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A DISCUSSION AND ANALYSIS OF THE VALIC DECISION

LAURENCE M. JONES †

THE PROBLEM.

PROBABLY the most controversial development in the insurance business in recent years has been the variable annuity.¹ Although it was introduced in this country in 1952 by the Teachers Insurance and Annuity Association (TIAA) when it organized the College Retirement Equities Fund (CREF) in an attempt to provide a retirement plan for teachers which would to some extent compensate for the inflation of recent years, the variable annuity caused no particular discussion until some commercial insurance companies proposed to issue such policies for sale to the general public. Since such proposals were made there has been a great schism among insurance authorities regarding the propriety of insurance companies issuing such contracts. On the one hand are those companies which consider variable annuities as merely a development of the annuity contract to meet modern situations and thus a definite part of the traditional insurance business. The opposition considers annuities as requiring a promise to pay a fixed sum, and since the amount payable under variable annuities depends on the returns from investments, such contracts should be considered as securities and not insurance.²

Actually there are two problems involved: one is whether variable annuities should be issued by insurance companies or investment

† Professor of Law, University of Maryland School of Law. A.B. 1930, J.D. 1932, State University of Iowa; LL.M. 1933, S.J.D. 1934, Harvard University.

1. Although some have objected to the use of the term variable annuity as a paradox, it seems to be accepted as the best description of a contract by which a principal sum and the income earned by it is to be distributed in periodic payments, the amount of the payments to vary depending on the rate of return actually earned. See Bellinger, Hagmann, and Martin, *The Meaning and Usage of the Word "Annuity,"* 9 J. AM. SOC'Y C. L. U. 261 (1955) opposing the use of the term. Compare Day, *A Variable Annuity Is an Annuity*, 1955 INS. L.J. 775 favoring the use of the term. See also HUEBNER AND BLACK, *LIFE INSURANCE* 99-100 (5th ed. 1958) comparing traditional and variable annuities.

2. These divergent points of view are illustrated by the following articles in 1956 INS. L.J.: Johnson, *The Variable Annuity; What It Is and Why It Is Needed* 357; Kvernland, *Some Economic and Investment Aspects of Variable Annuities* 373; Haussermann, *The Security in Variable Annuities* 382; Long, *The Variable Annuity; A Common Stock Investment Scheme* 393; Schechter, *Variable Annuities — Boon or Bane?* 764; Pyle, *The Case Against Variable Annuities* 776. In addition see Day and Melnikoff, *The Variable Annuity as a Life Insurance Company Product*, 10 J. AM. SOC'Y C. L. U. 45 (1955); Day, *A Variable Annuity Is Not a "Security"*, 32 NOTRE DAME LAW. 642 (1957); Morrissey, *Dispute Over the Variable Annuity*, 35 HARV. BUS. REV. 75 (1957).

companies, *i.e.*, whether such annuities should be treated as insurance or securities from the standpoint of economics; the other is whether such annuities should be treated as insurance or securities for the purpose of regulation by governmental authorities. Both problems involve the process of classification, the one from the standpoint of the economics of the insurance business versus the investment business, while the other is purely a legal matter for the courts and legislature to decide.

This problem of classification is not new; the courts traditionally have approached new problems by attempting to classify the situation before them under one of the accepted concepts and then applying the rules, principles, and standards applicable to that concept. This approach becomes difficult, if not impossible, when the new situation involves elements of several of the traditional concepts; it is like attempting to fit a square peg into a round hole. The difficulty becomes particularly acute when, as in the case of the variable annuity, the new situation has been deliberately created by combining the elements of several concepts in an attempt to create a new business device. The problem may arise in many ways; *e.g.*, in determining which principles of the common law should be applied, in interpreting legislation, or in deciding how business should be regulated. In each instance the assumption is that once the proper classification is made the problem will be solved; this seems to be the fallacy in such an approach. The mere arbitrary classification of a new situation under an old concept does not necessarily solve anything; in fact, it may create new problems. The real question is what body of law should be applied to this situation, or did the legislature contemplate this sort of transaction when the statute was passed, or how and by what agency should this business be regulated.

In the variable annuity there is just this sort of situation, a new type of business transaction which combines some of the elements of the traditional insurance contract with ideas taken from the investment business. The immediate question is what agency or agencies are going to regulate the business of issuing variable annuities.³ In the past the insurance business has been regulated by the states, as opposed to the federal government, through special administrative agencies. This is due to the decisions in *Paul v. Virginia*⁴ which for seventy-five years

3. The preliminary problem of who should issue such contracts, insurance companies or investment companies, seems to have been answered; several insurance companies have issued, or have indicated they are going to issue, such policies. Apparently no investment company has yet done so. However, some investment companies offer separate insurance and annuity contracts in connection with their periodic payment plans.

