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FUNDED PROGRAMS: TROUBLESOME SECURITIES

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I. INTRODUCTION

The decade of the Sixties witnessed the birth of a new marketing concept in the financial community which can be labeled for want of a more esoteric term the "one-stop financial supermarket." Historically, an insurance agent or mutual fund salesman would restrict his sales to one industry and was often discouraged from being licensed to sell both insurance and mutual funds. Today, however, the unmistakable trend in both the insurance and mutual fund industries is towards new and flexible economic packages that combine the financially attractive features of both life insurance and mutual funds and which are to be sold by one highly trained sales representative who tailor-makes financial programs to the needs of his clients.

One such package that has been marketed with success is the "funded program" (hereinafter referred to as "program" or "programs"), which coordinates the sale of mutual fund shares for cash with the purchase of insurance on which the premium is paid from the proceeds of a loan collateralized by the fund shares. These programs were pioneered in the early 1960's by the founders of Equity Funding Corporation of America, who looked past the short range thinking of their contemporaries in the insurance and mutual fund industries to a time when the American investor would be exposed to and would demand the economic advantages inherent in both life insurance and mutual funds.

Equity Funding commenced the sale of its programs in the early

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sixties. It was thought that registration of the programs with the Securities and Exchange Commission ("SEC") and the various states was not required because the life insurance contract was an exempt security and the sales representative delivered to the prospective client a copy of the mutual fund prospectus. In 1962, however, the SEC declared that a funded program was itself a separate security which must be registered under the Securities Act of 1933, even though its sale did not involve the sale of an equity security by a company offering the security.[1] This SEC determination forced Equity Funding to restrict its operations to the State of California, where it could operate on the basis of an intrastate exemption until a process for registering its funded programs could be worked out with the SEC.

Initially it was uncertain if the new security should be registered solely with the Division of Corporate Finance, which traditionally handles the registration of equity and debt financing, or if the company offering the programs should also be regulated by the Division of Corporate Regulations which regulates the mutual fund industry. Arguments could be made for either position.[2] It was decided that the funded programs would be registered in the Division of Corporate Finance on Form S-1 and would be re-registered annually by the company offering the programs,[3] which company would not be regulated by the Division of Corporate Regulation.

The establishment of a process for federal registration still left innumerable state regulatory problems. The primary question emerged as one of agency jurisdiction. As a hybrid of insurance and mutual funds, the funded programs did not fit any of the established state regulatory systems and as might be expected the states reached diverse conclusions as to what state agency or agencies should properly administer the sale of funded programs.[4]

The purpose of this article is to aid the lawyer practicing securities law to prepare the federal and state registrations of a funded program

1. Without a doubt the programs themselves constitute a "security" within the concept of "investment contract" as set forth in *Securities & Exchange Commission v. W. J. Howey Company*, 328 U.S. 293 (1946), involving § 2(1) of the Securities Act of 1933, *as amended* 15 U.S.C. § 77(b)(1) (1964) (hereinafter cited as the 1933 Act or the Securities Act of 1933 with numerical section designations). In SEC Securities Act Release No. 4491 (May 22, 1962), the Division of Corporation Finance stated that an equity funding type of program or plan

> [I]n and of itself constitutes a security, i.e., an investment contract and when publicly offered is required to be registered under the Securities Act of 1933. . . .
>
> The investment scheme transcends its component parts, including the mutual fund shares which presumably are registered under the Securities Act of 1933 (and the issuer of which presumably is registered under the Investment Company Act of 1940) as well as the insurance policy which may be exempt under section 3(a)(8) of the Securities Act (and the issuer of which may be exempt under section 3(c)(3) of the Investment Company Act of 1940).

2. *See* SEC Securities Act Release No. 4491 (May 22, 1962).

3. *See* text on federal regulation under the Securities Act of 1933, *as amended*, p. 101 *infra*.

4. *See* text on state regulation, p. 124 *infra*.

and to assist his client in complying with the numerous state and federal regulations that control the emerging funding industry.

A. *Funding Programs Defined*

"Equity funding programs," "secured funding programs," or "life funding programs" are programs designed to coordinate the acquisition of registered mutual fund shares with the purchase of either life, health and accident, or casualty insurance. The funding program allows a participating investor to purchase mutual fund shares for cash and then to acquire insurance protection by borrowing the amount of the premium required for the selected insurance policy by using the mutual fund shares to provide the necessary collateral for the premium loan. A program may be continued and premium loans accumulated up to a maximum of ten years.

B. *Method of Operations*

In its simplest form a "funding" company has three principal operations: mutual fund sales; insurance policy sales; and the arranging of financing for the secured loans. The financially stronger funding companies have expanded vertically into more sophisticated operations of mutual fund management and distribution, and insurance underwriting. Several funding organizations have recently formed, in addition to their mutual fund dealerships, wholly owned securities subsidiaries, for the purpose of effectuating brokerage transactions on national securities exchanges and in the over-the-counter market.[5]

The typical small funding company has two highly active wholly owned subsidiaries—a registered general insurance agency for one or more insurance companies, and a securities dealer which is both registered with the SEC and is a member of the National Association of Securities Dealers, Inc. (NASD).[6] The parent funding company registers the programs with the federal and state administrative agencies and arranges the financing of the loans. The source for financing the premium loans is the biggest obstacle to a small funding company. This problem is best solved through an affiliation with a large life insurance company, which will fund the insurance premium loans in exchange for the right of first refusal on some or all of the insurance premiums written by the funding company's general agency subsidiary. This arrangement is attractive both for the funding company and the life insurance company in that the funding company receives funds for the financing of its programs and the insurance company receives business that has been shown to have a low lapse ratio. Mechanically speaking, the premium is paid

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5. *See* text on the broker-dealer subsidiary under the Securities Exchange Act of 1934, *as amended*, p. 105 *infra*.

6. *See* text on NASD regulation, p. 122 *infra*.

annually directly to the insurance company, and the participant never receives a premium notice from the insurance company.

A funding organization can develop sales by franchising or licensing the programs to other dealers or by the development of its own captive sales force. The franchising or licensing of the funded program allows a medium-sized funding organization to avoid the costly expense of the development of a captive sales force. The best market for the funding organization is a small dealer firm whose salesmen have traditionally sold mutual funds or split dollar insurance and mutual fund plans. A license agreement may provide that at some future time, a funding organization will have the option to acquire the licensee broker-dealer by an exchange of stock in the funding company or the parent company thereby granting to the owners of the small broker-dealer an equity in the overall funding organization. Typically, when the funded program is licensed, the broker-dealer or dealer selling the program retains the entire dealer re-allowance on the mutual fund sales but is required to sell policies from an insurance company selected by the funding organization on which the funding organization receives an override.[7]

The parent funding company, or one of its subsidiaries, arranges financing for the programs by selling "custodial notes" to institutions. These custodial notes are themselves backed by each investor's pledged mutual fund shares and a collateral note signed by the investor at the time he begins his program. The custodial notes are themselves issued under and secured by a master custodian agreement executed by the funding company and the lending institution. Usually, all of the outstanding notes issued under the agreement are ratably secured by the agreement.[8] Both the custodial notes and the collateral notes are within the purview of the Uniform Commercial Code, and, upon any default, the holder of any such note has all the rights and remedies afforded a secured party under article nine of the Uniform Commercial Code.[9]

The loans arranged by the funding company for the investor are secured by the pledge of a certain quantity of mutual fund shares which the participant purchases from the funding company's wholly owned subsidiary securities dealership. Upon deposit with a custodian bank of the required number of mutual fund shares that are to be used as collateral,[10] the funding company initiates a loan on the participant's

7. However, section 11(d)(1) of the Securities and Exchange Act of 1934 would indicate that the funding organization can license only dealers and may not license any dealer who is both a broker and a dealer or transacts business with a medium of a national securities exchange. *See* SEC Securities Act Release No. 4491 (May 22, 1962).

8. *See* Appendix A for an example of a Model Custodial Note.

9. *See* Appendix B for an example of a Model Collateral Note.

10. Generally, most premium loans must be secured by mutual fund shares having a value of at least 250% of the premium. In the event the redemption value of participant's pledged shares declines below 135% of the participants aggregate indebtedness, his loan immediately becomes due and payable and a sufficient number of the pledged shares will

behalf in the amount of the insurance premium.[11] As each succeeding year's premium becomes due, a new loan is effected which is equal to the aggregate amount of the prior loan, the accrued interest, and the amount of the current premium. Participants in the programs are required to maintain "open accounts" with the mutual fund of which shares were purchased and used to secure the loans. Such "open accounts" provide for the automatic reinvestment of any dividends or capital gains distributions. Although it is economically advantageous for the funding company to do so, it ordinarily does not contractually obligate itself to provide the annual refinancing of the participants' insurance premiums as contemplated by the programs.[12]

Program loans from the funding company to the participating investor who purchases a program are evidenced by assignable term notes with the participant as maker and the funding company as payee. The term notes normally mature on the anniversary date of the insurance policy. These notes are then executed by the funding company on behalf of the participant pursuant to a limited power of attorney agreement. The limited power of attorney agreement is executed by the participating investor at the acceptance of the program and permits the funding company to arrange loans, to pay the insurance premiums with the proceeds of those loans, and to pledge mutual fund shares of the participants as the collateral for such loans.[13] Normally, the loans may be prepaid in whole or in part at any time without notice or penalty.

be sold by the custodian bank to pay the loan in full. Usually, however, when the value of the collateral declines to around 150%, the investor will be notified and given the choice of purchasing or putting up more mutual fund shares or taking a chance on the program terminating.

11. As shown in a recent prospectus prior to the beginning of the "Great Bear Market of 1970," the minimum amount required of an investor to initiate a program was approximately $762 which included a $9 custodian fee payable to a custodian bank. Of this amount, $65.89 represented the maximum deduction to be taken as a sales charge for the purchase of mutual fund shares. The shares so purchased would then have been pledged for a loan in the amount of $301 which would have been used to pay the premium on an insurance policy for the participant, the benefits of which would have varied widely depending upon the age of the participant, the type of policy, and the benefits desired. *See Handsome Couple*, BARRON'S, Nov. 24, 1969, at 5.

12. Therefore, the continuation of a program depends upon the ability of the funding company to provide funds for financing a new premium on each anniversary date. If the funding company is unable to provide funds for new loans, the programs may terminate.

13. In other words, under an agency agreement, the participant appoints the funding company as his attorney-in-fact to pay the insurance premiums for him as they become due; to issue promissory notes payable by him to the funding company in the amount of the insurance premiums and interest; and to pledge as collateral for the loan a sufficient amount of mutual fund shares to meet the collateral requirements. The agreement also authorizes the company to repledge the notes and mutual fund shares of the participant as collateral for loans made to the funding company under a custodial agreement which the funding company has with some institutional lender. The agency agreement is effective until terminated by the investor (which he may do at any time) or by the funding company (which it may do only on an anniversary date of the insurance policy when the loan is to be renewed). Normally, the agency agreement will provide that the participating investors mutual fund account be registered in the name of a bank as agent, and held by the bank as nominee, subject to instructions by the funding company as the participant's attorney-in-fact. Certificates are then issued and transferred to the bank only to the extent necessary to meet collateral requirements.

