.[144] Nevertheless, a general good faith clause is not an ordinary rule like most others in the civil code.[145] It contains an open norm, the content of which must be supplemented through

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[140] Disclosure Rule, §11 (3) (2013).

[141] Disclosure Rule, §18 (2013).

[142] FCPA, Article 7 (I) (2011).

[143] For example, Article 148 of the Taiwanese Civil Code provides: "A right shall not be exercised for the main purpose of violating public interests or damaging others. A right shall be exercised and a duty shall be performed in accordance with the means of good faith".

[144] Martijin W. Hesselink, The Concept of Good Faith 2-3 (2010) *available at* http://dare.uva.nl/document/226248 (last visited Feb. 13, 2012).

[145] *Id*. at 3.

concretization into various specific provisions and groups of typical cases.[146] Hence, the good faith clause in the FCPA will not apply unless protections provided by other articles that manifest specific duties of financial service providers have been exhausted.

2. Duty of Truthful Advertisements and Solicitation

In publishing or broadcasting advertisements or carrying out solicitation or promotional activities, a financial services provider is prohibited from engaging in falsehood, deception, concealment, or other conduct sufficient to mislead the other party, and is mandated to warrant the truthfulness of the content of its advertisements.[147] Furthermore, a financial service provider owes financial consumers the duty to satisfy at least the content of its advertisements, materials or explanations given during the solicitation or other promotional activities.[148] In addition, financial service providers are prohibited from introducing particular financial products or services in educational programs.[149]

To regulate solicitation or promotional activities further, the FSC promulgated Guidance for Financial Service Providers in Solicitation and Promotion (hereinafter the Solicitation Guidance).[150] Pursuant to the Solicitation Guidance, when advertisements or other promotional materials include information regarding interest rates, rates of return, expenses and risks, such information must be illustrated in an emphatic and easily understandable manner.[151] It also enumerates ten prohibitive activities during solicitation or promotion, namely: (i) violating the laws, administrative regulations or rules of private regulators; (ii) conducting that involves misrepresentation, fraud, concealment or misleading; (iii) damaging the reputation of the financial services industry or other businesses; (iv) committing trademark infringement that is sufficient to cause consumers' perplexities; (v) intentionally introducing false reports from a newspaper or magazine as part of the advertisement; (vi) proclaiming the performance of products in an exaggerating manner; (vii) making consumers believe that a product's approval by a regulator equates to a governmental guarantee; (viii) marketing certain products prior to receiving necessary approval from a regulator; (ix) providing misleading information

[146] *Id.*
[147] FCPA, Article 8 (I) (2011).
[148] *Id.*
[149] FCPA, Art 8 (III) (2011).
[150] Jin Guan Fa Zhi (FSC Legal Decree) No. 10000707321 (December 12, 2011).
[151] Solicitation Guidance, Article 4 (2011).

with respect to the guaranteed rate of return; and (x) using insignificant letters to material restrictions in the contract.[152]

3. Duty of True Representation

Prior to entering a contract to provide financial products or services, a financial service provider is compelled to explain fully to the consumer the material aspects of those products or services and the important content of the contract and to disclose the associated risks.[153] Such explanations and disclosures shall be stated in an understandable manner to the financial consumers, and the content thereof shall include, but not be limited to, matters significant to the rights and interests of consumers, such as transaction costs and potential returns and risks.[154] Details regarding what must be disclosed are supplied by the Guidance for Financial Service Providers' Disclosure of Important Contents and Risks of the Contract Before its Formation (hereinafter the Disclosure Guidance), which was promulgated by the FSC in December, 2011.[155] Article 5 of the Disclosure Guidance defines the "important content" of the contract as follows: (i) financial consumers' means and restrictions of exercising the rights or modifying, rescinding or terminating the contract; (ii) financial service providers' rights, obligations and liabilities with respect to a particular product; (iii) the calculation and methods of payments of all fees and penalties charged to financial consumers; (vi) whether certain products are covered by the protection of deposit insurance, an insurance security fund or other protective mechanisms created by the government; (v) methods of dispute resolution and approaches to filing complaints; and (vi) other matters that financial service providers are required to disclose in accordance with other laws and regulations periodically or occasionally.[156]