4. 75 U.S. (8 Wall.) 168 (1868).

imposed constitutional limitations on the power of the federal government to regulate insurance companies. Although these limitations have now been removed as a result of the decision in *United States v. South-Eastern Underwriters Ass'n*,⁵ the federal government, with limited exceptions, has refrained from exercising its power over insurance companies.⁶ However, the power is now there, and the conflict between state and federal regulation is weighted in favor of the federal government which can, when and if it wishes, appropriate the field. On the other hand the investment business, the issuing and sale of securities, has been and is regulated by both state and federal authorities. The first regulations, the Blue Sky Laws, were state regulations developed to prevent certain abuses in financing of business organizations. In recent times the federal government through the Securities and Exchange Commission has taken over much of the field although it has not yet completely excluded the states.⁷

The present problem, therefore, is one of determining who is to regulate the issuing of variable annuities and the sort of regulations which are to me imposed.⁸ It is no longer a question of power since both the state and federal governments have the power to regulate; it is simply a matter of policy, more specifically of federal policy, and at present Congress has determined to leave the regulation of the insurance business to the states while sharing the regulation of the investment and securities business with the state agencies. Thus for the moment it becomes necessary to classify variable annuities as either insurance or securities in order to determine by whom and how they shall be regulated. Before attempting such a classification, it may be helpful to analyze the concept of insurance, including the traditional

5. 322 U.S. 533 (1944).

6. Following the decision in the *Southeastern Underwriters* case, Congress passed the McCarran Act, 59 STAT. 33, 15 U.S.C. §§ 1011-15, which provides that the business of insurance shall be subject to the laws of the several states, and, with certain exceptions, no act of Congress shall be construed to invalidate or supersede any law enacted by any state for the purpose of regulating the business of insurance unless such act specifically relates to insurance. Exceptions are also made in the Securities Act of 1933, 48 STAT. 74, 15 U.S.C. § 77a, and the Investment Company Act of 1940, 54 STAT. 789, 15 U.S.C. § 80a-1 for the purpose of exempting insurance companies from the operation of these acts.

7. For a good discussion of the history and background of the regulation of the issuance of securities in England and America see LOSS, SECURITIES REGULATION ch. I (1951); ch. II deals with state regulation of securities and ch. III with the federal regulations, such as the Securities Act of 1933, the Security Exchange Act of 1934, and the Investment Act of 1940. See also LOSS AND COWETT, BLUE SKY LAWS ch. I (1958).

8. The specific question before the court in the *VALIC* decision, to be discussed later, was somewhat more limited. It was whether the respondents had to register with the Securities and Exchange Commission under the Securities Act of 1933 and comply with the Investment Company Act of 1940 before offering their variable annuity contracts to the public. However, it is the broader aspect of the problem which has attracted so much attention and caused so much discussion.

fixed-sum annuity, note how the insurance business is regulated and the purpose of such regulation, and then compare the investment and securities business and the manner in which it is regulated in order to determine which is more nearly like the variable annuity and which sort of regulation will better protect the public.

THE BUSINESS OF INSURANCE.

It is difficult to give a simple definition of insurance which will cover all phases of the business, but essentially it is a contract whereby one party, the insurer, agrees to indemnify another for a loss suffered as the result of a fortuitous event.⁹ Insurance is a type of risk-shifting device which normally involves the collection of a fund from many persons subject to the same risk, and from the fund so collected those persons who suffer a loss are reimbursed. In the case of life insurance, which is the type of insurance in which we are interested, the fund is collected from the premiums charged policy holders. The risk insured against is the chance of an early death; the uncertainty is the time of the loss (death), not the loss. Since in life insurance, other than term insurance, the eventual loss (death) is certain, the total of the premiums charged plus the interest which will be earned, minus the expenses, must equal the face value of the policies at maturity. The amount of the premiums is determined by past experience (losses) as reflected in the mortality tables, anticipated earnings (interest), and the cost of operation (expenses). Thus life insurance consists of collecting sums of money (premiums) from the policy holders which will, over a period of years, equal the face value of the policies at maturity. By combining many individual risks into a group and using the mortality tables the uncertainty, in the case of the individual, can be made certain in the case of the group; life insurance can thus be placed on a scientific and economically feasible basis.

An annuity contract, on the other hand, involves just the opposite type of calculations, for an annuity is an agreement to pay out a sum of money, plus earnings, in a series of installments. The problem is

9. There are as many definitions of insurance as there are attempts to define the term, and most writers, either before or after stating their definition, attempt to explain in some detail the meaning of the terms used. Professor Patterson has noted that what constitutes insurance may be different for different purposes, and thus we must know what the problem is before attempting to define the term. PATTERSON, *CASES AND MATERIALS ON INSURANCE* 2 (3d ed. 1955). This is a particularly apt comment in relation to the present problem which, as Mr. Justice Douglas pointed out, is whether the term insurance as used in certain federal statutes includes the concept of variable annuities. *SEC v. Variable Annuity Life Ins. Co.*, 79 Sup. Ct. 618, 620-21 (1959). The Securities and Exchange Commission will hereinafter be referred to as SEC and the Variable Annuity Life Insurance Company as VALIC; the case will be cited as *SEC v. VALIC*.

to determine how much money it is necessary to have on hand at the start to insure the continuance of the installments throughout the period during which payments are to be made. This, as previously stated, is just the reverse of life insurance but involves the same type of calculations. In the case of a life annuity the mortality tables must be used, the anticipated earnings must be determined, and the expenses must be deducted. Thus annuities have always been considered as a legitimate part of the insurance business.¹⁰ A simple comparison of life insurance and annuities may be made in the case of single-premium policies. In life insurance the amount of the premium must be sufficient, together with the interest it will earn in the future, to equal the face value of the policy at maturity plus the cost of operation. In an annuity the amount of the single premium must be sufficient, together with the interest which will be earned in the future, to equal the sum of the installments to be paid plus the expenses. Thus both life insurance and annuities involve the same type of calculations to place them on a scientific and economic basis. In both instances the insurer makes a definite promise; in both the insurer takes the risk of poor mortality experience, fluctuation in the interest rate, and higher than anticipated expenses.¹¹

THE REGULATION OF INSURANCE COMPANIES.

