STATE OF CALIFORNIA
OFFICE OF ADMINISTRATIVE LAW

In re:	
DEPARTMENT OF INSURANCE	DECISION OF DISAPPROVAL OF REGULATORY ACTION
REGULATORY ACTION: Title 10, California Code of Regulations	(Gov. Code, sec. 11349.3)
AMEND: 2534.40, 2534.41, 2534.42, 2534.43, 2534.44, 2534.45, 2534.46, 2534.47	OAL File No. 06-0509-01 S

DECISION SUMMARY

In this regulatory action, the Department of Insurance ("DOI") adopts provisions governing mutual fund investments involved in variable life insurance products. This action codifies Insurance Department Bulletin 97-2 in regulation form as mandated by AB 2778 (Chap. 347, Stats. 2002).

SUMMARY OF REGULATORY ACTION

On June 21, 2006, the Office of Administrative Law ("OAL") notified DOI of the disapproval of the above-referenced regulatory action. OAL disapproved the regulations for the following reasons: (1) failure to comply with the "Clarity" standard of Government Code section 11349.1, (2) failure to comply with the "Necessity" standard of Government Code section 11349.1, (3) failure to comply with the "Reference" standard of Government Code section 11349.1, (4) failure to comply with APA procedural requirements, and (5) failure to include an adequate summary and response to all public comments received regarding the proposed regulatory action and the rulemaking procedures followed in the final statement of reasons.

DISCUSSION

Regulations adopted by DOI must generally be adopted pursuant to the rulemaking provisions of the Administrative Procedure Act (the "APA;" Gov. Code, secs. 11340 through 11361). Any regulatory action a state agency adopts through the exercise of quasi-legislative power delegated to the agency by statute is subject to the requirements of the APA, unless a statute expressly exempts or excludes the act from compliance with the APA. (See Gov. Code, sec. 11346.) No

exemption or exclusion applies to the regulatory action here under review. Consequently, before these regulations may become effective, the regulations and the rulemaking record must be reviewed by OAL for compliance with the procedural requirements and the substantive standards of the APA, in accordance with Government Code section 11349.1.

CLARITY

OAL must review regulations for compliance with the substantive standards of the APA, including the "Clarity" standard, as required by Government Code section 11349.1. Government Code section 11349, subdivision (c), defines "Clarity" as meaning "written or displayed so that the meaning of regulations will be easily understood by those persons directly affected by them."

The "Clarity" standard is further defined in section 16 of Title 1 of the California Code of Regulations ("CCR"), OAL's regulation on "Clarity," which provides the following:

> "In examining a regulation for compliance with the 'clarity' requirement of Government Code section 11349.1, OAL shall apply the following standards and presumptions:
>
> (a) A regulation shall be presumed not to comply with the 'clarity' standard if any of the following conditions exists:
> (1) the regulation can, on its face, be reasonably and logically interpreted to have more than one meaning; or
> (2) the language of the regulation conflicts with the agency's description of the effect of the regulation; or
> (3) the regulation uses terms which do not have meanings generally familiar to those 'directly affected' by the regulation, and those terms are defined neither in the regulation nor in the governing statute; or
> (4) the regulation uses language incorrectly. This includes, but is not limited to, incorrect spelling, grammar or punctuation; or
> (5) the regulation presents information in a format that is not readily understandable by persons 'directly affected;' or
> (6) the regulation does not use citation styles which clearly identify published material cited in the regulation.
>
> (b) Persons shall be presumed to be 'directly affected' if they:
> (1) are legally required to comply with the regulation; or
> (2) are legally required to enforce the regulation; or
> (3) derive from the enforcement of the regulation a benefit that is not common to the public in general; or
> (4) incur from the enforcement of the regulation a detriment that is not common to the public in general."

Numerous provisions of DOI's proposed regulations fail to meet the Clarity standard. Examples of Clarity problems include, but are not limited to, the following:

Example #1: Proposed regulation section 2534.43 provides, in part, the following:

> "If mutual fund investments are involved in a variable product such product may be reviewed to determine if the investments involve hazardous operations."