The Disclosure Guidance further imposes upon financial service providers a duty to disclose investment risks, including potential maximum losses and currency exchange risks associated with certain types of products.[157] If such risks are inexpressible through numbers, they must be described literally.[158] The products or services manifested in the Disclosure Guidance are: investment trusts, foreign and domestic stocks, bonds, money

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[152] Solicitation Guidance, Article 5 (2011).
[153] FCPA, Article 10 (I) (2011).
[154] FCPA, Article 10 (II) (2011).
[155] Jin Guan Fa Zhi (FSC Legal Decree) No. 10000707321 (December 12, 2011).
[156] Disclosure Guidance, Article 5 (2011).
[157] Disclosure Guidance, Article 6 (I) (2011).
[158] Disclosure Guidance, Article 6 (II) (2011).

market products, mutual funds, OTC derivatives, structured products, gold and other precious metals, high-leveraged Forex trading, futures, option contracts and investment-link insurance products.[159] Any disclosure made by a financial service provider is barred from containing untrue, fraudulent, concealed, or misleading information.[160]

4. Duty to Ensure the Products' Suitability for Customers

To ascertain the suitability of products or services provided to a financial consumer, a financial service provider is obliged to collect sufficient information associated with such consumer prior to the formation of a contract.[161] Since the substance of information associated with consumers and the factors in determining the suitability need to be prescribed, the FSC promulgated the Guidance for Financial Service Providers to Ascertain the Suitability of Financial Services and Products to Consumers (hereinafter the Suitability Guidance).[162] The Suitability Guidance mandates that banks and securities firms establish standards to screen the eligibility of consumers, who offer to purchase an investment-oriented service or product and that they acquire the following information regarding potential consumers before entering the agreement: (i) occupation; (ii) financial background; (iii) source of income and capital; (iv) risk propensity; (v) prior experience with investments; (vi) objectives and demands of investments; (vii) risk preference; and (viii) professional ability in investments.[163] All of these factors and the nature of a product or service are to be taken into account by the financial service provider on a comprehensive basis in deciding the suitability of each product or service to a specific customer.[164] To ensure the correctness of the aforementioned information, financial service providers should obtain each consumer's signed verification of the information.[165] The "investment-oriented services or products" to which the above requirements apply refer to investment trusts, foreign and domestic stocks, bonds, money market products, mutual funds, OTC derivatives, structured products, gold and other precious metals, high-leveraged Forex trading, futures and option contracts.[166]

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[159] Disclosure Guidance, Article 6 (I) (2011).
[160] Disclosure Guidance, Article 3 (2) (2011).
[161] FCPA, Article 9 (I) (2011).
[162] Jin Guan Fa Zhi (FSC Legal Decree) No. 10000707321 (December 12, 2011).
[163] Suitability Guidance, Article 4 (2011).
[164] Suitability Guidance, Article 6 (2011).
[165] Suitability Guidance, Article 4 (2011).
[166] Suitability Guidance, Article 5 (2011).

In contrast, the Suitability Guidance is embedded with separate know-your-customer and suitability provisions concerning insurance products. It provides that insurance companies should gather the following customer information before entering the contract: (i) the policyholder's and insured's basic information, which is comprised of his or her name, gender, date of birth, ID number, and contact information; (ii) the relationship between the policyholder and the insured and between the beneficiary and the insured; (iii) the consumer's purpose and need for purchasing the insurance; and (iv) other data required by the competent authorities.[167] With respect to property and non-investment-linked insurance, only through considering the following matters can an insurance company fulfill its duty to determine the suitability of a product: (i) whether the consumer firmly understands that the premium is paid to purchase the insurance; (ii) whether the type of insurance, the amount of insurance and the premium are commensurate with the actual needs of a particular consumer; and (iii) whether the consumer has sufficient ability to bear the exchange rate risk if the product is dominated by foreign currencies.[168] As for the investment-linked insurance products, an insurance company not only has to probe the preceding factors (i) and (ii), it must also learn each consumer's risk preference, objective of investments, risk propensity and understanding of the fact that the loss of investment is to be borne by the consumer.[169] Insurance companies are also compelled to establish mechanisms to prevent consumers from purchasing products or services that exceed their financial ability or are unsuitable for them.[170]