Up to the present time the regulation of insurance companies and of the insurance business has been left almost entirely to the states. This is due to the historical accident of the decision in the case of *Paul v. Virginia*.¹² By placing constitutional limitations on the power of the federal government to regulate the insurance business, it left the states as the only effective political organization which could exercise control. Regulation developed because of abuses which occurred in the early days of the business and is still required because of the size of the business and its influence on the economic structure of society.¹³ The growth of life insurance in the United States in modern times has created a relatively few large companies with tremendous assets which must be invested properly if the companies are to be operated according to sound economic principles. Actually, these large sums represent money collected from policy holders which is to

10. HUEBNER AND BLACK, *LIFE INSURANCE* ch. 8 (5th ed. 1958). MACLEAN, *LIFE INSURANCE* ch. 3 (8th ed. 1957).

11. *Ibid.* See also Bellinger, Harmann, and Martin, *The Meaning and Usage of the Word "Annuity"*, 9 J. AM. Soc'y C. L. U. 261, 268 (1955).

12. 75 U.S. (8 Wall.) 168 (1868).

13. For the story of the scandals which led to the investigation by Charles Evans Hughes and the resulting legislation, see PUSEY, *CHARLES EVANS HUGHES* ch. 15 (1951).

be paid back to them when the policies mature. The policy holders, therefore, have an interest in how these funds are managed and the investment of them is of great concern to the government. It is important to make certain that proper reserves are provided and to see that the investments are the sort which will conserve the principal and produce the income required to pay claims as the policies mature. Since the policies mature slowly at long periods in the future, the types of investments required are long-term, fixed-sum, interest-bearing obligations. Thus the first regulations were designed to insure the sound economic organization and operation of the companies; this was accomplished by regulating the capital structure, requiring maintenance of proper reserves, and limiting the type of investments which might be made by insurance companies.¹⁴ More recently the licensing of agents has been required in order to prevent fraud and misrepresentation; the terms of the policies have been regulated; and, in some types of insurance, the rates to be charged are set.¹⁵ The history of governmental control of the insurance business and the type of regulations imposed indicate that the primary purpose is to insure that the companies will be organized and operated on an actuarially sound basis, and that the public will not be misinformed when dealing with insurance agents.

THE INVESTMENT BUSINESS — SECURITIES.

In the early history of this country the investments available consisted primarily of real estate mortgages and the obligations of municipal, state and federal governments. When the corporate form of organization became the typical business arrangement, other types of investments appeared. Corporate bonds representing debt type investments, and stocks representing equity or ownership investments became common. However, it was not until very recently that the small investor became an important factor in the securities market; this is especially true in the case of corporate stocks. The modern development which has brought thousands of small investors into the securities market is the mutual fund. These funds operate by selling shares to the individual investor, taking the money contributed by the shareholders and reinvesting it in corporate securities, usually common stocks.¹⁶ These securities are held in the fund and the dividends re-

14. See PATTERSON, *ESSENTIALS OF INSURANCE LAW* §§ 3, 4 (2d ed. 1957).

15. *Id.* §§ 5, 6, 7, 8.

16. There are now many types of mutual funds; some are the "closed-end" type in which only a limited number of shares are issued, while others are "open-end" in which an unlimited number of new shares may be issued. In certain funds the

ceived from them are in turn distributed to the shareholders. At regular intervals, for example, monthly, the value of the shares is determined by dividing the value of the total assets held by the fund by the number of outstanding shares; new shares may be bought or sold at this price until the next valuation period.¹⁷

The purpose of such funds is to give the small investor an opportunity to secure a fair return on his money and share in the growth of the economic system while receiving professional management of his funds. By regularly investing small amounts in the shares of a mutual fund, the average individual is able to secure many of the advantages, including diversification, heretofore available only to the large investor. Of course, the investor in a mutual fund runs the risk of a partial or complete loss of his money if the management of the fund is poor; the risk of the investment is on the participants in a mutual fund. However, the experience of the funds has been very good.¹⁸

THE REGULATION OF THE INVESTMENT BUSINESS.

The rapid expansion of business and the promotion of corporations in this country at the end of the nineteenth and the beginning of the twentieth centuries brought scandals and misuse of the funds of the investors which resulted in the passage of the first regulatory laws, the so-called Blue Sky Laws.¹⁹ These were state statutes, and the control and regulation of business corporations remained almost exclusively a state function until after the business depression in the thirties. The early laws were mostly of the anti-fraud type, designed

investments are balanced between equity and debt type investments; in others the investments are limited to those which are picked for the purpose of assuring a steady income, while still others choose investments with the idea of securing capital gains. In some funds the investments are limited to business engaged in certain types of activities, such as electronics or drugs. For a general discussion of mutual funds see Carter, *Mutual Investment Funds*, 27 HARV. BUS. REV. 715 (1949).