The personal liability of the participating investor is nonetheless limited, as the funding company (or its assigns) is required to look solely to the pledged mutual fund shares for the repayment of the loans together with any accrued interest. A participant has no contractual obligation to make additional purchases of mutual funds once a program is initiated; however, his failure to do so might very well result in the termination of the program since the annual increase in the loan requires a corresponding increase in collateral (unless the net asset value of the mutual fund shares also increases substantially).

The ideal objective and primary investor-appeal of the funding concept is that the participating investor will be able to utilize any appreciation in value of the pledged mutual fund shares and any dividends or capital gain distributions to aid in satisfying the principal and accumulated interest on the loans which are payable upon the termination of the individual program. Of course, an investor may discontinue the insurance or the purchase of mutual fund shares, or both at any time he desires. Upon the termination of his program, the participating investor must repay all of the accumulated loan principal as well as the accrued interest, usually by liquidating a sufficient number of the pledged shares. A profit or loss may be experienced upon termination of the program depending upon the performance of the mutual fund selected by the investor as compared with the amount of interest which has accrued on the loans.[14] As stated before, a participant may apply for or continue insurance separately without purchasing mutual fund shares, or he may invest in mutual fund shares without purchasing any insurance. In either case, the purchase of mutual fund shares and insurance under a program is normally at the same price and subject to the same sales and service charges and commissions as if each were purchased independently. However, insurance premium financing is involved, and a participating investor will incur interest charges and certain custodian fees in addition to the usual sales and service charges and commissions. The programs of most funding companies may be continued and premium loans accumulated for a maximum of ten years.

The company replaces a participant's note with a new note at the end of each year of the program (or quarterly, or semi-annually, depending upon mode of premium payment) in the amount of cumulative past borrowings, including accrued but upaid interest and the next premium due, at a per annum interest rate determined as above.

14. Interest on loans to participants may vary as the funding company may determine from time to time; however, the general interest rate is usually based on a formula related to the prime interest rate in effect in New York City at the time loans to participants are made or renewed by the funding company.

As of September 30, 1969, the interest rate per annum on program loans was running 8½% in many states where programs are permitted to be sold. However, the rate was 8% in Alabama, Alaska, Arizona, Delaware, District of Columbia, Georgia, Indiana, Louisiana, Maryland, Minnesota, Mississippi, Missouri, Ohio, Puerto Rico (if over $3,000), South Dakota, Virginia, and West Virginia; 7½% in New Jersey, New York, and Vermont; 7% in Illinois, Michigan, North Dakota, and South Carolina; and 6% in Kentucky, and Pennsyl-

C. *Federal Income Tax Consequences for Participating Investors*

Generally, participating investors are liable for federal income taxes on dividend and capital gain distributions on their mutual fund shares whenever these distributions are automatically reinvested in additional shares as required by the programs. Such dividends and capital gains are considered to be constructively received by a cash basis shareholder as soon as they are credited to his account.[15] Upon the termination of a program and the liquidation of the mutual fund shares to repay the loan, the disposition of those shares is treated the same as any sale of mutual fund shares, and the participant must first determine whether his gain or loss is short-term or long-term in order to ascertain whether that gain or loss receives capital treatment.[16] It appears as if the interest paid on loans to purchase life insurance pursuant to a funding program is probably not deductible.[17]

However, the amount of the annual premium due on an insurance policy taken out by a participant may be deductible for federal income tax purposes during the term of the program if the participant makes an irrevocable gift of the program to a qualified charitable institution, provided that the taxpayer completely divests himself of all ownership. The divestment must be complete to the extent that the participant receives no benefit from the accumulated cash value of his insurance policy nor attempts to borrow funds under such policy. The irrevocable nature of the gift will, of course, preclude the insured from designating any other persons as beneficiaries under the particular policy involved.[18]

II. REGULATION

The component functions of a funding organization are governed by an interplay of federal, state, and industry regulations. Accordingly, to a large extent a funding organization's corporate structure is dictated by these regulations. The funded programs must be registered under the

vania. The interest rate charged must, of course, always be below the ceiling set by the state's usury laws.

15. INT. REV. CODE OF 1954, §§ 45 and 451; Treas. Reg. § 1.451-2 (1964). *See* Treas. Reg. § 1.451-2(b) (1964). *See also* Ross v. Commissioner, 169 F.2d 483 (1st Cir. 1948); Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946).

16. INT. REV. CODE OF 1954, § 1222. *See* Treas. Reg. § 1.1222-1 (1965).

17. Although section 163 of the Internal Revenue Code of 1954 normally permits a taxpayer to deduct any interest paid or accrued upon an indebtedness regardless of the relationship of the interest obligation to the production of income during his taxable year, there are certain transactions wherein the relationship is important and may prevent the taxpayer from taking a deduction. Sections 264(a)-(c) pertain to the deductibility of interest paid on loans where the proceeds of such loans were used to purchase insurance. Section 264(a)(2) of the 1954 Code states that interest on indebtedness incurred or continued to purchase or carry a single premium life insurance endowment or annuity policy is *not* deductible; and, section 264(a)(3) maintains that interest on indebtedness incurred or continued to purchase or carry life insurance endowment or annuity contracts under a plan that contemplates a systematic borrowing of part or all of the increases in the cash value of any such contracts where the borrowing is either direct or indirect, is *not* deductible.

18. Treas. Reg. § 25.2511-1(h)(8) (1961). *See also* Fletcher Trust Co., 1 T.C. 798 (1943), *aff'd*, 141 F.2d 36 (7th Cir. 1944).

Securities Act of 1933, as amended, and under the Blue Sky laws of the various states where the programs are offered. The broker-dealer subsidiary must be registered and its sales activities, including margin and truth-in-lending requirements, are regulated by the Securities and Exchange Act of 1934 and the securities commissions of the various states. It is to the advantage of the broker-dealer subsidiary, as well as its sales representatives, to be members of the National Association of Securities Dealers, and as such their sales conduct and practices will be supervised by that regulatory body. The funding company must file periodic reports concerning the funded programs pursuant to the Securities and Exchange Act of 1934. Care must be taken to avoid an application to the funded program of the Investment Company Act of 1940 and the Investment Advisors Act of 1940. Finally, the insurance agency subsidiary and its sales representatives must be licensed by the various state insurance departments and the company must operate within the purview of the state usury laws.

A. *Securities Act of 1933, As Amended*

As non-exempt securities being offered for sale to the public in non-exempt transactions, the programs must be registered to avoid prohibitions of section 5 of the Securities Act of 1933.[19] The normal registration provisions of sections 6, 7, 8, and 10 of the 1933 Act[20] are applicable along with the rules regarding registration under regulation C.[21] As with the majority of registrations filed under the 1933 Act, the programs are registered with the Commission's Division of Corporation Finance on Form S-1. In much the same manner as an investment company, the funding companies' programs are in continuous registration. In effect this means a new registration statement is filed each year updating and supplementing the prospectus used in the preceding year. Although Form S-1 is perhaps the form most familiar to attorneys preparing regis-

19. Section 5 of the Securities Act of 1933, as amended, prohibits both offers to sell and offers to buy a security before a registration statement is filed. Section 5(b) makes it unlawful to make use of the mails or any means of interstate commerce to transmit a prospectus with respect to any security as to which a registration statement has been filed unless such prospectus contains the information specified by section 10 of the 1933 Act. SEC Securities Act Release No. 3844 (October 8, 1957). A prospectus is defined to include any notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale. An exception exists covering any communication sent after the effective date of a registration statement which shall not be deemed a prospectus if, prior to or at the same time with such a communication, a written prospectus meeting the requirements of section 10 of the Act was sent or given. Section 2(10) of the Securities Act of 1933, *as amended.*

20. Section 6 of the 1933 Act primarily sets forth who must sign the registration statement and also prescribes the registration fee. Section 7 generally relates to the information which must be included in the registration statement and directs one to the rules, while section 8 pertains mostly to the filing of amendments. Section 10 holds the heart of the prospectus requirements and any prospectus which is filed must conform to the demands of that section.

21. SEC Reg. C, 17 C.F.R. § 230.400-494 (1968).

tration statements for public offerings, the form presents some problems when applied to the registration of funded programs. These problems are primarily the result of "saddling-up old reliable" (Form S-1) as a registration vehicle,[22] rather than working out some sort of compromise form to accommodate the type of security involved.[23] The problems themselves are not so great that they destroy the objective of the prospectus—disclosure to the investor—and on the whole, "old reliable" has done a commendable job. One of the problems presented on the cover page of Form S-1 is the computation of the registration fee.[24] Here, the "Amount being registered" is the company's best estimate of the maximum dollars amount of program loans which will be initiated and the amount of mutual fund shares it may be able to sell in order to provide sufficient collateral for such loans during the ensuing year. The "Proposed maximum offering price per unit" is indeterminable, because the amount any one participant will invest in a program will vary with each individual according to his own financial investment philosophy and investment objectives. The "Proposed maximum aggregate offering price" is estimated for purposes of calculating a registration fee and is the same figure as the "Amount being registered."

The Commission has realized these problems and in August of 1970 gave notice to the public in Securities Act Release No. 5075 of a proposed guide to be published in definitive form to assist in the preparation of registration statements relating to "equity funding" programs. In regard to the registration fee calculation, the Commission stated:

> The Calculation of the Registration Fee for registration statements relating to equity funding programs should be based on all elements of the program, namely, the cost of the mutual fund shares plus cost of life insurance premiums (interest on loans and any other fees should also be considered).

In addition, the Commission pointed out the importance of a prominent statement in the introductory section of the prospectus discussing the effect of a decline in the value of mutual fund shares pledged as collateral (resulting in the need to furnish additional shares as collateral or risk a termination of the program). Special attention should be drawn to hypothetical tabular illustrations of the ten-year results of

22. Appendix II under the General Rules and Regulations of the Securities Act of 1933, *as amended*, provides:

> Form S-1 shall be used for registration under the Securities Act of 1933 of securities of all issues for which no other form is authorized or prescribed. . . .

23. Section 10(d) of the Securities Act of 1933, *as amended*, provides:

> [T]he Commission shall have authority to classify prospectuses according to the nature and circumstances of their use or the nature of the security . . . and, by rules and regulations and subject to such terms and conditions as it shall specify therein, to prescribe as to each class the form and contents which it may find appropriate and consistent with the public interest and the protection of investors.

24. Section 6(b) of the Securities Act of 1933, *as amended*, provides that the applicant shall pay a filing fee of one-fiftieth of one per centum of the maximum aggregate price at which such securities are proposed to be offered. In no case shall the fee be less than $100.

a program based on the smallest size program offered, and, if tabular data is not shown for all funds offered, the mutual funds so illustrated should include the lowest performer among those offered plus disclosure of any funds discontinued in the past three years whose performance has been less than the lowest now shown. Also in the tabular illustrations of program results, a column should be included which reflects the net value of the program to a participant upon termination which would be the value of the program upon termination less the accumulated debt for insurance premium and interest. In the alternative, the table may show the difference in the cost of investment (including borrowings) and the value at termination. The proposed guide also calls for a summary to be set forth under "RISK FACTORS" as follows:

SUMMARY

	Plan A	*Plan B*	*Plan C*
Total payments made during the period set forth in the hypothetical table	$	$	$
Total liquidating value of mutual fund shares upon termination			
Plus: Cash surrender value of life insurance			
Less: Amount needed for repayment of loan for insurance premium and interest			
Net value			
Net gain (or loss) if program liquidated	$	$	$

The following salient features of the programs should be set forth within the prospectus in bold type: (1) participation in a program does not give the holder any equity ownership interest whatsoever in the funding company; (2) participating investors have no voting rights nor any right to share in the company's profits or losses; (3) a program, as such, has no sales value and cannot be bought or sold in an after-market; (4) mutual fund dealers who also act as securities brokers are prohibited by federal statute from arranging loans of the type contemplated by the programs and are not authorized by the issuing company to make any offering under the prospectus.