No definition is provided in these regulations or relevant statutes for the key term "variable product". Nor does the rulemaking record justify the lack of definition by demonstrating that "variable product" is a term of art with a settled meaning for persons directly affected which would justify the lack of a definition. In addition, other parts of this regulatory package use the term "variable contract", again, without definition. OAL assumes DOI intends both terms to be interchangeable, but, without definition, persons directly affected have no way of knowing if any difference is intended or precisely what products or contracts constitutes a "variable product" governed by these regulations. This is a presumed clarity violation under Title 1 CCR section 16(a)(3). Other key terms not defined in this package include "hazardous operations", "hazardous conditions", "subaccount", and "expedited filing procedure".

Example #2: Proposed regulation section 2534.43 is unclear because it uses two key undefined terms interchangeably without any discussion in the regulation text or rulemaking file of whether any difference is intended in the meaning of the key terms "hazardous operations" and "hazardous conditions". Proposed section 2534.43 provides, in pertinent part:

> "§ 2534.43. Notifications and Procedures Concerning Hazardous Operations.
>
> If mutual fund investments are involved in a variable product, such product may be reviewed to determine if the investments involve hazardous operations.
>
> A hazardous condition shall not exist if the variable contract issued, or issued for delivery, in this state." [Emphasis added.]

The inconsistent use of the key underlined terms is a presumed Clarity violation under Title 1 CCR section 16(a)(1) and (3).

Example #3: Proposed regulation section 2534.43 uses improper hierarchy for the first level subdivision below the second paragraph; i.e. "(1)" is used instead of "(a)" for each subdivision following the second paragraph. Confusingly, DOI reverts to the proper use of "(a)" for first level subdivision hierarchy below the fourth paragraph. Consistent hierarchy must be used throughout these regulations to satisfy the Clarity standard.

The above examples of Clarity standard violations and all other Clarity problems with these proposed regulations must be corrected with appropriate 15-day notice, if needed, before the regulations can be approved by OAL. The other clarity issues were discussed in detail with DOI Senior Staff Counsel Gene Woo and DOI Staff Counsel George Teekell at a meeting at OAL on June 16, 2006.

NECESSITY

Government Code section 11349.1, subdivision (a)(1) requires OAL review all regulations for compliance with the "Necessity" standard. Government Code section 11349, subdivision (a) defines "Necessity" to mean that

> ". . . the record of the rulemaking proceeding demonstrates by substantial evidence the need for a regulation to effectuate the purpose of the statute, court decision, or other provision of law that the regulation implements, interprets, or makes specific, taking into account the totality of the record. For purposes of this standard evidence includes, but is not limited to facts, studies, and expert opinion."

Section 10, subdivision (b) of Title 1 of the CCR provides that in order to meet the "Necessity" standard the rulemaking record must include:

> "(1) A statement of the specific purpose of each adoption, amendment, or repeal; and
>
> (2) information explaining why each provision of the adopted regulation is required to carry out the described purpose of the provision. Such information shall include, but is not limited to, facts, studies, or expert opinion. When the explanation is based upon policies, conclusions, speculation, or conjecture, the rulemaking record must include, in addition, supporting facts, studies, expert opinion, or other information. An 'expert' within the meaning of this section is a person who possesses special skill or knowledge by reason of study or experience which is relevant to the regulation in question."

Necessity for the majority of this regulatory action is provided by the mandate in Insurance Code section 10506(h) that DOI "promulgate . . . a regulation superseding Insurance Department Bulletin 97-2 that shall become effective January 1, 2003." The Necessity provided by that statutory mandate, however, does not extend to provisions not contained in Bulletin 97-2; specifically, proposed section 2534.41 which requires DOI's prior approval of material changes to non-mutual fund investments or private placement investments. The only evidence of Necessity for section 2534.41 is in the initial statement of reasons, pp. 1-2:

> "2534.41
> The proposed regulation clarifies what material changes to an insurer's variable authority still require the Commissioner's prior approval or acknowledgement. The proposed regulation also explicitly states that material changes involving Mutual Fund Investments are not subject to the Commissioner's prior approval or acknowledgement prior to implementation. This regulation clarifies that not all material changes to an insurer's variable authority may be implemented without the Commissioner's prior approval or acknowledgement."