17. There are certain charges made by the operators of the fund to cover management expenses and the price at which new shares are offered for sale is somewhat higher than the redemption price at which the fund repurchases shares from shareholders. *Ibid.* Part of the government's objection to the variable annuity contracts issued by VALIC was based on the fact that the charges deducted from the premiums paid by the policyholders exceeded the amounts which investment companies are allowed to charge as management fees. See SEC's brief at 22-23, 29, SEC v. VALIC, 79 Sup. Ct. 618 (1959).

18. For example, the net asset value of one share in the Massachusetts Investors Trust has increased from \$3.81 at the time shares were first offered on July 15, 1924, to \$13.46 on Sept. 30, 1959. The year-end values at five-year intervals are as follows: 1924 — \$4.04; 1929 — \$6.84; 1934 — \$3.13; 1939 — \$3.50; 1944 — \$3.90; 1949 — \$4.61; 1954 — \$9.33. Massachusetts Investors Trust, 141st Quarterly Report, Sept. 30, 1959.

19. See LOSS AND COWETT, BLUE SKY LAWS ch. I (1958) giving the history and background of the Blue Sky Laws; also LOSS, SECURITIES REGULATION ch. I (1951) for a history of securities legislation in England and America, and ch. II for a discussion of state regulation of securities.

to require full disclosure of all the pertinent facts relating to the issuance of the securities and to prevent fraudulent representations being made to the purchasers. These were followed by statutes requiring the registration and regulation of persons engaging in the business of selling securities, and finally by acts requiring the registration of the securities themselves.²⁰ However, the losses resulting from the failure of businesses in the depression period of the thirties, the scandals which followed the disclosures that securities had been issued and sold without adequate value behind them, and that fraudulent representations had been made to the purchasers caused the federal government to enter the field of security regulation. It was quite obvious that the state Blue Sky Laws with their varying requirements could not adequately control the evils because of the interstate nature of the business, the variation in the acts, and the laxity of enforcement in many instances.²¹

The first of the federal regulations was the Securities Act of 1933²² which combined disclosure requirements with anti-fraud measures. This was followed by the Securities and Exchange of 1934²³ which created the Securities and Exchange Commission and provided for the regulation of the securities market. Later came the Investment Company Act of 1940²⁴ which dealt directly with the regulation of mutual funds. It requires the registration of such companies, a statement of their plans regarding diversification, borrowing, lending, underwriting, and investment policies. The act is designed to accomplish five objectives: (1) regulate selling practices, (2) provide honest and unbiased management, (3) assure participation in the management by the shareholders, (4) provide adequate and feasible capital structures, and (5) require financial statements and accounting to security holders. From the definitions and exceptions included in these acts it is clear that mutual funds are subject to the controls therein provided unless they are expressly excepted. The purpose of the regulations imposed by these acts is to require anyone issuing or selling securities to make a full disclosure of all pertinent facts so that an interested investor may have

20. Most modern acts combine all three types of provisions. *Ibid.*

21. LOSS, SECURITIES REGULATIONS ch. III (1951). The Uniform Securities Act is designed to overcome the objection that state statutes may vary from state to state; however, in view of the variations in the so-called uniform acts which have been enacted by various states it is doubtful if it will entirely accomplish that objective. See note 63 *infra*.

22. 48 STAT. 74, 15 U.S.C. § 77a. This statute will be referred to as the Securities Act.

23. 48 STAT. 881; 15 U.S.C. § 78a.

24. 54 STAT. 789, 15 U.S.C. § 80a-1. This statute will be referred to as the Investment Company Act. For a good discussion of this act see Note, *The Investment Company Act of 1940*, 41 COLUM. L. REV. 269 (1941). There are, of course, other federal statutes regulating the offering and issuance of securities, but these are the ones which are involved in the present controversy.

an opportunity to decide for himself whether to take the risk involved in making the investment.

THE VARIABLE ANNUITY.

A variable annuity differs from a traditional annuity in that the amounts received by the annuitant may vary from period to period.²⁵ Assuming the annuity is paid monthly, this means the income received by the annuitant may vary from month to month depending on the investment experience of the issuing company and how often the annuity is revalued.²⁶ Thus the annuitant runs the risk of the investment policies of the issuing company and conceivably might receive no income if the investments proved worthless. On the other hand, if the investments are highly successful and produce a large return his payments will increase accordingly. Actually the companies issuing variable annuities assume an anticipated interest rate in evaluating their contracts, and only in so far as their experience varies from the anticipated rate will there be any fluctuation.²⁷ If their experience continues to be as good as that of the mutual funds, the holders of the variable annuities run very little risk of complete loss of income although there will be some variation depending on business conditions.²⁸

The variation in the amounts payable under a variable annuity occurs because the insurer does not contract to pay a definite sum (enter into a debt obligation) but puts the premiums into an accumulation fund which is in turn invested in common stocks. During the

25. There have always been annuities in which the actual amount received by the annuitant has varied; *e.g.*, participating annuities in which the amount payable varies depending on the income earned by the company and its mortality experience. See MACLEAN, *LIFE INSURANCE* 57-58 (1957). However, the variation in such instances is more or less incidental, and is the result of sharing in a favorable investment experience without any risk of loss to the annuitant if the experience should be unfavorable to the company. Such contracts are quite different from the variable annuities issued by VALIC. SEC v. VALIC, 79 Sup. Ct. 618, 631-2 (1959); Maclean, *supra* at 55-56.