5. Financial Institutions' Liability for Breaching Duties

In principle, a financial services provider must exercise the due care of a good administrator in transacting with consumers.[171] Nevertheless, a financial service provider is inferred to have been negligent if it violates its duty of true representation or to ensure product suitability and is subject to liability for damages that result from the violation.[172] A financial service provider may be discharged from such liability by offering proof that occurrence of the damage cannot be attributed to (i) its failure to explain fully the suitability of a product or service to the financial consumer; (ii) its

[167] Suitability Guidance, Article 8 (2011).
[168] Suitability Guidance, Article 9 (2011).
[169] Suitability Guidance, Article 10 (1)-(3) (2011).
[170] Suitability Guidance, Article 10 (4) (2011).
[171] FCPA, Article 7 (III) (2011).
[172] FCPA, Article 11 (2011).

non-disclosure or misrepresentation; or (iii) its failure to disclose the risks fully.[173]

6. Brief Conclusion

Overall, the Taiwanese laws and regulations also recognize the investment nature of the separate. Both the ILI Regulation and the Disclosure Rule imposed upon the insurer carrying ILI various duties similar to the issuer of securities products. The most distinguishable feature of the Taiwanese law is the duties to be borne by all financial service providers including insurers under the FCPA. It not only establish rules for conducting business but also endow upon the financial consumers a right to claim for damages without proving the fault of the financial service provider. The burden of proof is shifted to the financial service provider to show that it is neither intentional nor negligent in causing the loss. Such legislation has escalated the degree of consumer protection as retailed customers usually are in lack of capability to realize the complex financial products and the process of investment decision not to mention to offer evidence to demonstrate the fault of a financial institution and its directors, officers or managers.

IV. PRESENT LAWS AND REGULATIONS IN CHINA AND THEIR DEFICIENCIES

A. In General

Although ILI products are categorized as life insurance so that articles with respect to life insurance in the Insurance Law are affirmatively applicable, and the term "investment-linked insurance" is seen nowhere in the entire Insurance Law. This fact indicates that the legislature did not foresee the necessity of supervising the separate account of the ILI products through the officially-promulgated "law" at the time Insurance Law was enacted or amended. The first and perhaps the only authority of law which granted permission for insurance companies to offer ILI products is Article 48 of the Regulation on the Administration of Insurance Companies. This article enumerates the types of insurance products that a life insurance company is permitted to sell subject to the approval of the China Insurance Regulatory Commission (the CIRC).[174] Among those permissible types of

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[173] *Id.*
[174] Regulation on the Administration of Insurance Companies, Article 48 (2002).

products,[175] though not explicitly, the so-called “innovative life insurance products” or “other life insurance services” are the two categories considered to embrace the ILI products. Accordingly, in order to satisfy the supervisory need associated with the launch of the first ILI policy in the year 2000, the CIRC then announced “Tentative Measures for the Administration of Investment-Linked Insurance” (Tentative Measures) which contains twenty-five abbreviate articles as the fundamental rule for the supervision of the ILI products. The following discussions are based primarily on the Tentative Measures.

B. The Tentative Measures

1. Descriptions of Investment-Linked Insurance Products

Pursuant to the Tentative Measures, ILI is defined as “the life insurance product which combines the protective function of ordinary insurance products with at least one investment account with cash value”.[176] The “investment account” refers to the independent asset management account in which the sum of its value is divided into certain number of shares with equal value determined by the market value of the portfolio in such account.[177] While the insurance company bears the risk of the life insurance protection, policyholders completely assume the risk of their investments.[178] They may freely select the investment account(s) they attempt to inject the cash value of their policies.[179] In principle, unless provided elsewhere by other laws or regulations, assets in the investment account(s) are managed independently and segregated from the ordinary asset accounts of the insurance company so that it is prohibited for the erecting any creditor-debtor relationship between these two sets of accounts.[180]