The prospectus should inform the investor that a number of states have so-called "anticombination" or "anti-inducement" statutes which have been interpreted to prohibit the sale of programs in those states.[25]

25. *See* N.C. GEN. STAT. Ch. 58-44.5 and 58-57.3 (1969); IOWA CODE ANN. § 506.10 (1970).

Due notice of this fact must be explicitly set forth, usually under "Risk Factors." A statement that the prospectus does not constitute an offering in any jurisdiction in which such offering may not lawfully be made is not in itself completely sufficient to import such notice.

The format of the prospectus itself varies somewhat with each funding company, although they all by necessity contain much the same information. In practice, the format of most funding prospectuses now in use may well be unintelligible to the typical prospective investor in a funding program. In the funding prospectus presentation, intelligibility is especially important, even more so than with the normal mutual fund or common stock offer. With the funded program, the investor is handed at least two prospectuses, one for the program (or programs) and at least one for the mutual fund in which he will purchase his shares for collateral. Thus, the investor in a funded program is susceptible to at least twice as much confusion as the average common stock investor. Even if the investor is familiar with the term "common stock," such familiarity may not be assumed in the case of a participant in a funded program. Prior to talking with the funding company's sales representative the participant may never have heard of such a program; therefore, it is especially important that the program prospectus be readable at least to the extent of giving the potential investor a clear definition of the concept.[26] In the opinion of the authors of this article, an informative funding prospectus can be presented very well in a question and answer form, as opposed to a tightly drawn document oriented solely toward liability prevention. Appropriate questions which would act as a table of contents might include: What are funding programs? What risk factors should I, as an investor, consider? How will I, as a participant, be taxed on my investment in a program? How does the program work? Is a program suited to my needs? In which mutual funds may I invest? What type of insurance is available? How much must I invest? Must I make any additional investments? Can I vote the shares? How much are the premiums? How are the loans arranged? How much collateral must I furnish? How long does a program last? Can I modify the program? Who is in charge of the company? How does the company operate? This format should at least stimulate more questions in the mind of the investor

26. In SEC Securities Act Release No. 4936 (Dec. 9, 1968), the Commission gave guides for the preparation and filing of registration statements, stating in the general provisions thereof:

> 5. *Voluminous and Verbose Prospectuses.*
>
> Prospectuses are sometimes difficult to read and to understand. Registrants have been encouraged to reduce the size of the prospectus by careful organization of the material, appropriate arrangement and subordination of information, use of tables and the avoidance of prolix or technical expression and unnecessary detail . . .

Rule 460(f) under the '33 Act states that

> in passing upon requests for acceleration, the Commission will consider whether there has been a *bona fide* effort to make the prospectus reasonably concise and readable, so as to facilitate an understanding of the information required or permitted to be contained in the prospectus.

with the practical result that a more meaningful dialogue with the sales representative will be achieved.

The publicity and prospectus delivery requirements of the 1933 Act are fully applicable to funding programs, and the publicity regulations of the various state insurance commissions must also be observed.[27] Since public distribution of the programs is made throughout the year, the distribution is never fully concluded and another registration is continuously contemplated. Hence, the exercise of caution in regard to publicity or advertising is essential.

B. *Securities Exchange Act of 1934, as Amended*

1. The Broker-Dealer Subsidiary

The arrangement of the premium loan by the pledge of the mutual fund shares purchased by cash necessitates that careful attention be given to the corporate structure, function, and sales activity of the registered broker-dealer subsidiary.

Since the earliest beginnings of the industry, the subsidiary corporation distributing the programs has been registered with the SEC to conduct business as a securities dealer—not as a broker. In a release by the Division of Trading and Exchanges,[28] the SEC discussed the application of section 11(d)(1) of the Securities Exchange Act of 1934, as amended,[29] to broker-dealers involved in funding program distributions. Section 11(d)(1) provides that:

> [I]t shall be unlawful for a member of a national securities exchange who is both a dealer and a broker or any person who both as a broker and a dealer transacts a business through the medium of a member or otherwise, to effect through the use of any facility of a national securities exchange or of the mails or of any means or instrumentality of interstate commerce, or otherwise in the case of a member, (1) any transaction in connection with which, directly or indirectly, he extends or maintains or arranges for the extension or maintenance of credit to or for a customer on any security (other than an exempted security) which was a part of a new issue in the distribution of which he participated as a member of a selling syndicate or group within thirty days prior to such transaction . . . .[30]

In order to avoid a violation of section 11(d)(1) of the Securities

27. Section 10(a)(3) of the Securities Act of 1933, *as amended*, states that when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense.

28. SEC Securities Exchange Act Release No. 6726 (February 8, 1962).

29. 15 U.S.C. § 78 (1964). Throughout the remainder of this article, the Securities Exchange Act of 1934, *as amended*, is referred to solely by section numbers.

30. § 11(d)(1) of the Securities Exchange Act of 1934, *as amended*.

Exchange Act, a funding company should organize a wholly owned subsidiary which limits its activities solely to those of a dealer in mutual funds—specifically those mutual funds whose shares are sold to investors participating in the funding programs which will be used as collateral for premium loans pursuant to the funding concept. The problem of section 11(d)(1) itself arises as a result of the manner in which mutual funds are sold. Normally in the sale of mutual fund shares, both the underwriter and the retailing broker-dealer are participating in the distribution of a "new issue" within the meaning of section 11(d)(1) of the Securities Exchange Act of 1934. Any such broker-dealer may *not* extend credit or arrange for the extension of credit on securities of this "new issue," even though the proceeds of the loan are to be applied to the financing of insurance premiums.[31]

The limitation of section 11(d)(1) of the Securities Exchange Act of 1934, as amended, creates a serious problem for the larger funding companies which have aspirations of vertical integration. For those large organizations, it is economically vital that they have within their corporate organizations a registered broker-dealer who may effectuate broker's transactions in the over-the-counter market or on the national exchanges. This is particularly true for those funding organizations that have within their structure their own mutual fund, or wish to retain within the organization, the brokerage commissions generated by the stock transactions in its fund's portfolio. In a recent proxy solicitation for its mutual fund, a large highly diversified funding company announced the formation of such a broker-dealer to transact brokerage business generated by its fund. The question then arises whether the limitations of section 11(d)(1) would apply where the funding organization has two subsidiaries, one a dealer that sells the funded program and arranges loans in connections with that program and the other a broker-dealer who transacts brokerage business in the over-the-counter market or on the national exchanges. Will the fact that both subsidiaries are jointly owned by the same parent corporation invoke the prohibitions of section 11(d)(1)? Will the SEC and the Federal Reserve Board look past the corporate structure to the substance of the problem? In the opinion of the authors, the SEC and the Federal Reserve Board most likely will not prohibit this dual existence broker-dealer and dealer sub-

31. SEC Securities Exchange Act Release No. 6726 (February 8, 1962). As a caveat, the director of the Division of Trading and Exchanges stated in that release that the SEC might very well look through the form to the substance of this type of arrangement to find a violation of section 11(d)(1) of the Securities Exchange Act. However, the caveat was issued in the dawn of the development of the concept, in a period when the Commission was rather uncertain of the procedures that might prove necessary to prevent any circumventing of the federal securities laws. In its 26th Annual Report to Congress, for the fiscal year ended June 30, 1960, the Commission listed contracts combining insurance and mutual fund shares as one of its major problems at that time and that such programs were under consideration by the SEC which was seeking to determine the best way to handle the problems that such programs might present.

sidiary if, in fact, the officers and directors of each subsidiary are separate and their functions are not comingled. This conclusion is supported by the proxy solicitation of the funding company's mutual fund, as mentioned above, which was processed through the SEC. The limitations of section 11(d)(1), however, would apparently prohibit the licensing or franchising of a funded program to a broker-dealer transacting brokerage business in over-the-counter or national exchanges.

2. Periodic Reporting Requirements

Since the funding company must register its programs under the Securities Act of 1933, as amended, it must annually renew this registration. The funding company is required by Section 15(d) of the 1934 Act, as amended, to file periodic reports under section 13 of that Act, regardless of whether it fits the category of section 12(g) of the Securities Exchange Act of 1934, as amended. Section 12(g) of the Securities Exchange Act of 1934, as amended in 1964, requires that a company with a class of equity securities held of record by 500 or more persons with total assets in excess of one million dollars must register under Section 12(g).[32] However, the mandate of Section 15(d) of the 1934 Act extends the reporting requirements to all companies which have filed a public offering for the year within which the registration statement became effective under the Securities Act of 1933, as amended. In several of the funding corporate structures, the funding company itself is actually a wholly-owned subsidiary. Thus, a disclosure requirement which is designed to provide information of maximum utility to investors and their advisors serves no purpose in regard to participants of a funding program, because such a participant has absolutely no equitable interest in the funding company. A purchaser of a funding program merely owns an insurance policy and some shares in a registered mutual fund in addition to the benefits of a financing arrangement for which he pays for the services of the funding company.

The reporting requirements extend to the reporting company and its subsidiaries but do not necessarily apply to the parent company—especially where the parent company has not yet made a public offering itself. Of course, once the parent corporation has its own public offering with a registration statement filed and effective under the 1933 Act, or has a class of equity security holders of 500 or more persons and gross assets in excess of one million dollars, it will be a reporting company[33] and its statement will include information concerning its subsidiaries. The subsidiary funding company will not itself have to report other than to give notice to the Commission that the information which is required

32. *See* Sowards, *The Securities Acts Amendments of 1964: New Registration and Reporting Requirements*, 19 U. Miami L. Rev. 33 (1964).

33. Unless exempt as an insurance company. *See* rules 12h-1 and 12(g)(2)(G), 17 C.F.R. § 240.12h-1 (1968).

to be reported has been incorporated in the parent's report. Hence, there is no useful purpose served by having the funding company report. As indicated in the *Wheat Report*,[34] current reporting requirements are aimed at keeping the market place informed. However, as stated previously, there is no after-market for the funding programs once a participant has invested, therefore, the program cannot be resold or traded.[35]

The Commission's reporting system has been criticized by former chairman Cohen as falling short of the desired result of disclosure to investors. He stated that the system

> provide[s] a permanent record of the most important information about these corporations and a framework within which other information can be assessed. But, the nature and timing of these reports prevent them from serving as an adequate medium for the rapid and widespread dissemination of current material information to the investing public.[36]

3. TRUTH IN LENDING

Although broker's margin loans to customers were specifically excluded from the Truth in Lending Act,[37] the Securities and Exchange Commission has adopted rule 10b-16[38] under the 1934 Act which requires broker-dealers who extend credit to customers for the financing of securities transactions to furnish specified information with respect to the amount of and reasons for the credit charges. Basically, the rule requires that securities customers be given a plain statement disclosing the charges involved in each transaction, including the dollar amount and the annual interest rate of the finance charge.