26. CREF apparently determines the value of its annuity units on a yearly basis while VALIC seems to use a monthly basis. This means that the amount received by the annuitant each month will remain constant throughout the year under a CREF annuity but will vary each month under a VALIC contract. See *THE BIRTH AND WORTH OF A CREF ANNUITY UNIT*, pamphlet issued by CREF. See also SEC v. VALIC, 79 Sup. Ct. 618, 630 n. 28 (1959). During the pay-in period both companies revalue the accumulation units monthly. SEC v. VALIC, *supra* at 628; CREF pamphlet, *supra*.

27. VALIC uses an annuity table which assumes an interest rate of 3½%. SEC v. VALIC, 79 Sup. Ct. 618, 630 (1959); VALIC's brief at 9-10, SEC v. VALIC, *supra*.

28. The value of an annuity unit and the payments under the annuities issued by CREF have varied as follows: Initial value — \$10; 1953-54 — \$9.46; 1954-55 — \$10.74; 1955-56 — \$14.11; 1956-57 — \$18.51; 1957-58 — \$16.88; 1958-59 — \$16.71; 1959-60 — \$22.03. See GREENOUGH AND KING, *RETIREMENT AND INSURANCE PLANS IN AMERICAN COLLEGES* 40 (1959).

accumulation period²⁹ an annuitant is credited with a certain number of accumulation units each time he pays a premium; the number will depend on the value of a unit, and the value of a unit varies from period to period. To determine the value of an accumulation unit for any period, the insurer tabulates the total value of all the stocks held by the fund and divides this value by the total number of outstanding accumulation units.³⁰ During this pay-in period the accumulation units which the annuitant receives in return for his premiums represent his share in the accumulation fund and are quite similar to shares in a mutual fund. If there are no restrictions on the transfer or sale of the accumulation units or if there are no insurance features incorporated in the contract this similarity is very great. On the other hand, if the sale or transfer of the units is restricted or if the variable annuity contract also includes some life insurance protection or waiver of premium benefits, the similarity is not so great.³¹

When the time arrives for the annuity payments to begin (the payout period), the accumulation units are converted into annuity units. At this point the variable annuity begins to look more like the traditional annuity and less like a share in a mutual fund. To determine the number of annuity units to which an annuitant is entitled, the value of his accumulation units is first determined; then by the use of the mortality tables and the application of actuarial science it is possible to determine how many annuity units can be paid to the annuitant monthly for life.³² The annuitant is thus assured of an income which he cannot outlive, as in the case of a traditional fixed-sum annuity, and which will over the period of his life liquidate the value of his accumulation units. These

29. The discussion assumes that the contract calls for a deferred annuity in which the cost of the annuity is paid not in a lump sum but by making a series of payments over a period of time. These premiums are invested and the interest earned is accumulated and added to the principal until the time arrives for the annuity payments to begin. At that time the sum accumulated must be sufficient to purchase an immediate annuity of the amount desired.

30. See *SEC v. VALIC*, 79 Sup. Ct. 618, 628 n. 25 (1959); *THE BIRTH AND WORTH OF A CREF ANNUITY UNIT*, pamphlet issued by CREF.

31. Under the CREF plan the annuity contracts are not transferable, have no cash surrender value, and do not provide waiver of premium or other insurance features. Failure to pay premiums does not terminate the contract, but premium payments may be resumed only after a lapse of five years except in limited circumstances. *YOUR RETIREMENT ANNUITY 6-7*, pamphlet issued by TIAA (1959). The VALIC contracts include five-year declining-term life insurance benefits, a grace period for the payment of premiums, cash surrender and loan provisions, and waiver of premium benefits at any time prior to the commencement of the annuity payments. *SEC v. VALIC*, 79 Sup. Ct. 618, 627-30 (1959); VALIC's brief at 21-23, *SEC v. VALIC*, *supra*. The proposed Prudential plan apparently contains very few insurance features and limited surrender rights. Day and Melnikoff, *The Variable Annuity as a Life Insurance Company Product*, 10 J. AM. Soc'y C. L. U. 45 (1955).

32. This determination takes into account the mortality factor. See *SEC v. VALIC*, 79 Sup. Ct. 618, 630 n. 28 (1959); *THE BIRTH AND WORTH OF A CREF ANNUITY UNIT*, pamphlet issued by CREF.

payments will expend both the principal and income of the fund, rather than merely distributing the earnings as in the case of shares in a mutual fund, and this constitutes the principal difference between a variable annuity and a mutual fund. This arrangement whereby both the principal and income of a fund are to be paid out in a series of installments can be accomplished only by actuarial calculations which take account of the mortality factor.