In addition, the total value of each policy is determined by the shares possessed in each investment account and the value per share.[181] The revenue or losses incurred from each investment account should be

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[175] Eight categories of insurance products that a life insurance company is allowed to offer are “(1) Accident insurance, (2) Health insurance, (3) Traditional life insurance, (4) Innovative life insurance products, (5) Traditional annuity insurance, (6) New annuity insurance products, (7) Other life insurance services, and (8) Reinsurance for the above insurance services”.
[176] The Tentative Measures, Article 2 (2000).
[177] The Tentative Measures, Article 3 (2000).
[178] The Tentative Measures, Article 7 (3) (2000).
[179] The Tentative Measures, Article 3 (2000).
[180] The Tentative Measures, Article 3 & 7 (4) (2000).
[181] The Tentative Measures, Article 7 (5) (2000).

attributed to the policies to which they attach.[182] Therefore, the cash value of each policy is required to update on a monthly basis, and insurance companies are obligated to provide the latest amount of the insurance protection which varies with the cash value on a yearly basis.[183] Insurance companies are also of the duty to estimate and disclose the per-share-value of each investment account.[184]

2. Regulations of Sale

Article Five of the Tentative Measures explicitly designated the CIRC permission as the prerequisite for the sale of ILI products within the territory of China.[185] CIRC is also endowed the authority to restrict the sale of a particular ILI product in a given geographical area.[186]

Qualified sales personnel for the ILI products need to conform to the following three criteria: (1) having participated in the training session of the ILI product and received the certificate; (2) at least one year experience in the sale of life insurance products with outstanding record of sale; and (3) no serious violation of sales regulation or involvement in any form of fraud or deception.[187] In addition, such sales personnel are barred from providing customers with misleading or deceptive information, or intentionally concealment of important information.[188] As legal risks incurred from the deceptive or misleading measure of sale can harm the interests of both policyholders and insurers, the CIRC has instructed life insurance companies to improve the perception of such potential damage and closely oversee the sales conduct of their personnel.[189] The CIRC also urges life insurance companies to ensure that the disclosure of information is in a timely and precise manner.[190]

On the occasion of selling ILI products, life insurance companies need to provide prospectus written in plain language to articulate the following matters: (1) major features of the ILI policy and factors influencing the return of investment, (2) strategies of the investment accounts and subjects

[182] The Tentative Measures, Article 7 (6) (2000).
[183] The Tentative Measures, Article 7 (7) & (8) (2000).
[184] The Tentative Measures, Article 10 (2000).
[185] The Tentative Measures, Article 5 (2000).
[186] The Tentative Measures, Article 6 (2000).
[187] The Tentative Measures, Article 9 (2000).
[188] The Tentative Measures, Article 16 (2000).
[189] Notice on Related Matters Regarding the Enhancement of the Administration of the Sale of Investment-linked Insurance Products (2007), http://www.circ.gov.cn/Portal0/default.htm (last visited March 20, 2008).
[190] *Id.*

of investments, (3) the operation of the separate accounts and its restrictions, (4) the average rate of returns on the separate account in the past ten years or the entire period since the creation of such separate account, (5) expenses, (6) methods of the evaluating the per-share value of each separate account, and (7) estimated rate of return.[191] The prospectus and the policy to which the prospectus attach should be submitted to the CIRC for review. Once any misrepresentation in the prospectus is discovered, the CIRC may order the insurance company to cease the distribution of such prospectus until certain corrections has been made.[192]

3. Supervision and Discipline

The Tentative Measures places significant emphasis on monitoring the financial stability of the ILI separate accounts. Life insurance companies offering the ILI products are compelled to submit the annual financial reports of each investment account by the end of March of the following year.[193] A notice by the insurance company to the CIRC is mandatory when the aggregate value of redemption exceeds 1% of an investment account's total net asset value in the previous day.[194] If, at the end of every fiscal year, the total amount of redemption exceeds 30% of an investment account's total net asset value at the beginning of that year, or irreparable losses have occurred, which may seriously impair the interests of the policyholders, the insurance company may file the application with the CIRC to close such investment account.[195]