Before the first credit transaction is made, a customer opening a new margin account must be given a written statement showing: (1) the conditions for interest charges; (2) the annual rate of interest; (3) the method of computing interest; (4) when interest rates can be changed without prior notice; (5) how the customer's debit balance is calculated; (6) the nature of any special charges; and (7) the nature of any lien on a customer's property being held as collateral. Quarterly statements must also be sent to the customer showing: (1) the beginning and closing balances; (2) the balance at the end of the interest period; (3) debits and credits entered during the period; (4) the interest charge; (5) the beginning and ending dates of the interest period; (6) the rate of rates of interest and the interest charge for each different rate; (7) the debit

34. SEC, DISCLOSURE TO INVESTORS, THE WHEAT REPORT (1968).
35. *Id.* at 332.
36. Address by Chairman Manuel F. Cohen, Baltimore Sec. Analysts Soc'y, Jan. 6, 1969 (1967-1969 Transfer Binder) CCH Fed. Sec. L. Rep. ¶ 77, 652 at 83, 414 (1969).
37. Consumer Credit Protection Act, 82 Stat. 146 *et seq.* (1968); as implemented by the Federal Reserve Board in Regulation Z, 12 C.F.R. § 226 (1969). [Hereinafter cited as the "Truth in Lending Act."]
38. 17 C.F.R. § 240.10b-16 (1970).

balance or balances or the average debit balance upon which interest was computed; and (8) other credit charges.

The stated purpose of the Truth in Lending Statute is "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit."[39] The Commission believed, at that time, that the standard form of customer's agreement did not achieve this desirable goal; hence, the adoption of the rule.[40]

Specific reference is made in the SEC Release adopting the rule to equity funding programs.[41] The requirement of initial disclosure to a participant may be met if the dealer furnishes to the customer a prospectus containing the information relating to initial disclosure. In regard to the quarterly statement requirements, the release stated that such requirements could be met in the case of equity funding programs registered under the 1933 Act if the broker *or* dealer furnishes to the customer within one month after each extension of credit, a statement or statements containing the information required to be disclosed under rule 10b-16(a)(2), relating to the quarterly statement.[42]

4. Margin Requirements

The term "margin" has been judicially construed to mean collateral or security used in connection with a purchase of securities,[43] and is commonly understood to be a credit device which more or less allows a purchaser to trade in securities while paying less than the full purchase price initially.[44]

In conformity with the margin requirements set by the Board of Governors of the Federal Reserve Board, all premium loans undertaken in conjunction with a funding program must be secured by mutual fund

39. SEC Securities Exchange Act Release, No. 8773 (Dec. 8, 1969).

40. Reference to such is to be found in Senate Report No. 392 (June 29, 1967) to the effect that the SEC has the necessary authority to pass any rules which may be necessary in regard to truth in lending, hence the omission of such rules from the Truth in Lending Act subsequently adopted by Congress.

41. SEC Securities Exchange Act Release No. 8773 (Dec. 8, 1969).

42. As matters now stand, companies falling within the purview of Regulation G of the Federal Reserve System are included in the Truth in Lending Act; however, a request for an interpretation has been made as to whether such companies are within this exemption of rule 10b-16 to the Act. The SEC and the Federal Reserve Board are considering what changes, if any, should be made in rule 10b-16.

43. *See* Kelly and Webb, *Credit and Securities: The Margin Requirements*, 24 Bus. Law. 1153, 1154 (1969):

> [A]n investor will deposit a percentage of the purchase price with his broker in a margin account and the broker will lend the investor the remainder of the purchase price. The broker will then retain the purchased stock as collateral and have the power to dispose of it if the investor does not maintain an amount in his account equal to an established percentage of the current market value of such stock. The amount deposited by the investor at the time of purchase is the 'initial margin' and the amount which must be maintained in accordance with a percentage of the market value is the 'maintenance margin'. Initial margins are the percentages set by the Federal Reserve Board. . . .

44. Goldenberg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959).

shares having a value equal to at least 250% of the premium. In addition, in the event the redemption value of the participant's shares declines below 135% of the participant's aggregate indebtedness, his loan immediately becomes due and payable and sufficient pledged shares are sold by the custodian bank to pay the loan.[45]

The following regulations promulgated by the Board of Governors of the Federal Reserve System are of primary concern in regard to the funding programs: Regulation T,[46] based upon the authority given to the Board of Governors in section 7(c) of the Securities Exchange Act of 1934, as amended; Regulation U,[47] based on the authority designated to the Board of Governors under section 7(d) of the 1934 Act; and Regulation G,[48] also based on the power source of section 7(d) of the Exchange Act, but which was not put into effect until the early part of 1968.

In 1968, these regulations were rendered applicable to certain over-the-counter stock and securities in addition to those traded on a national exchange.[49]

Regulation T[50] primarily sets forth certain rules which apply to every broker or dealer including those who are exchange members, or those who effect transactions in securities through the medium of any such member, as well as any broker dealer who is registered with the SEC pursuant to section 15 of the Securities Exchange Act of 1934[51] where credit is extended or maintained for the purpose of purchasing or carrying securities.[52] Pursuant to Regulation T a broker-dealer must set up a "general" account for normal margin customers whereby the broker-dealer must receive payment within five business days or "break the

45. The program is then automatically terminated and any remaining shares after the loan is paid are transferred to the participant. Most funding companies set an intermediate percentage (usually around 150%), whereby a participant is notified and given the option of putting up more shares for collateral or allowing the collateral to stand as is with the risk of automatic termination.

46. 12 C.F.R. § 220 (effective as of October 1, 1934). In United States v. McDermott, 131 F.2d 313 (7th Cir. 1942) the constitutionality of Regulation T was upheld in a criminal action. The argument presented by the defendant was to the effect that the Securities Exchange Act of 1934, is indefinite and therefore invalid as amounting to a delegation of legislature power by Congress to the Board of Governors of the Federal Reserve System to define criminal offenses and the regulation does not define any offense with sufficient certainty.

47. 12 C.F.R. § 221 (effective as of May 1, 1936).

48. 12 C.F.R. § 207 (effective as of March 11, 1968). In Collateral Lenders Comm. v. Board of Governors, 281 F. Supp. 899 (S.D.N.Y. 1968) the regulation was attacked as soon as it became effective. It was held therein that the regulation was constitutional and the term "excessive credit" as used in § 7(d) of the 1934 Act was not unconstitutionally vague.

49. 82 Stat. 452 (1968). To be designated as an OTC margin stock, an issue must have a regular market and be held by more than 1,500 public stockholders. The stock must have been traded for at least six months, with daily quotations continuously available, and certain minimum financial requirements relating to the issuer must be met.

50. 12 C.F.R. § 220 (1969).

51. 12 C.F.R. §§ 220.1 and 220.2(b) (1969).

52. § 7(c) of the Securities Exchange Act of 1934, *as amended*. However, rule 7(c)2-1 under the Securities Exchange Act exempts from this section those securities which are exempt from § 12(a) of the 1934 Act.

trade."[53] A series of "special" accounts[54] may be set up for certain situations which require that payment be made within seven business days plus delivery time.[55] In either type of account, if payment is not made within the required period, the broker-dealer is required to take affirmative action to "break the trade," meaning that the broker must either cancel or otherwise liquidate the transaction.[56]

A report of the House Committee on Interstate and Foreign Commerce indicates that the main purpose of section 7 of the Securities Exchange Act "is to give a Government credit agency an effective method of reducing the aggregate amount of the nation's credit resources which can be directed by speculation into the stock market. . . ."[57] In addition, it was recognized that an important by-product of section 7 would be that some measure of protection is afforded to the small speculator by making it impossible for him to spread himself too thinly.[58]

Prohibitions against arranging for credit in excess of that permitted under Regulation T apply to arrangements for such credit made by salesmen of a registered broker-dealer whether arrangements are for the accounts of the salesmen themselves and members of their families or for unrelated customers.[59] The term "arrange" is not defined in the Act or any rule or regulation thereunder. However, in no event may a person subject to the Regulations "arrange" for loans by others on a margin less than that on which the registrant itself could have made loans.[60] However, the SEC has stated that it is

> not prepared to find an 'arranging' by a broker-dealer where the customer on his own initiative and without recommendation, assistance or advice from the broker establishes credit and the terms thereof with another for accomplishing collateral loan transactions and the only function, activity or connection of the broker and its employees with the parties and the transactions is to execute the customer's orders and follow the customer's

53. 12 C.F.R. § 220.3(b) (1969).

54. The special accounts include the special cash account, special omnibus account, special miscellaneous account, the specialist's account, and the special subscriptions account. Three other special accounts have been added and include the special bond account, the special convertible debt security account, and the special equity funding account.

55. However, under SEC Reg. T, § 4(c)(5), 12 C.F.R. § 220.4(c)(5) (1969), the period may be extended until 35 calendar days under very unusual circumstances; but in no event merely to allow time for customers to make payment. *See* 26 Fed. Res. Bull. 1173 (1940). *See also* John W. Yeaman, Inc., SEC Securities Exchange Act Release No. 7527 (1965); Merritt Vickers, Inc., SEC Securities Exchange Act Release No. 7409 (1964).

56. 12 C.F.R. § 220.4(c)(7) (1969).

57. H.R. Rep. No. 1383, 73d Cong., 2d Sess. 8 (1934).

58. *Id.*

59. *See In re* Sutro Bros. & Co., 41 S.E.C. 443 (1963), where failure of supervision resulted in the arrangement for credit in violation of Regulation T, and it was held to be appropriate in the public interest to suspend the broker-dealer from membership in the National Association of Securities Dealers.

60. *Id.* at 450.

> instructions as to delivery of securities and receipt of payment.[61]

Of course, Regulation T does not suggest that the broker or dealer is to be an insurer of the fact that customers employ credit only to the extent that such credit could be provided by a broker or dealer. Regulation G now regulates those other sources of credit other than banks and broker-dealers. Nonetheless, it is clear than when a broker or dealer permits himself to act as intermediary between a customer and a factor in regard to the customer's dealings with the factor, the broker may become so involved in the extension or maintenance of credit for the customer that the broker or dealer will be held to be "arranging."[62] The test applied by the SEC is whether the activities bear such an integral relationship to the credit itself, that without such performances the credit would not be extended by the factors.[63]

Regulation U is concerned solely with the credit activities of banks which are lending money for the purpose of purchasing or carrying securities;[64] whereas, Regulation T is concerned with the function of the broker or dealer in securing such a loan.[65] Regulation G covers all other lenders and is appropriately entitled, "Securities Credit by Persons Other than Banks, Brokers, or Dealers."[66]

Regulation G requires an initial registration on Federal Reserve form G-1 with the district Federal Reserve Bank within 30 days of the end of the quarter, in the case of any person or corporation, extending or arranging for the extension of credit totaling $50,000 or more during any calendar quarter, or which has outstanding at any time during the calendar quarter a total of $100,000 or more in credit when such credit is secured directly or indirectly, in whole or in part, by collateral that includes any margin securities, unless such person is subject to Regulation T or Regulation U.[67] Quarterly filings thereafter are made on form G-4.[68]

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61. *Id.* at 452.