The above statement is simply a description of the regulation and provides no rationale as required by Title 1 CCR section 10(b)(2) for the requirement of prior approval of non-mutual fund or private placement investments or for the procedural mechanism set forth in section 2534.41. Given the intense objection (see discussion under Summary and Response to public Comments) to DOI's Authority to adopt this regulation or its Consistency with Insurance Code section 10506, substantial evidence providing Necessity for section 2534.41 is particularly crucial. The rulemaking file is devoid of substantial evidence providing sufficient Necessity for this proposed regulation.

REFERENCE

Government Code section 11349.1 requires that OAL review all regulations for compliance with the "Reference" standard. "Reference" is defined in the Government Code section 11349, subdivision (e), as ". . . the statute, court decision, or other provision of law which the agency implements, interprets, or makes specific by adopting, amending, or repealing a regulation." Furthermore, Government Code section 11344, subdivision (d), provides that OAL shall "[e]nsure that each regulation is printed together with a reference to the statutory authority pursuant to which it was enacted and the specific statute or other provision of law which the regulation is implementing, interpreting, or making specific." [Emphasis added.]

Proposed section 2534.43 has the following "Authority" and "Reference" citations:

> "NOTE: Authorities cited: Section 1065.1, et seq. and Section 10506, subdivision (h) Insurance Code. References: Section 1065.1, et seq. and Section 10506, subdivision (h) Insurance Code."

The use of "et seq." following the citation of Insurance Code section 1065.1 for both Authority and Reference violates the specific statute citation requirement of Government Code section 11344(d).

INCORRECT APA PROCEDURES

1. Government Code section 11347.3(b)(12) requires every rulemaking file to contain:

> "(12) An index or table of contents that identifies each item contained in the rulemaking file. The index or table of contents shall include an affidavit or a declaration under penalty of perjury in the form specified by Section 2015.5 of the Code of Civil Procedure by the agency official who has compiled the rulemaking file, specifying the date upon which the record was closed, and that the file or the copy, if submitted, is complete." [Emphasis added.]

DOI's table of contents for this rulemaking lists a second Form 399 as Tab J. The Tab J Form 399 has a signature date of May 8, 2006. The certification of closure of this file under penalty of perjury is dated July 18, 2005. This sworn closure of the file obviously predates the addition of Tab J in violation of the GC section 11347.3(b)(12) requirements.

2. Proposed regulation Section 2534.45 lists factors determining the existence of hazardous operations underlying a variable product. Subdivision (c) is one factor listed as follows:

> "(c) In addition, pursuant to the **National Association of Securities Dealers Conduct Rule 2310**, as well as **Insurance Department Bulletin 87-3** (dealing with variable life insurance), brokers and agents selling variable products must comply with suitability standards. Such standards obligate the broker or agent to make certain that there are reasonable grounds for believing that a variable contract recommended to a customer is suitable for that customer. It is expected that due diligence will be given to the consideration of suitability by brokers and agents licensed to sell variable contracts in California." [Emphasis added.]

Neither the National Association of Securities Dealers Conduct Rule 2310 or Insurance Department Bulletin 87-3 is included in the rulemaking file. Bulletin 87-3 was additionally not available on DOI's website at the time of this file review. At a minimum, both documents must be added to the file to allow OAL and the regulated public to confirm their existence and correct titles. And, if DOI is attempting to further incorporate the suitability standards set forth in both documents into the regulation text, the documents must be properly noticed pursuant to Government Code section 11347.1 and incorporated by reference pursuant to Title 1 CCR section 20.

Since DOI defines "suitability standards" in the subsequent sentence, it appears that reference to the documents may be superfluous. If so, DOI should simply delete the first sentence of proposed subdivision (c).

SUMMARY AND RESPONSE TO PUBLIC COMMENTS

Government Code section 11346.9, subdivision (a), provides that an agency proposing regulations shall prepare and submit to OAL a "final statement of reasons." One of the required contents of a final statement of reasons is a summary and response to public comments. Specifically, Government Code section 11346.9, subdivision (a)(3), requires that the final statement of reasons include:

> "A summary of each objection or recommendation made regarding the specific adoption, amendment, or repeal proposed, together with an explanation of how the proposed action has been changed to accommodate each objection or recommendation, or the reasons for making no change. This requirement applies only to objections or recommendations specifically directed at the agency's proposed action or to the procedures followed by the agency in proposing or adopting the action. . . ."