Insurance companies carrying the ILI products are also required to carry out the public disclosure through publishing the following information on a semi-annual basis in the media designated by the CIRC: (1) Brief description of the investment accounts' financial status, (2) Rate of returns on each investment account in the past five years, (3) The portfolio of each investment account according to the previous trading day, (4) Fees of account management, and (5) Any alternations of the investment strategies of each account.[196]

Under the circumstance that the insurance company violates the Tentative Measures, the CIRC is empowered to execute certain measures of

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[191] The Tentative Measures, Article 15 (2000).
[192] The Tentative Measures, Article 17 (2000).
[193] The Tentative Measures, Article 20 (2000).
[194] The Tentative Measures, Article 22 (2000).
[195] *Id.*
[196] The Tentative Measures, Article 21 (2000).

discipline against the insurance company.[197] These measures that may be utilized separately or collectively include "the order of correction", "the order to cease the sale of a particular ILI product", "withdrawal of the permission to sell ILI products", and "the order of surrender all the ILI businesses to another company".[198]

C. The Rule of Disclosure on New Types of Life Insurance Products

For the purpose of furnishing applicants with information, he/she needs in a proper manner so as to facilitate the protection of interest of the applicant, the insured and the beneficiary, the CIRC enacted "Measures Regulating the Information Disclosure of New Types of Insurance Products" (Disclosure Measures) on September 2009. The Disclosure Measure places emphasis on the methods of the disclosure, standard of conducts as well as the content of disclosure.

Generally, the disclosure should be made at least under the following occasions: (1) the introduction and description made on the media and insurer's website, (2) introduction and description made during the product presentation, (3) introduction and description conducted by the sales person, (4) the follow-up interview by the service representatives, and (5) periodical materials mailed to the customer by the insurer.[199] In addition, the Disclosure Measure imposes upon insurers additional duties in the case of selling new types of products to individuals. First, insurers should provide applicants with policy clauses, product descriptions, and application reminders.[200] Second, where standard clauses are used, insurer is obliged to explain the content of the policy to the applicant.[201] Third, insurers are required to ensure that the applicant has read the following sentence and acknowledged the content through signing on the document: "I have read the policy clauses, product descriptions and application reminders, and understand the feature, the interests and the uncertainties of the product".[202] Where making the disclosure, an insurer is required to disclose information regarding the new types of products in common and understandable language, and should accurately describe the nature of the products.[203] Insurers are responsible for the objectiveness and truthfulness of the

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[197] The Tentative Measures, Article 23 (2000).
[198] *Id.*
[199] Disclosure Measure, Article 3.
[200] Disclosure Measure, Article 6 (I).
[201] Disclosure Measure, Article 6 (II).
[202] Disclosure Measure, Article 6 (III).
[203] Disclosure Measure, Article 5.

disclosed information, and prohibited from conducting material omission, deceiving or misleading the applicant, insured, beneficiaries and general public.[204] Insurers and their agents are not allowed to compare the new types of products (including ILI) with other insurance products, bank deposits, mutual funds and bonds simply on their rate of return in the disclosure material.[205] Insurer is also required to establish a follow-up interview mechanism to ensure that issues are properly handled.[206]

With respect to the content of disclosure, the Disclosure Measure mandates the product description of the ILI product to contain the following information:

> (1) The Risk Alert: the product description should not only emphasizes that the product is the ILI product and applicant is the one assuming risks, but also remind applicants the adverse consequence and risks of ceasing to pay the premium;
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> (2) Basic Features of the Product: the product description should reveal the nature of the ILI product and the insurer's liability and reasons that may discharge the insurer from its liability;
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> (3) Description of the Investment Accounts: this part should include the following information: (a) principles and objectives of asset allocation in the investment account and its strategies and subjects of investments, (b) information regarding the monthly prince variation of the unit price of the subjects of investments in the past ten years or its entire period of investment where less than ten years, (c) time in which the applicant is permitted to withdraw from the investment account and related fees, (d) Method of valuation to the unit price of the investment subject, (e) major risks associate with each investment account, (f) the standard for comparison on the rate of return among different investment accounts;
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> (4) Explanation on Fees and Potential Returns: four matters are required to disclose in this part, namely, the premium (single, fractional or additional), any fee, amount allocated to the investment account, and the value of the investment account and the death benefit based on various hypothetical rate of returns. The demonstration of hypothetical rate of returns needs to be provided on a yearly basis;
>
> (5) Cooling-off Period and Matters Related to Cancelation: the insurer bears the duty to disclose: (a) definition of the cooling-off period, and its starting point and length, (b) applicant's option to rescind the contract in cooling period and the surrender value, and (c) The method of calculating the surrender value after the