Once the number of annuity units is determined it remains constant during the pay-out period; however, the actual income in dollars received by the annuitant may vary from period to period. This variation occurs because the value of an annuity unit changes from period to period and reflects the investment experience of the annuity fund, just as the value of an accumulation unit varies during the pay-in period and depends on the investment experience of the accumulation fund. To determine the value of an annuity unit for any period the current market value of all the investments held by the annuity fund is divided by the total number of annuity units outstanding. By multiplying the number of annuity units owed to any annuitant by the value of one unit the actual income payable to that annuitant can be determined. How often the value of the annuity unit is determined will depend on the practice of the particular company,³³ but once the annuity option has been selected and the pay-out period has begun, it is no longer possible for the annuitant to withdraw from the plan or liquidate his units by "cashing in" his holdings; he is completely "locked in" and is dependent on the management and investment policies of the company for his protection. It was this feature of the plan which convinced the concurring Justices in the *VALIC* decision that the owner of a variable annuity needed the protection of the federal statutes regulating investment companies as much as, or even more than, a shareholder in a mutual fund.³⁴

THE SUPREME COURT DECISION.

It is now necessary to consider the decision of the Supreme Court in the case of *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*.³⁵ The action was instituted by the SEC³⁶ to enjoin VALIC³⁷ from offering its variable annuity contracts to the public without registering them under the Securities Act of

33. See note 26 *supra*.

34. SEC v. VALIC, 79 Sup. Ct. 618, 631 (1959).

35. 79 Sup. Ct. 618 (1959); 28 *FORDHAM L. REV.* 379 (1959); 1959 *WASH. U.L.Q.* 206.

36. The National Association of Securities Dealers, Inc. (NASD) was allowed to intervene as a petitioner. SEC v. VALIC, 79 Sup. Ct. 618, 619 n. 1 (1959).

37. The Equity Annuity Life Insurance Company (EALIC) was allowed to intervene as a respondent. *Ibid.*

1933³⁸ and without complying with the Investment Company Act of 1940.³⁹ The District Court denied relief⁴⁰ and the Court of Appeals affirmed;⁴¹ the Supreme Court reversed in a five to four decision in which only three Justices joined in the majority opinion, two others concurring in a separate opinion. The majority, if one can thus describe the opinion of Mr. Justice Douglas, held that the federal statutes were applicable, that the contracts offered by the respondents did not constitute insurance as commonly understood because there was no risk-taking, and that the respondents did not come within the provisions exempting insurance contracts and insurance companies from the federal regulations. The concurring Justices considered the intent and purpose of Congress in passing the legislation and the actual operation of the respondents' contracts in holding that their activities came within the scope of the statutes. The dissent, on the other hand, found nothing in the federal acts indicating an intent on the part of Congress to change our traditional policy of leaving the regulation of insurance to the states,⁴² and feeling that variable annuities are a bona fide development in the field of insurance, held that they should be exempt from the regulations.

Even though both the Securities Act and the Investment Company Act contain provisions exempting insurance and insurance companies,⁴³ the majority held them applicable to the variable annuities issued by the respondents. Mr. Justice Douglas pointed out that these are federal statutes and the term insurance as used in them is a matter for the federal courts to interpret. Since state courts and insurance commissioners had taken different views regarding variable annuity contracts, he concluded there was no uniform meaning which could be implied from the use of the term insurance in the federal acts. Mr. Justice Harlan, dissenting, replied:

38. 48 STAT. 74, 15 U.S.C. § 77a.

39. 54 STAT. 789, 15 U.S.C. § 80a-1.

40. SEC v. Variable Annuity Life Ins. Co., 155 F. Supp. 521 (1957); 43 CORNELL L. Q. 517 (1958); 26 GEO. WASH. L. REV. 344 (1958); 46 GEO. L. J. 542 (1958); 71 HARV. L. REV. 562 (1958); 56 MICH. L. REV. 656 (1958); 33 N. Y. U. L. REV. 76 (1958); 106 U. PA. L. REV. 483 (1958); 11 VAND. L. REV. 1453 (1958); 4 VILL. L. REV. 147 (1958).

41. SEC v. Variable Annuity Life Ins. Co., 257 F.2d 201 (1958); 32 TEMP. L. Q. 121 (1958).

42. See note 6 *supra*.

43. Section 3 (a) (8) of the Securities Act, *supra* note 38, provides that the provisions of the act shall not apply to any insurance or endowment policy or annuity contract issued by a corporation subject to the supervision of the insurance commissioner of any state. Section 3 (c) (3) of the Investment Company Act, *supra* note 39, provides that an insurance company is not an investment company within the meaning of the act; Section 2 (a) (17) of the same act defines an insurance company as a company which is organized as an insurance company, whose predominant business activity is the writing of insurance, and which is subject to supervision by the insurance commissioner of a state.