DOI received substantial public comments regarding the regulations, both in written form and in the form of testimony at the July 1, 2005 public hearing. DOI's summary and response to comments contained in the final statement of reasons was inadequate in numerous cases. Generally, the summaries were too general and superficial; i.e., the summary did not adequately summarize each objection or recommendation made regarding the proposed regulations. As a

direct consequence, the responses were similarly incomplete or not fully responsive to the comments received. Examples of problems with summary and response to comments include the following:

Example #1: Randall A. Doctor, of Barger and Wolen submitted two written comments and testified at the public hearing. In a letter dated July 1, 2005, pp. 5-7, commenter Doctor made extensive and sophisticated legal objections to DOI's authority to enact proposed section 2534.41 which requires life insurers offering non-mutual fund or unregistered investment options underlying variable products to notify DOI of any material change and obtain DOI prior approval prior to making such change. Commenter Doctor's comment was as follows:

> "Accordingly, Section 10506(h) only requires life insurers to 'notify' the commissioner at any time it implements a material change respecting the 'mutual funds' underlying the variable contract separate account. Nowhere in Section 10506(h) or elsewhere[3] does an insurer have an obligation to notify the Commissioner with respect to changes relating to non-mutual funds. Therefore, the Draft Regulations improperly subject life insurers seeking to offer non-mutual funds (unregistered investment options) under their variable products to a prior approval or acknowledgement standard in absence of any statutory authority to impose such a standard. Not only does Section 10506(h) specify that the applicable filing standard in 'notification,' nothing in Section 10506(h) requires changes respecting non-mutual fund investment options to be subject to a filing with the Commissioner in the first place.
>
> The point that there is only a notification requirement and that it only applies to 'mutual funds' (and that there is no filing requirement whatsoever with regard to non-mutual funds) is highlighted by the legislative history of AB 2778. AB 2778 was enacted in 2002 and was the bill that added the above-quoted language to Section 10506(h). In an early version of AB 2778, the Legislature sought to broadly apply the notification requirements to all '***investment option***' underlying the variable contract, not just to investment options registered with the SEC as mutual funds.
>
> Specifically, AB 2778 as amended on April 22, 2002 broadly required the insurer to 'notify the commissioner at any time it implements a material change respecting ***investment options*** available or to be available with a policy or contract providing variable benefits.' (Emphasis added). Enclosed under Tab 1 is

[3] In his Initial Statement of Reasons for Section 2534.41 of the Draft Regulations, the Commissioner states that the 'proposed regulations clarifies what material change to an insurer's variable authority still require the Commissioner's prior approval or acknowledgement . . . . This regulation clarifies that not all material changes to an insurer's variable authority may be implemented without the Commissioner's prior approval or acknowledgement.' We point out that there is no authority requiring prior approval or acknowledgement with respect to any material changes, a point which must be recognized by the Commissioners as he only cites Section 10506(h) as authority for Section 2534.41 of the Draft Regulations and there is no prior approval or acknowledgement requirement in Section 10506(h). Therefore, no clarification in needed for a requirement that does not exist.

a copy of AB 2778 as amended on April 22, 2002. However, the version of AB 2778 actually adopted by the Legislature on August 27, 2002 and signed into law is much narrower. That same provision was changed to read (as quoted above) that the notification requirement was only applicable to changes respecting '***mutual funds***' underlying the variable contract. Therefore, it is clear that in Section 10506(h) the Legislature only requires notification of material changes, relating to 'mutual funds.'

The problematic provisions of the Draft Regulations that exceed the Commissioner's stated authority include the following:

Section 2534.41--'If the Commissioner determines that a filing involving material changes involving non-mutual fund investments or private placement investments[4] fails to comply with the filing requirements or is incomplete, as described in Section 2534.46(c) of these regulations, the Commissioner shall issue a letter rejecting the filing for a material change. Pursuant to Insurance Code Section 10506, subdivision (h), material changes involving Mutual Fund Investments are not subject to the Commissioner's prior approval or acknowledgement prior to implementation.'

Section 2534.42--'(a) For purposes of this article, Mutual Fund Investments include but are not limited to, investments that are registered with the Securities and Exchange Commission pursuant to the Investment Company Act of 1940(15 U.S.C. 80b-1, et seq.). Private Placement investments involving non-mutual fund investments are specifically excluded from this definition. (b) Filings with the Commissioner, pursuant to Section 2534.46 of this article, are deemed to be notifications as delineated in Insurance Code Section 10506, subdivision (h).'