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[204] *Id.*
[205] Disclosure Measure, Article 8.
[206] Disclosure Measure, Article 9.

cooling-off period.[207]

During the policy period, where the balance in the policy account is insufficient to prevaricate the risk premium, the insurer is obliged to notify the applicant with the warning of the legal consequence of the non-payment.[208]

It is mandatory that insurers carrying ILI should publish information semi-annually regarding: (1) Introduction on investment account, major investment strategy and instruments; (2) The finance condition of every investment account; (3) Comparison among every account its respective rate of returns by using charts; (4) Principles of valuation of the assets in the investment account; (5) Formulas of calculating the rate of return; (6) Percentage of stocks, bond or mutual funds in the investment portfolio; and (7) Other information required by the CIRC.[209]

With respect to the follow-up interview, the insurer is required to ascertain the following matters: (1) The applicant did make the purchase and sign on the policy; (2) Whether applicant has knowledge with regard to the cooling-off period; (3) The applicant has knowledge with regard to the insurance liability and when the insurer is relived from liability; (4) The applicant has knowledge with regard to the uncertainty of investment return; (5) Fees; and (6) The applicant has knowledge with regard to the losses of surrendering the policy.[210]

D. Commentary

Although several articles in the Tentative Measures have recorded some important features of the separate account, such account remains being treated as part of the life insurance product with which it is associated and subject to the supervision of insurance regulations and the CIRC. Tentative Measures correctly describe the share, the determination of the net asset value, and the independent management of the separate account, whereas the Measures ignore the following two aspects: the policyholders' risk retention and the distinction between the life insurance itself and the separate account. In lack of perceiving the most distinguishable characters of the separate account, the CIRC fails in identifying the separate account as securities product. This pitfall leads to the unsophisticated enactment of the Tentative Measures.

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[207] Disclosure Measure, Article 18.
[208] Disclosure Measure, Article 19.
[209] Disclosure Measure, Article 21.
[210] Disclosure Measure, Article 24.

First and foremost, none of the articles concerning disclosure requires the insurer to explicitly inform policyholders they ought to assume the risk of loss in the investment account. Nor did any of the disclosure requirements specify the necessity of unveiling particular types of risk involved in the portfolio. Both shortages deviate from either the informative function or the protective function of the disclosure.

Contrasting to the disclosure mechanism of securities investment funds in China, disclosure requirements provided by the Tentative Measures are exceedingly primitive. Disclosure function of securities investment funds are underlay by a series of formats and standards promulgated pursuant to the Securities Investment Funds Law.[211] Such disclosure standards contain sophisticated instructions on the format and content of the annual report, semiannual report, interim report, listing announcement, and custodial agreements.[212] The annual report of the investment fund, for instance, should include the following items: (1) Important notes and contents, (2) Fund introduction, (3) Major financial indexes, net value performance and income distribution of fund, (4) Manager report, (5) Custodian report, (6) Audit report, (7) Financial and accounting report, (8) Investment portfolio report, (9) Members and structure of fund tranche holders (and the top ten holders), (10) Change of open-end fund tranche, (11) Disclosure of important event, and (12) Contents of documents for reference.[213] The separate account of the ILI products, the securities product comparable to mutual fund, necessitates at least the same disclosure standard as those imposed on mutual fund.

The Disclosure Measure promulgated subsequent to the Tentative Measures seemed to better identify the nature of the ILI separate account (or investment account) as an investment product rather than insurance product. Information required to disclose in according to the Disclosure Measure very much resembles the above disclosure requirement of the investment fund, particularly the mandatory disclosure on risk alert and the reporting requirement. Nevertheless, the fact that the Disclosure Measure is silent on the disciplinary measure in case of violation or insurer's civil liability in

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[211] Securities Investment Funds Law (2007).