"I can find nothing in the history of the Securities Act of 1933 which savors in the slightest degree of a purpose to depart from or dilute this traditional federal 'hands off' policy respecting insurance regulations. On the contrary, the exemption of insurance from that Act, which is couched in the broadest terms, reflected not merely adherence to tradition but also compliance with a supposed command of the Constitution."⁴⁴

And with respect to the Investment Company Act, he stated:

"Similarly, I can find nothing in the history of the Investment Company Act of 1940 which points in any way to a change in federal policy on this score. Here tradition, perhaps more than constitutional doubt, explains the exemption of insurance companies from the Act."⁴⁵

In referring to the provisions exempting insurance and insurance companies from the effect of the federal acts, the concurring Justices said:

"Except for these exclusions, there is little doubt that these contracts and the companies issuing them would be subject to the Federal Acts."⁴⁶

Thus we are brought to the determining question which is whether variable annuity contracts are to be considered insurance within the meaning of these federal statutes. In reaching their decisions the various Justices considered the nature and purpose of the variable annuity, its investment and insurance features, and all of them recognized that it contained some elements of insurance. The majority stated:

"In some respects the variable annuity has the characteristics of the fixed and conventional annuity; they continue until the annuitant's death or in case other options are chosen until the end of a fixed term or until the death of the last of two persons; payments are made both from principal and income; and the amounts vary according to the age and sex of the annuitant. Moreover, actuarially both the fixed-dollar annuity and the variable annuity are calculated by identical principles. Each issuer assumes the risk of mortality from the moment the contract is issued. That risk is an actuarial prognostication that a certain number of annuitants will survive to specified ages. Even if a substantial number live beyond their predicted demise, the company issuing the annuity — whether it be fixed or variable — is obligated to make the annuity payments on the basis of the mortality prediction reflected in the contract. This is the mortality risk assumed both by respondents and by those who issue fixed annuities. It is this

44. SEC v. VALIC, 79 Sup. Ct. 618, 635 (1959).

45. *Id.* at 636.

46. *Id.* at 623.

feature, common to both, that respondents stress when they urge that this is basically an insurance device.”⁴⁷

The concurring Justices agreed that the contracts contained insurance features :

“Obviously they have elements of conventional insurance, even apart from the fixed-dollar term life insurance and the disability waiver of premium insurance sold with some of these contracts (both of which are quite incidental to the main undertaking). They patently contain a significant annuity feature (unless one defines an annuity as a contract necessarily providing fixed-sum payments), and the granting of annuities has been considered part of the business of life insurance.”⁴⁸

Mr. Justice Harlan, speaking for the dissent, put it even stronger :

“It is certainly beyond question that the ‘mortality’ aspect of these annuities — that is the assumption by the company of the entire risk of longevity — involves nothing other than classic insurance concepts and procedures, and I do not understand how that feature can be said to be ‘not substantial,’ determining as it does, apart from options, the commencement and duration of annuity payments to the policyholder.”⁴⁹

But in spite of these features a majority of the Justices held the federal statutes applicable.

Other features of the contracts convinced the court that companies issuing variable annuities should be subject to the regulatory provisions of the federal acts. These features are : (1) the premiums paid by the annuitants are to be invested in equity securities, primarily common stocks; and (2) the benefit payments will vary with the results of the investment policy of the company; no investment risk is taken by the company. During the pay-in period the position of the annuitant is quite similar to that of a shareholder in an investment company; this was recognized by all the Justices. The majority opinion stated :

“The difficulty is that, absent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interests reflects — which may be a lot, a little, or nothing.”⁵⁰

The concurring Justices indicated the same attitude :

“But the point is that, even though these contracts contain, for what they are worth, features of traditional annuity contracts, ad-

47. *Id.* at 621.

48. *Id.* at 627.

49. *Id.* at 634-5.

50. *Id.* at 621-2.

ministering them also involves a very substantial and in fact predominant element of the business of an investment company, and that in a way totally foreign to the business of a traditional life insurance and annuity company, as traditionally regulated by state law. This is what leads to the conclusion that it is not within the intent of the 1933 and 1940 statutes to exempt them."⁵¹

Again the same Justices said:

"But what the investor is participating in during this period, despite its acknowledged 'insurance' features, is something quite similar to a conventional open-end management investment company, under a periodic investment plan."⁵²

Even the dissent admits the similarity:

"On the other hand it cannot be denied that the investment policies underlying these annuities, and the stake of the annuities in their success or failure, place the insurance company in a position closely resembling that of a company issuing certificates in a periodic payment plan."⁵³

Viewing the respondent's operations as essentially similar to those of a mutual fund investment company, Mr. Justice Brennan concludes that the regulatory provisions of the Securities and Investment Company Acts should apply. He reaches this conclusion after examining the purpose of the federal regulations and comparing them with state insurance regulations. The latter, he believes, are designed primarily to guarantee the economic soundness of traditional insurance companies, the solvency and adequacy of reserves to meet the company's fixed-debt obligations. Where the only obligation of the company to pay is dependent upon the results of its investment policies, a different sort of regulation is required:

"But the situation changes where the coin of the company's obligation is not money but is rather the present condition of its investment portfolio. To this extent, the historic functions of state insurance regulation become meaningless. Prescribed limitations on investment and examination of solvency and reserves become perfectly circular to the extent that there is no obligation to pay except in terms measured by one's portfolio. . . .

"In this sort of operation, examination by state insurance officials to determine the adequacy of reserves and solvency becomes less and less meaningful. The disclosure policy of the Securities Act of 1933 becomes, by comparison, more and more relevant. And the detailed protections of the 1940 legislation — disclosure of invest-

51. *Id.* at 627.

52. *Id.* at 629.