Sections 2534.41 and 2534.42 are problematic for two reasons. First, Section 2534.41 expressly provides for a filing requirement for material changes involving non-mutual funds. However, as described above, Section 10506(h) and the relevant legislative history are clear; there is only a filing requirement (a notification requirement) in connection with changes respecting ***mutual funds***. Section 10506(h) provides for no filing requirement (notification, approval or acknowledgement) whatsoever in connection with changes respecting non-mutual funds. Second, Section 2534.41 is problematic because it only states that changes respecting mutual funds are not subject to the Commissioner's prior approval or acknowledgement prior to implementation of the change, yet Section 2534.42 excludes non-mutual funds from the definition of mutual fund investments. Thus, taken together, Sections 2534.41 and 2534.42 mean that not only are changes respecting non-mutual funds subject to a filing requirement, they are also subject to the Commissioner's prior approval or acknowledgment prior to implementation, not simply notification.

[4] The term 'Private Placements' is another term used for 'non-mutual fund.'

Accordingly, the Commissioner's attempt in Sections 2534.41 and 2534.42 to subject changes respecting non-mutual funds to a filing requirement with a prior approval or acknowledgement standard prior to implementation is in excess of the authority expressly conferred upon him by Section 10506(h), and is inconsistent with Section 10506(h) in that it attempts to alter, amend, enlarge or impair the scope of that section. Therefore, the Draft Regulations do not comply with the APA and should be subject to OAL Rejection."

DOI's summary and response of Commenter Doctor's two and one-half page comment is as follows:

"Comment No. 4:

Commentator: Randall A. Doctor, Barger & Wolen
Date of Comments: July 1, 2005
Type of Comment: Written (Two Letters)

Summary of Comment:	**Response to Comment:** The Commissioner has considered the comment and has not changed the proposed regulations in response to the comment.
(a) The Non-Mutual Fund Provisions Of The Draft Regulations Lack Statutory Authority And Must Be Removed The commentator asserts there is no statutory authority for the imposition of a filing requirement and a filing standard upon filings involving non-mutual funds. The commentator argues that Insurance Code section 10506(h) relates only to changes relating to mutual funds.	**(a) The Non-Mutual Fund Provisions Of The Draft Regulations Lack Statutory Authority And Must Be Removed** The commentator ignores the language in Insurance Code section 10506(h) which states: "The commissioner may make reasonable rules and regulations as he or she considers necessary, proper, and advisable concerning the issuance and delivery of these policies and contracts and the payment of benefits thereunder and the manner in which the separate accounts shall be administered and which types of policies and contracts, if any, shall be subject to his or her approval prior to issue."

	The proposed regulations have been promulgated, in part, as response to AB 2788 which the Legislature enacted in 2002. The Commissioner is aware that the legislature [sic] was enacted to enable speedier processing of notifications of material changes by insurers. However, there is nothing in the enabling statute, Insurance Code section 10506(h), that prevents the Commissioner from setting reasonable standards governing what constitutes a complete filing.

"

DOI's summary fails to adequately summarize these specific objections contained in the excerpt of commenter Doctor's letter:

- The plain language of Insurance Code section 10506(h) does not require notification or prior approval of material changes to non-mutual funds.

- DOI's reading of Insurance Code section 10506(h) is inconsistent with the language of the statute because it attempts to alter, amend, or enlarge the statute.

- DOI's initial statement of reasons is inaccurate in justifying proposed section 2534.41 as an attempt to clarify what material changes to an insurer's variable authority still require DOI prior approval or acknowledgement when Insurance Code section 10506(h) contains no prior approval or acknowledgement requirement for any type of investment; i.e. there is no need to clarify a requirement that doesn't exist.

- The legislative history of amendments to AB 2778 demonstrates that the Legislature only intended to require notification of material changes relating to mutual fund investments.