[212] Standards of the Contents and Formats of Information Disclosure Required for Securities Investment Funds, No.1-2, http://www.csrc.gov.cn/n575458/n4001948/n4002030/4073534.html (last visited March 29, 2008); Standards of the Contents and Formats of Information Disclosure Required for Securities Investment Funds, No. 3-4. http://www.csrc.gov.cn/n575458/n4001948/n4002030/4073564.html (last visited March 28, 2008); and the Contents and Formats of Custody Agreement, http://www.csrc.gov.cn/n575458/n4001948/n4002030/4076565.html (last visited March 28, 2008).

[213] Standards of the Contents and Formats of Information Disclosure Required for Securities Investment Funds, No. 2, Chap. 2 Sec. 1-12 (2007).

case of breach of the duty of disclosure makes it difficult to force the insurer to comply with various disclosure requirements embodied in it unless insurers are willing to follow some or all of its provisions on a voluntary basis.

Last but not least, despite the disclosure requirement, neither the Tentative Measure nor the Disclosure Measure has imposed upon the insurer the duty to know its customer and ensures the suitability of the product to the applicant. Both Measures also did not have in place the standard of conduct in solicitation. In this aspect, Taiwan's Financial Consumer Protection Act providing for various duties which insurers are mandated to fulfill when conducting the sale and insurers' civil liability once one of the duties is breached certainly is a model to which China may refer when conducting further reforms.

CONCLUSION

Given that traditional financial regulations and regulatory framework is founded on a sectoral basis, insurance companies and their products are governed by insurance laws and regulations and supervised by the insurance regulators despite the insurance product may contain the part which may be classified as the products of other sectors (i.e., deposits, securities). The evolving trend of integration among financial services and innovation of financial products has gradually obscured the clear boundary between financial sectors so as to increase the demand of the functional regulation.[214] The separate account of the ILI product recognized as the securities product is the typical example of the insurance industry's intrusion into the security business. The SEC of the United States was able to identify the securities character of the separate account and apply the Securities Act of 1933, Investment Company Act of 1940 and related rules to it. This is how the functional regulation effectuates.

The separate account of the ILI products in China, as discussed earlier, is subject to the regulation of the Tentative Measures and the supervision of the CIRC. As the Tentative Measure has never placed emphasis on the distinctive feature of the separate account, it fails in defining separate account as the securities product so that more delicate and well-functioned securities regulations have never been provided the opportunity to apply in the supervision of the separate account. For the purpose of fitting the separate account of the ILI product into the present securities regulation in

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[214] For details, *see* Eugene M. Katz, *Securities Activities, Merchant Banking and Functional Regulation Under the Gramm-Leach-Bliley Act*, 56 CONSUMER FIN. L.Q. REP. 182, 183 (2002).

China, it is suggested that the establishment of a separate rule resembling the Rule 151 of the 1933 Act and Rule 6e-2 and 6e-3 (T) of the 1940 Act may be feasible. The brand new rule may provide criteria for the identification of the separate account and tailor present securities regulations especially the disclosure rules particularly to fit into the supervisory need of the separate account.

With respect to the rule governing the disclosure, both the NAIC Model Law and the Taiwanese Disclosure Rule offer a feasible model for further amendment. Given that the separate account of an ILI contract is an investment product in nature, obligation imposed onto those making the sale of investment products should also be applied to the insurer engaging in the ILI business. Insurers' duties introduced in Taiwanese ILI Regulation and the FCPA are viable approaches to make insurers carrying ILI liable for their deceptive or misleading solicitation, failing the understand the objectives and financial condition of the customer and misrepresentation.

It is no deniable that fitting the separate account into the regulatory framework of the securities products is a difficult task.[215] Nevertheless, considering the positive influence associated with the enhancement of the investor protection and reduction of asymmetry of information, adapting the current regulatory framework seems to be inevitable.

[215] Cohen, *supra* note 100, at 91.