62. Where a broker became involved to the extent of conveying the customer's communications and instruction to the factor and responding to requests and directives of the factor concerning the customer's transactions; it was held that such was engaged in "arranging" credit. *See In re* Sutro Bros. & Co., 41 S.E.C. 443 (1963).

63. *In re* Sutro Bros. & Co., 41 S.E.C. 443, 457 (1963).

64. The general rule as set forth in 12 C.F.R. § 221.1(a) (1969) states:

> [N]o bank shall extend any credit secured directly or indirectly by any stock for the purpose of purchasing or carrying any margin stock in an amount exceeding the maximum loan value of the collateral.

65. *See* Effros, *A Note on Regulation T*, 82 BANKING LAW J. 471 (1965).

66. 12 C.F.R. § 207 (1968).

67. 12 C.F.R. § 207.1(a) (1969).

68. 12 C.F.R. § 207.3(a) (1969). Regulation G is primarily a registration provision and secondarily regulates lending for the purpose of carrying or purchasing a margin security. § 207.1(c) provides,

> Any person subject to the registration requirements of paragraph (a) of this section who, in the ordinary course of his business, extends or maintains or arranges for the extension or maintenance of any credit for the purpose of purchasing or carrying any margin security . . . if such credit is secured directly or indirectly in whole or in part, by collateral that includes any such security, is a 'lender' subject

Substance prevails over form;[69] however, mistakes made in good faith may be rectified if action is taken promptly.[70]

Although the funding company's wholly-owned broker-dealer subsidiary is subject to Regulation T, once the funding company reaches the $50,000 or $100,000 quarterly figure, the funding company will fit the requirements of Regulation G and must register, since "margin security" includes mutual fund shares.[71] However, the regulations promulgated by the Board of Governors do not regulate the acts of foreign lending institutions. The Securities Act of 1934 exempts from its coverage those who transact business in securities outside the jurisdiction of the United States. Section 30(b) of the '34 Act states:

> The provisions of this chapter or of any rule or regulation thereunder shall not apply to any person insofar as he transacts a business in securities without the jurisdiction of the United States, unless he transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of this chapter.[72]

However, a recent amendment to Section 7 of the '34 Act (Public Law 91-508) extends penalties for violations of the margin requirements to borrowers who are either United States "persons" or foreign "persons" controlled by United States "persons."

Sanctions for violations of the regulations of the Board of Governors of the Federal Reserve System may be imposed by administrative action,[73] criminal prosecution,[74] or by virtue of a private right of action brought in a civil court.[75]

> to this part and shall not . . . extend or arrange for the extension of any purpose credit in an amount exceeding the maximum loan value of the collateral. . . .

Once registered, termination of registration may be effected by filing form G-1 for approval by the Board of Governors. As a condition precedent to filing, the registrant must have had no outstanding credit secured in whole or in part, directly or indirectly by collateral that includes any margin securities. § 207.1(b).

69. 12 C.F.R. § 207.2(c) (1969).

70. 12 C.F.R. § 207.4(d) (1969).

71. 12 C.F.R. § 207.2(d) (1969).

72. Schoenbaum v. Firstbrook, 405 F.2d 200, 208 (2d Cir. 1968); Metro-Goldwyn-Mayer, Inc. v. Transamerica Corp., 303 F. Supp. 1354 (S.D.N.Y. 1969); Kook v. Crang, 182 F. Supp. 388 (S.D.N.Y. 1960).

73. *In re* Sutro Bros. & Co., 41 S.E.C. 443 (1963); *see also* Joseph V. Schields, Jr., SEC Securities Exchange Act Release No. 8484 (Jan. 3, 1969); Delafield & Delafield, SEC Securities Exchange Act Release No. 8480 (Dec. 26, 1968); Flittman, SEC Securities Exchange Act Release No. 8449 (Nov. 14, 1968); Bendall, Jr., SEC Securities Exchange Act Release No. 8448 (Nov. 14, 1968); Pickard & Company, Inc., SEC Securities Exchange Act Release No. 8447 (Nov. 14, 1968).

74. *See* United States v. McDermott, 131 F.2d 313 (7th Cir. 1942).

75. Remar v. Clayton Securities Corp., 81 F. Supp. 1014 (D. Mass. 1949). *See also* Goldenberg v. Bache & Co., 270 F.2d 675 (5th Cir. 1959); Smith v. Bear, 237 F.2d 79 (2d Cir. 1956); Aubin v. H. Hentz & Co., 303 F. Supp. 1119 (S.D. Fla. 1969); Pearlstein v. Scudder & German, 295 F. Supp. 1197 (S.D.N.Y. 1968); Serzysko v. Chase Manhattan Bank, 290 F. Supp. 74 (S.D.N.Y. 1968), *aff'd*, 409 F.2d 1360 (2d Cir. 1969), *cert. denied*

Section 7(c) of the Securities Exchange Act states that "it shall be unlawful" for any broker or dealer to arrange credit for the purchase of securities in violation of the regulations of the Board of Governors. The precise issue of whether a private right of action exists for a violation of the regulations of the Board of Governors based upon the words "it shall be unlawful," has not yet been argued before the Supreme Court. However, lower courts have consistently upheld a private right of action for such violations, and it is likely that if the issue were to reach the Supreme Court, the decision would follow the reasoning of the Court in the *Borak* case.[76]

In October, 1967, when the Federal Reserve Board formulated its proposal of Regulation G to cover loans by persons other than banks, brokers, or dealers, no mention was made of the equity funding concept, although the argument could conceivably have been made that equity funding companies were within the concept of the general rule which maintained that every person who in the ordinary course of his business makes or arranges for the making or maintenance of any loan for the purpose of purchasing or carrying any registered security and who is not already subject to Regulation T or Regulation U is a lender subject to this part.[77] At this time amendments were also proposed to Regulations T[78] and U,[79] but as with Regulation G, no specific mention was made of the equity funding concept. However, as early as February, 1962, the Commission had warned that equity funding programs might pose problems under the provisions of Section 7(c)(2) of the 1934 Act and Regulation T.[80]

Finally in December, 1968, specific reference was made to equity funding programs in proposed amendments to Regulations G[81] and U,[82] wherein such programs were specifically included within the definition of registered equity security. As stated in the notice of the Federal Reserve Board,

> The purpose of the change in [Reg. G] paragraph (d)(2) of § 207.2 is to establish that credit to finance programs for the combined purchase of registered equity securities (including securities issued by most investment companies registered pursuant to the Investment Company Act of 1940) and goods, services, other securities, or investments ("equity funding") is subject to the regulation.[83]

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396 U.S. 904 (1969); Moscarelli v. Stamm, 288 F. Supp. 453 (E.D.N.Y. 1968); Reader v. Hirsch & Co., 197 F. Supp. 111 (S.D.N.Y. 1961).

76. J. I. Case Co. v. Borak, 377 U.S. 426 (1964).
77. 12 C.F.R. § 207.1, 32 Fed. Reg. 14853 (1967).
78. 12 C.F.R. § 220, 32 Fed. Reg. 14855 (1967).
79. 12 C.F.R. § 221, 32 Fed. Reg. 14857 (1967).
80. SEC Securities Exchange Act Release No. 6726, Feb. 8 (1962).
81. 12 C.F.R. § 207.2(d)(2), 33 Fed. Reg. 18629 (1968).
82. 12 C.F.R. § 221.3(b)(3), 33 Fed. Reg. 18630 (1968).
83. 33 Fed. Reg. 18629 (1968).

A similar statement was issued regarding paragraph (b)(3) of section 221, Regulation U.[84] The Board of Governors then granted time in which interested persons could comment, submitting views, arguments, or relevant information regarding the inclusion of equity funding programs within the confines of the Regulations. Certainly, to have left the amendment as proposed and subjecting the programs to the same margin requirements as other registered securities would have in all probability sounded the death knell for the program by resulting in a greatly increased cost factor for the participant.[85] In February, 1969, equity funding programs were specifically included in the new term "regulated security," subjecting such securities to the margin requirements to which registered equity securities, over-the-counter margin stock, and shares of most investment companies are limited by Regulations G and U. For such securities the maximum loan value of any regulated security at that time was 20% of its current market value.[86] Along with the amendments of Regulations G and U, the application of Regulation T was broadened to cover all brokers and dealers regardless of whether such broker or dealer is a member of a national securities exchange or transacting any business in securities through the medium of such a member.[87] The Board of Governors granted an opportunity to some of the firms engaged in extending credit or equity funding programs to give an oral presentation manifesting the industry's views in regard to the Regulation.[88] The results of the presentation were apparent in the new proposals released in June, 1969. Under section 207.4(f)—Regulation G—the specific rules relating to equity funding programs were set forth:

> (f) *Combined purchase of mutual funds and insurance.* An extension of purpose credit provided for in a plan, program, or investment contract, registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77), which provides for the acquisition both of a security issued by an investment company . . . and an insurance policy or contract, shall be subject to all the provisions of this part except that where the credit is secured by the security and does not exceed the premiums on such policy (plus any accrued interest), the maximum loan value of such security shall be 40 per-

84. 33 Fed. Reg. 18630 (1968).

85. As stated in one funding company's prospectus, dated May 15, 1969:

An amendment to Regulation G proposed by the Federal Reserve Board would bring the programs under margin requirements. Under this proposed amendment the terms of the Programs would have to be revised to require that the value of the collateral, at the time each loan is effected, be 500% of the aggregate amount of the loan. This revision would require a participant contemplating a minimum program to purchase mutual fund shares with a net asset value of at least $1,675 instead of the present minimum purchase of $700.

86. 34 Fed. Reg. 2257, 1159-61 (1969).

87. 34 Fed. Reg. 2507 (1969).

88. *Id.*

> cent of its current market value, as determined by any reasonable method.[89]

Significant changes were also proposed in Regulation T as a special account status was granted to the equity funding concept:

> (k) *Special equity funding account.* In a special equity funding account a creditor, who is the issuer or a subsidiary or affiliate of the issuer of a plan, program, or investment contract, registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77), that provides for the acquisition both of a security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8) and of insurance may arrange for the extension or maintenance of credit, not in excess of the premiums on such policy (plus any applicable interest), on a security issued by such an investment company that serves as collateral under such a plan, program, or investment contract: *Provided,* That such credit is extended or maintained by a lender subject to Part 207 of this chapter (Regulation G) or a bank subject to Part 221 of this chapter (Regulation U). A creditor, arranging credit in a special equity funding account shall not extend, arrange, or maintain credit in the general account or any other special account in §§ 220.3 and 220.4.[90]

The reason for the addition of section (k) is clear; its purpose is to permit a creditor (securities dealer) to arrange for the extension or maintenance of credit in connection with the sale of equity funding programs issued by the creditor itself, or a subsidiary or affiliate of the creditor, on the mutual fund shares which are to serve as the collateral under the program: *Provided,* the creditor does *not* extend or arrange for credit in a general account or any other special account.[91]

The term "creditor" is defined in Regulation T as "any broker or dealer including every member of a national securities exchange."[92]

By virtue of the June, 1969, amendment to Regulation T, the sting was taken out of the Release by the Trading and Exchange Division stating that the SEC might look through the dealer subsidiary to find a violation of section 11(d)(1) of the 1934 Act.[93] At the same time the amendment firms up the real basis of the relationship of the subsidiary with the parent, by demanding that it actually serve only as a dealer, and not as a broker, since the amendment to Regulation T forbids any dealer who arranges for an extension or maintenance of credit from carrying any other special accounts or general accounts.