DOI's response focuses solely on additional language in Insurance Code section 10506(h) and does not directly address each of the objections listed above. Given the importance of the Authority and Consistency issues raised by commenter Doctor and the complete lack of an adequate response by DOI in its final statement of reasons to the specific objections, OAL reserves its decision on both the Authority and Consistency standards regarding proposed section 2534.41 for further determination based upon DOI's supplemental summary and response submitted with its resubmittal of this disapproved regulatory action. Further, OAL's tentative opinion is that the additional language in 10506(h) cited by DOI in its response, does not independently confer authority on DOI to adopt proposed section 2534.41 because the powers

enumerated in the cited additional language do not extend to a requirement for prior notification and approval by DOI of a material change involving non-mutual fund investments or private placement investments. DOI may have authority for proposed section 2534.41, but it does not appear to be in the additional language in Insurance Code section 10506(h) cited by DOI in its response.

Example #2: Commenter Doctor in his July 1, 2005 letter, pp.7-9, listed five facts demonstrating a lack of Necessity for proposed section 2534.41:

> 1) Since Congress has determined that non-mutual fund investments do not need to be reviewed by or registered with the SEC prior to sale, ". . . it is certainly true that it is not necessary for the Department to review such investments either."
>
> 2) In the eight years of filings under Bulletin 97-2, DOI ". . . has never made a determination that even one mutual fund (registered) or one non-mutual fund (unregistered) constitute a hazard that should prohibit it from being offered in California."
>
> 3) The author of AB 2778, Assemblyman Calderon, found that no investment option has been deemed hazardous to the public or policyholders by DOI since Insurance Code Section 10506 became law in 1972.
>
> 4) In the two and one-half years since section 10506(h) was amended by AB 2778 life insurers have made filings for both mutual funds and non-mutual funds pursuant to Bulletin 97-2 on a "file and use" basis without a single problem.
>
> 5) Each of the other 49 states defers to federal securities law and the SEC to regulate investment options underlying variable products.

Commenter Doctor then concluded that the uncontradicted facts stated above demonstrate DOI's failure to provide substantial evidence of the need for proposed section 2534.41 and that lack of Necessity makes this section "arbitrary, unreasonable, and burdensome."

DOI summarizes the above facts and argument as ". . . the Commissioner has failed to show the necessity for the proposed regulations." This is a wholly inadequate summary on its face. In addition, DOI's response is simply a contradicting legal conclusion devoid of reasons why the commenter's objections are without merit. DOI's response states:

> "The commentator has attempted to show that there is no need for the proposed regulations because there is no evidence that any filings have been rejected by the Department. The argument is irrelevant as the Department is still required to review the filings to determine if any hazardous conditions exist that would endanger policy holders. Further, the commentator ignores that the proposed regulations are an attempt to correct some of the problems that have come up while Insurance Department Bulletin 97-2 has been in effect."

DOI's response neither refutes the commenter's five facts nor specifies what the ". . . problems that have come up while Insurance Department Bulletin 97-2 has been in effect" are that provide Necessity for proposed section 2534.41. This failure also impacts OAL's finding of a lack of Necessity for section 2534.41, discussed elsewhere.

Example #3: Mr. Timothy LeBas, Deputy Commissioner of the California Department of Corporations, submitted a written comment dated July 14, 2005 in which he requested that the proposed regulation be broadened to have DOI inquire into disciplinary actions against an applicant by the Department of Corporations, other state securities regulations, The National Association of Securities Dealers, and the Commodities Futures Trading Commission in addition to any SEC disciplinary action. DOI's response was simply that ". . . the Commissioner has decided to retain the original language." This fails to provide a reason for rejecting the Deputy Commissioner's recommendation as required by Government Code section 11346.9(a)(3).

The above examples and all other public objections and recommendations directed at DOI's proposed action or rulemaking procedures followed must be substantially summarized and responded to before the regulations can be approved by OAL. OAL met with DOI Senior Staff Counsel Gene Woo and DOI Staff Counsel George Teekell on June 16, 2006 and provided them with a detailed identification of other comments inadequately summarized and/or responded to in this rulemaking.

CONCLUSION

For the reasons set forth above, OAL disapproved this regulatory action. If you have any questions, please contact me at (916) 323-8916.

Date: June 28, 2006

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Gordon R. Young
Senior Staff Counsel

For:

WILLIAM L. GAUSEWITZ
Director

Original: John Garamendi, Insurance Commissioner
Cc: Gene Woo, Senior Staff Counsel