As to the lending institution's side of the transaction, where the rule

89. 34 Fed. Reg. 9194, 9195 (1969).
90. 12 C.F.R. § 220.4(k), 34 Fed. Reg. 9201 (1969).
91. 34 Fed. Reg. 9203 (1969).
92. 12 C.F.R. § 220.2(b) (1969).
93. SEC Securities Exchange Act Release No. 6726 (Feb. 8, 1962).

regarding the purpose of the loan has always been substance over form, special consideration was given to Regulation U in section 221.3(x) with respect to equity funding programs:

> (x) *Combined purchase of mutual funds and insurance.* (1) An extension of purchase credit provided for in a plan, program or investment contract that is registered with the Securities and Exchange Commission under the Securities Act of 1933 (15 U.S.C. 77), which provides for the acquisition both of a security issue by an investment company described in subparagraph (v)(5) of this section and an insurance policy or contract, shall be subject to all the provisions of this part, except that, where the credit is secured by the security and does not exceed the premium on such policy (plus any applicable interest), the maximum loan value of such security shall be 40% of its current market value, as determined by any reasonable method.[94]

Thus, the equity funding programs were clearly brought within the reach of Regulation U by virtue of the funding company's transactions as an entity securing loans from banks. A bank may extend exempt credit in connection with the wholesale financing of equity funding plans or programs to persons registered pursuant to Regulation G who extend credit in accordance with that Regulation.

The unfortunate result of the proposed amendments of June, 1969,[95] was the unnecessary duplication of margin requirements affecting each branch of the normal equity funding type of operation. The remedy adopted in August, 1969, was to be found in the final amendments to Regulations G and U.[96]

Under the miscellaneous provisions of Regulation G relating to the combined purchase of mutual funds[97] and insurance, a new subparagraph[98] was added to permit a person (or corporation) to extend exempt credit in connection with the wholesale financing of equity funding programs or plans to persons registered pursuant to Regulation G provided the credit is secured by registered mutual fund shares owned by the customer. An additional requirement which must be met in order to qualify for the exemption is conformity with the rules of the Commission regarding hypothecation of customer's securities.[99] The person extending the credit must receive a written statement that such mutual fund shares are to be carried for the account of one or more customers under an equity funding plan, program, or investment contract.

94. 12 C.F.R. § 221.3(x), 34 Fed. Reg. 9207, 9208 (1969). The Board of Governors regards credit available in connection with equity funding program as being for the purpose of purchasing or carrying margin stock.

95. 34 Fed. Reg. 9191, 9208 (1969).

96. 34 Fed. Reg. 13524, 13525 (1969).

97. 12 C.F.R. § 207.4(f) (1969).

98. 12 C.F.R. § 207.4(f)(2), 34 Fed. Reg. 13525 (1969).

99. 17 C.F.R. § 240.15c2-1 (1969).

Similarly, under the miscellaneous provisions of Regulation U pertaining to the coordination by funding programs of the acquisition of mutual fund shares with insurance,[100] a subparagraph[101] was added permitting a bank to extend exempt credit in connection with the wholesale financing of the funded programs to the funding company subsidiary which falls within the purview of Regulation G.[102] To qualify for the exemption, the bank credit must be secured by the customers' registered mutual fund shares and also pledged in conformity with the regulation regarding hypothecation of customer's securities.[103] The funding company subsidiary receiving the loan from the bank must also furnish the bank with a written statement to the effect that such securities are carried for the account of one or more customers under an equity funding plan or program.

The basic effect of the amendments is to bring into line all of the margin regulations relating to the issuance of the funding programs. Once the funding company reaches the volume amount of programs which brings the Regulation G registration requirements into play, then the registration is done on the funding company level where the execution of the custodian notes is involved under the funding company's master custodian agreement.

Thus, the Federal Reserve Board and the margin requirements set by its Board of Governors have had a significant effect upon the equity funding concept—both in the actual financial arrangements of the programs themselves and in the multi-corporate structure of the organization of the equity funding companies. But, perhaps, even more important, it is seen that the type of security involved—the funding program—has warranted special attention, and the Federal Reserve Board has carved out regulations peculiar unto the equity funding industry itself within the overall framework of the margin regulations.

C. *The Investment Company Act of 1940*

In 1962, when the Commission released its opinion that the funding programs were themselves securities within the meaning of section 2(1) of the Securities Act,[104] a caveat issued by the SEC stated:

> [I]t appears that programs of the type discussed . . . may result in the creation of an investment company as defined in the Investment Company Act of 1940. Accordingly, the requirements of that Act, including particularly sections 7, 26, and 27 thereof, should be considered by the sponsors of these plans.[105]

100. 12 C.F.R. § 240.221.3(x), 34 Fed. Reg. 13525 (1969).
101. 12 C.F.R. § 240.221.3(x)(2), 34 Fed. Reg. 13525 (1969).
102. 12 C.F.R. § 240.207.4(f) (1969).
103. 17 C.F.R. § 240.15c2-1 (1969).
104. SEC Securities Act Release No. 4491 (May 22, 1962).
105. *Id.* However, the Commission has not yet required the average funding company dealing in another company's mutual fund shares to register as an investment company.

Section 7 of the Investment Company Act[106] prohibits certain transactions by unregistered investment companies, while Section 26 of that Act relates to certain provisions which must be included in the trust indenture or agreement of custodianship pursuant to which securities are issued by a registered unit investment trust. Section 27 is concerned with periodic payment plan certificates issued by registered investment companies. At the time of its release, the SEC was obviously waiting to see what form and shape the funding companies would take and how they would style their operations. The problems posed to the SEC by the funding companies were manifested in the Commission's report to Congress at the end of its fiscal year in 1960.[107] Therein the Commission stated that the equity funding concept was one of the primary problems before the SEC at that time.[108]

In determining whether the normal funding company is required to register pursuant to section 8 of the Investment Company Act of 1940, it must first be ascertained whether the company and its operations fall within the definition of an investment company as set forth in section 3(a), and particularly sections 3(a)(1) and 3(a)(3). If the company falls within the rather broad definition of section 3(a)(1), or the more specific criteria of 3(a)(3), then it must register pursuant to section 8. Registration is required unless the company falls within an exclusion of section 3(b), meets one of the more specific exclusions of 3(c)(2)–(15), or finds an exemption from registration under section 6 of the Investment Company Act.

Section 3(a) of the 1940 Act defines an investment company as

> any issuer which—(1) is or holds itself out as being engaged primarily, or proposes to engage primarily in the business of investing, reinvesting or trading in securities; ... or (3) is engaged or proposes to engage in the business of investing, reinvesting, owing, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding forty per centum of the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis.[109]

In Section 3(a)(1) the emphasis is on the type of business activity in which the company is *"primarily engaged."* However, in the alternative definition presented in 3(a)(3) a different standard is provided. The objective criterion of at least forty percent of the "issuer's" total assets

Obviously where the funding company has its own mutual fund subsidiary, that subsidiary must register as an investment company.

106. 15 U.S.C. § 80(a) *et seq.* (1964) [hereinafter cited as the Investment Company Act of 1940 with numerical sections].

107. Twenty-sixth Annual Report of the Securities Exchange Commission to Congress for the fiscal year ended June 20, 1960.

108. *Id.* at 5.

109. Investment Company Act of 1940, § 3(9).

consisting of "investment securities" is the test, and the words "primarily engaged" are not within the definition of section 3(a)(3).[110] In effect, the definition is applicable to *activities* as well as "companies."[111] Section 3(a)(3) actually creates a presumption that a company is an investment company, and such a presumption may be refuted if the company can show that it falls within an exception or section 3(b) or 3(c).[112]

Section 3(b)(1) presents an automatic exception to companies that are primarily engaged in non-investment company business either directly or through *wholly* owned subsidiaries.[113] Section 3(b)(2) further excepts certain companies upon application provided the Commission finds that they are engaged primarily in non-investment company activity either directly or through *majority* owned subsidiaries.[114]

In determining whether a company is primarily engaged in a non-investment company business, for purpose of finding an exception in section 3(b), the principal considerations are as follows: (1) the company's historical development; (2) its public representation of policy; (3) the activities of its officers and directors; (4) the sources of its present income; and, most important, (5) the nature of its present assets. Notwithstanding the definitions of section 3(a) or the exclusions of section 3(b), a company need not report if it fits one of the descriptions of section 3(c).[115]

The normal equity funding type of organization can find an exclusion in section 3(c)(6) and 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(6) states:

> Any person[116] who is not engaged in the business of issuing face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: (A) Purchasing or otherwise acquiring notes, drafts, acceptances, open accounts receivable, and other obligations representing part or all of the sales price of merchandise, *insurance, and services*; (B) making loans

110. Investment companies offering their shares for sale to the public must file a registration statement for their securities under the Securities Act of 1933 as well as register under the Investment Act of 1940. Even if the public offering is entirely intrastate, the registration requirements of the Securities Act must be complied with because the intrastate exemption contained in section 3(a)(11) of the 1933 Act is made inapplicable by section 24(d) of the Investment Company Act to any security of an investment company.

111. *See* The Prudential Insurance Company of America, Investment Company Act Release No. 3620 (Jan. 22, 1963).

112. SEC v. S & P Nat'l Corp., 360 F.2d 741 (2d Cir. 1966).

113. Section 2(a)(41), of the Investment Company Act of 1940 defines "wholly owned subsidiary" as one whose voting securities are at least 95% owned by its parent, either directly or through other wholly owned subsidiaries.

114. Section 2(a)(23) defines a "majority owned subsidiary" of a person as a campany with 50% or more of its outstanding voting securities owned by such person; or by a company which is a majority owned subsidiary of such person.

115. The Tonopah Mining Co. of Nevada, 26 S.E.C. 426 (1947). *See* United Stores Corp., 10 S.E.C. 1145 (1942); The M.A. Hanna Co., 10 S.E.C. 581 (1941).

116. Section 2(a)(27) defines "person" as a natural person or a company.

> to . . . prospective purchasers of, specified merchandise, *insurance, and services*; . . . .[117]

With the primary function of a funding program being the purchase of insurance, the exception provided by section 3(c)(6) is applicable on its face to the average small funding company that does not have its own subsidiary mutual fund. In conjunction with that function, the primary source of income for the company consists of commissions generated mainly from the sale of insurance and additionally commissions from the sale of mutual fund shares of registered investment companies. Hence, section 3(c)(7) is also applicable. It provides:

> Any company primarily engaged, directly or through majority-owned subsidiaries, in one or more of the businesses described in paragraphs (3), (5), and (6) of this subsection, or in one or more of such businesses (from which not less than 25 per centum of such company's gross income during its fiscal year was derived) together with an additional business or businesses other than investing, reinvesting, owning, holding, or trading in securities.[118]

Of course, one of the primary duties of the funding company is to use its resources and services to obtain the loans secured by the investors' mutual fund shares in order to finance the insurance premiums.

Until the funding company reaches the size and growth whereby it specifically sets up (either by acquisition or otherwise) a wholly owned mutual fund as such, regardless of how it avoids having to register and report as an investment company itself, the policy of public disclosure for the benefit of the investor is served without subjecting the funding company to needless duplications. The programs are registered under the Securities Act of 1933; the mutual fund shares offered in the programs must be named within the funding company's prospectus for the programs; and those mutual fund shares themselves have already been registered under the Securities Act and the Investment Company Act. Consequently, any customer who invests in a program also receives a prospectus of the mutual fund in accordance with the delivery requirements of section 5(b)(2) of the Securities Act of 1933, as amended.

D. *Investment Advisers Act of 1940*

As to the applicability of the Investment Advisers Act of 1940,[119] and the necessity of registration thereunder, the definition of an "Investment Adviser" in Section 2(a)(11) specifically excludes in subpart (c) "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who

117. Investment Company Act of 1940, § 3(c)(6) (emphasis added).

118. Investment Company Act of 1940, § 3(c)(7).

119. 15 U.S.C. § 80(b) (1964) [hereinafter cited by numerical sections of the Investment Advisors Act of 1940].

receives no special compensation therefor . . . ."[120] Such a definition gives recognition to the fact that brokers and dealers commonly give a certain amount of advice to their customers in the course of their regular business and that it would be inappropriate to bring them within the scope of the 1940 Act merely because of this aspect of their business.[121]

E. *NASD and Suitability*

Although the funding programs are registered securities, each program sold to a participating investor must be individually structured to suit the particular participant's needs and objectives as nearly as possible. There has been a triple mandate promulgated by the NASD, the SEC, and court decisions applicable to the securities dealer selling such programs. The mandate is to make a reasonable inquiry as to certain confidential information concerning the customer's marital and occupational status, his financial situation and needs, including his present financial assets as well as certain income information, and at least an overview as to the prospective participant's investment objectives. Each prong of this triple mandate is in the form of a "suitability" rule.

As an NASD member, the funding company's broker-dealership subsidiary is regulated by the Rules of Fair Practice of the National Association of Securities Dealers, Inc. Article III, section 2 of those rules states:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[122]

Although a breach of the Rules of Fair Practice is in the nature of a breach of an ethical standard and does not necessarily in and of itself give rise to a private right of action,[123] the ramifications of severe violations and corresponding disciplinary action by the NASD could result in suspension or expulsion by the NASD[124] and subsequent action by the Securities and Exchange Commission.[125] Even if the broker-dealership

120. Investment Advisors Act of 1940, § (a)(11)(c).

121. SEC Investment Advisers Act Release No. IA-2 (October 28, 1940).

122. National Association of Securities Dealers, Inc., NASD Manual D-5 (reprint 1965) [hereinafter cited as NASD Manual].

123. Colonial Realty Corp. v. Bache & Co., CCH FED. SEC. L. REP. § 91351 (S.D.N.Y. March 20, 1964, *aff'd*, 358 F.2d 178 (2d Cir. 1966). *See* Lowenfels, *Private Enforcement in the Over-the-Counter Securities Markets: Implied Liabilities Based on NASD Rules*, 51 CORNELL L.Q. 633 (1966).

124. The NASD is a self-regulating body registered with the Securities and Exchange Commission pursuant to section 15A of the Securities Exchange Act of 1934, *as amended*. *See* Gerald M. Greenberg, 40 S.E.C. 133 (1960); Powell & McGowan, Inc. SEC Securities Exchange Act Release No. 7302 (April 24, 1964).

125. Such action could result in censure, fines, a temporary suspension from doing

were not a member of a national securities association registered with the SEC, the seller would still be subject to one of the suitability rules promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended.[126] Rule 15b10-3 dictates:

> Every nonmember broker or dealer and every associated person who recommends to a customer the purchase, sale or exchange of any security shall have reasonable grounds to believe that the recommendation is not unsuitable for such customer on the basis of information furnished by such customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, any other information known by such broker or dealer or associated person.[127]

The suitability rule could conceivably be expanded into the area of Rule 10b-5 liability with its implied private right of action.

Regardless, the SEC has in fact promulgated a suitability rule specifically governing the same area of funding programs. Rule 15c2-5 (a)(2) states:

> (a) It shall constitute a "fraudulent, deceptive or manipulative act or practice" as used in section 15(c)(2) of the Act for any broker or dealer to offer or sell any security to, or attempt to induce the purchase of any security by, any person, . . . unless such broker or dealer, before any purchase, loan or other related element of the transaction is entered into; . . .
>
> (2) Obtains from such person information concerning his financial situation and needs, reasonably determines that the entire transaction, including the loan arrangement, is suitable for such person, and delivers to such person a written statement setting forth the basis upon which the broker or dealer made such determination.[128]

The third prong of the triple mandate emanates from court interpretation of the common law. Court decisions may be applicable in two distinct areas. The first area involves the Shingle Theory.[129] Since *Strong v. Repide*,[130] the concept that fraud may be implied where the relationship between two parties, though not of a fiduciary nature, raises a duty to disclose facts and the disclosure is not made, has been firmly en-

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business, a permanent bar from participation in the securities industry, or even criminal prosecution. Disciplinary action may be directed at the firm as well as the individuals responsible for the violations.

126. 17 C.F.R. § 240.15b10-3 (1967).

127. SEC Securities Exchange Act Release No. 8135 (Oct. 2, 1967).

128. 17 C.F.R. § 240.15c2-5 (1962).

129. The shingle theory was originally set forth by the Securities and Exchange Commission and has been adopted by the courts. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943); *see also* Mac Robbins & Co., SEC Securities Act Release No. 6846 (July 11, 1962).

130. 213 U.S. 419 (1909).

trenched in corporate law and securities regulation.[131] The Shingle Theory is virtually a non-rebuttable presumption that a broker-dealer undertakes to deal fairly with its customers and the public in accordance with the standards of the profession when he opens his office and hangs out his shingle. It has been held that any person, regardless of his knowledge or access to the market and market information, is entitled to rely on the implied representations made by his broker-dealer that customers will be treated honestly and fairly.[132]

The second area of court interpretation relates to the insurance industry as presented in the case of *Anderson v. Knox.*[133] An insurance salesman induced the plaintiff to purchase a bank financed insurance program by fraudulently expressing certain affirmations of fact and an opinion of *suitability*. The plaintiff relied on the salesman and in fact the program was far from suitable in light of the plaintiff's income, financial condition, prospects and family. A key factual issue of the case was whether the representation of suitability was in truth a representation of fact and not a mere expression of opinion. At the time of the sale the plaintiff did not understand the program and the insurance salesman was said to be aware of this confusion on the part of the purchaser. The court maintained that it was not necessary to determine whether a fiduciary relationship existed since the salesman had held himself out as an expert and induced the plaintiff to rely upon the salesman's statements.[134] Regardless of whether a fiduciary relationship exists between the salesman and the purchaser of insurance, the insurance sale is itself involved with a security as part of the funding program. Therefore, by virtue of the Shingle Theory and the language of *Strong v. Repide,*[135] liability could certainly be found by a court for a violation of the suitability covenant even if there were no fiduciary relationship.[136]

F. *State Regulation*

The business of underwriting insurance has been held to be greatly affected with a public interest and is not a right but rather a privilege

131. *See* Arleen W. Hughes, 27 S.E.C. 629 (1948), *aff'd*, Hughes v. SEC, 174 F.2d 969 (D.C. Cir. 1949).

132. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943). The SEC has extended the doctrine somewhat in requiring the broker-dealer to make an investigation of the issuer and its security prior to making a recommendation to a customer and also that he disclose to his customer all material facts upon which he bases his recommendation. *See* D. F. Bernheimer & Co., SEC Securities Exchange Act Release No. 7000 (Jan. 23, 1963); Charles E. Bailey & Co., 35 S.E.C. 33 (1953).

133. 297 F.2d 702 (9th Cir. 1961).

134. Exemplary damages may be awarded in addition to any compensatory damages proved where the recovery is based on an intentional deception.

135. 213 U.S. 419 (1909).

136. Certainly at least the state insurance commissioner may suspend the license of a life insurance agent for making false and fraudulent statements in selling programs. *See* Steadman v. McConnell, 149 Cal. App. 2d 334, 308 P.2d 361 (1957) wherein the court also held the relationship to be that of a fiduciary.

granted by the state wherein such insurance is to be written.[137] Because of its privileged character and in consideration of the general health and welfare of the state's citizens, the regulation and control of insurance companies has been held to be within the police power of the states.[138] This power to regulate by the states is broad and extends to all insurance brokers and companies seeking to engage in the transaction of underwriting insurance, whether carried on by a foreign or domestic company.[139] Typically, provision has been made in most states for the creation or appointment of insurance boards, superintendents, or commissioners whose general duties include the regulation and supervision of the transaction of insurance businesses within the state to protect the public's interest and to see that violations of the state's insurance laws are properly restricted.[140] Some state statutes provide that insurance boards or officials shall have the power or duty to approve or disapprove insurance policies in accordance with other statutes which prescribe what provisions policies may contain in substance in that state. The approval or disapproval may extend beyond physical appearance of the printed policy to include substantive matters relating to the statutory conformity of certain clauses or provisions in the policy.[141]

Each state has the right to regulate and license all agents and brokers who are engaged in the insurance business within that state.[142] State regulations prohibiting an agent from transacting business on behalf of a non-admitted insurer are constitutional.[143]

If the funding company's wholly-owned insurance agency subsidiary is to do business in another state, it must normally secure a non-resident agent's license or some variation thereof from the state in which it wishes to do business. There may be an exception to this requirement if the funding company's organization is developed to such an extent that executive personnel who are residents of the state can secure a normal resident's license. Usually an admitted insurance company actually sends the applications for agent's licenses to the state insurance commission. In order for the agency to sell insurance written by a particular company, the agency must first be registered with the

137. Hartford Accident and Indemnity Co. v. N.O. Nelson Mfg. Co., 291 U.S. 352 (1934); O'Gorman & Young Inc. v. Hartford Fire Ins. Co., 282 U.S. 251 (1931); Merchants Mutual Auto. Liability Ins. Co. v. Smart, 267 U.S. 126 (1925); Springer v. Colburn, 162 So.2d 513, 514 (Fla. 1964); Feller v. Equitable Life Assurance Soc., 57 So.2d 581 (Fla. 1952).

138. Osborn v. Ozlin, 310 U.S. 53 (1940); Life & Casualty Ins. Co. v. McCray, 291 U.S. 566 (1934); German Alliance Ins. Co. v. Hale, 219 U.S. 307 (1910); Springer v. Colburn, 162 So.2d 513, 514 (Fla. 1964); Feller v. Equitable Life Assurance Soc., 57 So.2d 581 (Fla. 1952).

139. *See* FLA. STAT. § 624.11 (1969).

140. *E.g.*, FLA. STAT. § 624.0100 *et seq.* (1969).

141. *See* FLA. STAT. § 627 (1969).

142. O'Gorman & Young, Inc. v. Hartford Fire Ins. Co., 282 U.S. 251 (1931); American Fire Ins. Co. v. King Lumber & Mfg. Co., 250 U.S. 2 (1919); La Tourette v. McMaster, 248 U.S. 465 (1919); State *ex rel* Vars v. Knott, 135 Fla. 206, 184 So. 752 (1938).

143. Robertson v. California, 328 U.S. 440 (1946), *reh. den.*, 329 U.S. 818 (1946).

insurance commission of the agency's home state to sell for that company. Before the funding programs can be sold in a particular state, the program's prospectus and all supplemental sales literature must be submitted to the insurance commissioner of that state for his approval[144] in addition to the programs being duly registered to meet the state's securities laws.

Many states have so-called "anti-combination" or "anti-inducement" laws included in their statutes regulating the sale of insurance. These anti-inducement statutes generally prohibit insurance companies and insurance agents from giving, selling, or purchasing any stocks, bonds, or securities as an inducement to sell insurance.[145] Opinions have been issued in some states stating that the funding programs will not be construed to be in violation of such anti-inducement statute.[146] However, other states have been most reluctant about permitting the funding programs to be sold in the state and maintained that the programs offer improper inducements to purchase insurance.[147]

III. CONCLUSION

The concept of "funding programs" is by no means merely limited to the combination of mutual fund shares with insurance. Theoretically almost any type security which could serve as sufficient collateral could operate as the "funding catalyst" in securing a loan, with which insurance premiums could be adequately financed. Variable annuities could conceivably be integrated into such a program although in and of themselves margin regulations could prove to be a prohibitive incident, unless the Board of Governors of the Federal Reserve System were to carve out another special category of the funding industry in regard to the margin requirements.

The possibilities for variations of the equity funding concept are

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144. *See* FLA. STAT. § 626.0600 *et seq.* (1969).

145. *See* FLA. STAT. § 626.0614(2) (1969); Chapter 553, section 222, MARYLAND CODE (1963). *See also* rule 330-1.12 of the Rules and Regulations of the Florida Department of Banking and Finance, Division of Securities (1969):

> Insurance Company Licenses—An insurance company not licensed to do an insurance business in the State of Florida shall meet the financial and managerial standards for licensing as prescribed by the Florida Insurance Code prior to making application to the Commission for registration of its securities.

146. *See* Opinion of Attorney General of Maryland to the Securities Commissioner of Maryland, October 25, 1963, 3 CCH BLUE SKY L. REP. ¶ 70,622 (1963); Illinois Securities Department Bulletin No. 91, January, 1961, 1 CCH BLUE SKY L. REP. ¶ 16,791.015 (1961).

Programs are now being sold in the following states: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Georgia, Hawaii, Illinois, Indiana, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, New Jersey, New Mexico, New York, Ohio, Oregon, Pennsylvania, Tennessee, Texas, Utah, Virginia, Washington, and the District of Columbia, and Puerto Rico.

147. Proposals whereby insurance premiums are financed upon or through the credit or credit facilities of either the agent or the insurer are deemed to be inducements in the State of New York to the purchase of life insurance and, unless specified in the insurance policy would violate provisions of section 209 of the New York Insurance Law.

unlimited. As a funding organization grows, it may horizontally expand into other financial products and by vertical integration it may become involved directly in the management of its own mutual fund, insurance company, bank, and savings and loan association. The organization may also sponsor and sell oil and gas participations, real estate investment trusts, and other diverse investments. Funding organizations may join other institutions in an attempt to gain membership on the New York Stock Exchange.

The anticipation of expansion into other product lines is the greatest argument for a funding organization to develop its own captive sales force. The sales organization itself may generate only token profits and, in fact, many offices within the system may be unprofitable. However, once the "pipeline" has been established the funding organization can sell its own proprietary products through its distribution system. It will be the management and control of the funds generated by the sale of these proprietary products that will generate the profits of the funding organization.

It is not expected that the infant funding industry will restrict its activities solely to this country. In recent years the overseas sale of mutual funds has stimulated the concept of an equity investment in the minds of many foreigners. Traditionally, Europeans have been exposed to and have accepted the concept of insurance. Funding in the European and foreign markets would seem the next logical step.

The industry's only limitation for future growth appears to be its capacity to obtain and train qualified sales representatives who would be able to tailor-make investment programs for the economic future and well-being of the American investor.

APPENDIX A

Model Custodial Note

ABC FUNDING, INC., a Florida Corporation, ____________ after date for value received, promises to pay to the order of ________ the sum of ____________ Dollars, plus interest thereon from the date hereof at the rate of ____ % per annum, payable at the Corporate Trust Department office of Last National Bank and Trust Company at Miami, Florida, upon presentation and surrender of this Note. This is one of the Custodial Notes issued under and secured by a Master Custodian Agreement dated January 4, 1969, as thereafter or hereafter amended, herinafter termed the "Agreement" executed by and between ABC FUNDING, INC. and Last National Bank and Trust Company as Custodian, and the rights of the holder hereof are subject to the provisions of that Agreement. For a statement of the nature and extent of the security and of the rights of the holders of said Notes under the Agreement and the terms and conditions under which they are issued and shall be issued and secured, reference is made to the Agreement. All of the Notes issued and to be issued under the Agreement at any time outstanding shall be ratably and alike secured by the Agreement. If any of the events of default specified in the Agreement shall occur, all Custodial Notes outstanding thereunder may be declared due and payable in the manner and with the effect provided in said Agreement. This note may be prepaid in whole or in part at any time and from time to time without notice or penalty but only out of funds received in payment of the unpaid principal amounts of the collateral notes given as security for the payment of Custodial Notes under said Agreement. This Note shall not be valid or become obligatory for any purpose until the certificate of authentication endorsed thereon shall have been executed by the Custodian under the Agreement.

The payee and any holder hereof by the acceptance of this Note represents to ABC FUNDING, INC. that it is being acquired for investment and not with a view to distribution as those words are used in the Securities Act of 1933, as amended.

It is expressly agreed that the undertaking of the undersigned to pay the principal amount of this note is included herein for the sole purpose of establishing the continuing existence of the indebtedness evidenced by this Note and the payee, for itself, its successors and assigns, and any holder hereof by the acceptance of this Note, agrees that if the undersigned shall fail to pay this Note when due, the payee or any holder hereof shall have recourse for the payment of the principal amount hereof only to the unpaid principal amounts of the collateral given as security for the payment of the same as hereinbefore referred to and shall have no recourse to the undersigned, its successors or assigns, for the payment of the principal amount of the indebtedness evidenced hereby.

ABC FUNDING, INC.

By: ____________________
Authorized Signature

This is one of the Custodial Notes described in the within mentioned Agreement.

LAST NATIONAL BANK AND TRUST COMPANY

By: ______________________________
Authorized Signature

APPENDIX B

MODEL COLLATERAL NOTE

One year after date, for value received, the undersigned, which term wherever used herein shall mean all and each of the principal maker(s) of this note, jointly and severally, promises to pay to ABC Funding, Inc., or order at the Corporate Trust Department offices of Last National Bank and Trust Company, at Miami, Florida, __________ Dollars, plus interest from the date hereof at the rate of ____________ per cent (____%) per annum, payable in arrears.

This Note, including interest, is secured by certificates of participation or shares representing an equity interest in one or more open-end investment companies registered under the Investment Company Act of 1940, as amended, (referred to herein as "collateral shares") pledged by the undersigned, the redemption value of which is equal to or in excess of One Hundred Fifty percent (150%) of the principal amount hereof at the date hereof. If at any time the redemption value of such collateral shares is less than One Hundred Fifty percent (150%) of the unpaid principal amount the holder shall give notice thereof by registered or certified mail, postage repaid, to ABC Funding, Inc. as the attorney-in-fact for the undersigned, and the said Corporation shall, forthwith upon receipt of such notice, either so notify the undersigned by registered or certified mail, postage prepaid, directed to the last address of the undersigned recorded on the books and records of said Corporation, or cause sufficient additional collateral shares of the undersigned, if any, to be pledged to secure the payment of this note so that the redemption value of the collateral shares pledged hereunder will then be at least One Hundred Fifty per cent (150%) of the unpaid principal amount hereof. If at any time the redemption value of such collateral shares is less than One Hundred Thirty-Five per cent (135%) of the unpaid principal amount of this note, the same shall become immediately due and payable without notice or demand and the holder hereof may thereupon, without further notice, sell or cause such collateral shares to be redeemed to the extent, in the discretion of the holder, necessary to provide cash in the amount of the unpaid principal amount hereof and accrued interest and thereafter, and upon every default by the undersigned, the holder shall have all the rights and remedies of a secured party afforded by the Uniform Commercial Code as from time to time in effect in the State of Florida or afforded by other applicable law.

It is expressly agreed that the undertaking of the undersigned to pay the principal amount of this note and accrued interest is included herein for the sole purpose of establishing the continued existence of the indebtedness evidenced by this note and the payee, for itself, its successors and assigns, and any holder hereof by the acceptance of this note, agrees that if the undersigned shall fail to pay this note when due, the payee or any holder hereof shall have recourse for the payment of the principal amount hereof and accrued interest only to the collateral given as security for the payment of the same as hereinbefore referred to and shall have no recourse to the undersigned, his legal representatives or assigns, for the payment of the amount of the indebtedness evidenced hereby.

It is furthermore expressly certified by ABC Funding, Inc. for itself, its sucessors and assigns, that this note supersedes any and all prior notes made by undersigned or ABC Funding, Inc. as attorney-in-fact for the undersigned; that the unpaid principal amount of any such prior note or notes, and the unpaid amount of accrued interest under any such prior note or notes, has been included in the principal amount hereof; and that any such prior note or notes have been cancelled in accordance with the provisions of a Master Custodian Agreement dated January 4, 1969, as thereafter or hereafter amended, executed by and between said ABC Funding, Inc. and Last National Bank and Trust Company.

Notwithstanding anything otherwise herein contained, this note shall not be obligatory in respect of the principal maker if transferred by ABC Funding, Inc. to any person other than the Custodian under said Master Custodian Agreement to be held by said Custodian as collateral security subject to the terms and provisions of that Agreement or obligatory for any purpose unless certified by said Custodian in the form hereinafter provided; and interest and charges, if any, charged or contracted for hereunder in no event shall exceed the maximum amount permitted by law.

This note may be prepaid in whole or in part at any time and from time to time without notice or penalty.

No delay or omission on the part of the holder in exercising any right hereunder shall operate as a waiver of such right or of any right of such holder, nor shall any delay, omission or waiver on any one occasion be deemed a bar to or waiver of the same or any other right on any future occasion. Every one of the undersigned and every endorser or guarantor of this note regardless of the time, order or place of signing waives presentment, demand, protest, and notices of every kind and assents to any extension or postponement of the time of payment or any other indulgence, to any substitution, exchange or release of collateral, and to the addition or release of any other party or person primarily or secondarily liable.

	Name(s) of principal maker(s):
Insurance Company:	____________________
	____________________
Policy Number:	By: *ABC FUNDING, INC.* as Attorney-in-fact
Date of Issue:	By: ________________ Authorized signature

This is one of the collateral notes held as a part of the collateral security subject to the aforesaid Master Custodian Agreement.

We hereby certify that the principal amount of the foregoing note does not exceed (1) the unpaid principal amount of any prior collateral note in the name of the maker(s) held by the Bank as part of the collateral security under the aforesaid Master Custodian Agreement, plus (2) any accrued but unpaid interest thereon, plus (3) the current premium on an insurance policy or policies on behalf of the maker(s).

Dated: ____________

LAST NATIONAL BANK AND TRUST COMPANY

By: ________________________
Authorized Signature