53. *Id.* at 635.

ment policy, regulation of changes of that policy, or capital structure, conflicts of interest, investment advisers — all become relevant in an acute way here. These are the basic protections that Congress intended investors to have when they put their money into the hands of an investment trust; there is no adequate substitute for them in the traditional regulatory controls administered by state insurance departments, because these controls are not relevant to the specific regulatory problems of an investment trust.”⁵⁴

And this is true under a variable annuity even after the pay-out period begins:

“... [T]he investor, during the pay-out period, is in almost every way as much a participant in something equivalent to an investment trust as before. . . . [T]he individual payment is still a payment measured basically in the same way as one’s interest in an investment trust is measured. And in a very real sense the investor is more vitally interested in the investment experience of the company at this period than he ever was in the pay-in period . . . [because] he has become completely ‘locked in’.”⁵⁵

For this reason Mr. Justice Brennan concludes:

“It is not rational to say that Congress abandoned the very appropriate protections of the Investment Company Act in this investor’s case in favor of provisions of state regulation that are quite irrelevant to the basic problem of protecting him.”⁵⁶

Since variable annuity contracts contain both insurance and investment features, and since the latter are an important element, a majority of the Justices held that the regulatory provisions of the Securities and Investment Company Acts should apply.

The dissenting Justices also recognized that variable annuity contracts contain both insurance and security features, but felt that “analysis by fragmentation is at best a hazardous business”, and finding nothing in the federal acts to indicate that Congress intended to abandon the “traditional federal ‘hands off’ policy respecting insurance regulation” or to provide for concurrent regulation by both state and federal authorities, concluded that the respondents did not have to comply with the federal statutes.⁵⁷ They did, however, suggest that if experience indicates federal control is desirable Congress could so provide.

54. *Id.* at 625, 629.

55. *Id.* at 631.

56. *Ibid.*

57. *Id.* at 635, 637. The concurring Justices also recognized that classifying the contracts as insurance or securities did not solve the problem when they said: “It is rather meaningless to view the problem as one of pigeonholing these contracts in one category or the other.” *Id.* at 627.

THE SOLUTION.

The immediate problem before the court was whether the respondents had to comply with the terms of the Securities Act and the Investment Company Act and register with the Securities and Exchange Commission, but in a broader sense the problem was, and still is, whether federal or state agencies are to regulate the issuing of variable annuities. It is the broader aspect of the problem which has attracted so much attention and caused NASD and EALIC to intervene in the case, and it is with this larger aspect that the Justices seemed to be principally concerned. Although they deny that the problem can be solved by merely classifying variable annuities as insurance or securities, that is essentially how they went about solving it. And one cannot quarrel too much with their conclusion that variable annuities should be considered as securities rather than insurance for, as has been pointed out, they are in many respects similar to shares in a mutual fund. On the other hand, it is also true that they contain substantial insurance features and could easily be so classified, as the dissenting Justices did. Thus on a purely conceptual basis either result may be sustained. But classifying the annuities as securities and subjecting them to the federal regulations does not really solve the basic problem which is a matter of policy — who should regulate such business, and what type of regulations should be imposed? The majority of the Justices answered these questions by leaving the regulation to the federal authorities and allowing them to impose the type of regulations designed for securities, and then suggesting that perhaps Congress might wish to make changes:

“If there is deemed wise any adjustment of the regulatory scheme in the light of new developments in the subject matter to which it extends, Congress may make it.”⁵⁸

The dissent would have left the regulation to the state insurance authorities with a similar suggestion:

“If the innovation of federal control is nevertheless to be desired, it is for the Congress not this Court, to effect.”⁵⁹

Thus neither side seemed to be too sure of its position and hedged by suggesting that Congress could change the result if that were

58. *Id.* at 633. Part of VALIC's objection to federal regulation was based on the premise that the present laws, if applied, would prohibit them from issuing variable annuities. VALIC's brief at 51-53, SEC v. VALIC, 79 Sup. Ct. 618 (1959). While recognizing that this argument has some validity, the concurring Justices expressed doubt whether such a result would necessarily follow. SEC v. VALIC, *supra*, at 632-33. This may be the reason for the suggestion concerning the possible need for “adjustment” in the laws.

59. SEC v. VALIC, 79 Sup. Ct. 618, 637 (1959).

deemed desirable. This in effect still leaves open the broad question of who should regulate this type of business and the sort of regulations which should be applied.

Prior to the decision by the Supreme Court, most of the opinions seemed to favor treating variable annuities as insurance, thus making them subject to regulation by the state insurance authorities.⁶⁰ This is what the insurance companies contended for and what they seem to desire⁶¹ in spite of the fact that it means regulation by approximately fifty different agencies with varying requirements and standards. For companies doing a nationwide business it would seem much more desirable to have a single federal agency regulating the conduct of their business. However, to insure such a result it would be necessary for the federal government to appropriate the field, a result which does not necessarily follow from the fact of federal regulation. For example, the creation of the Securities and Exchange Commission and the regulation of the issuance of securities by federal authorities have not abolished state regulatory bodies; the Blue Sky Laws still remain and are enforced by the states.⁶² The actual result of the present decision, therefore, is that insurance companies issuing variable annuity policies must comply with the state insurance laws and regulations, the federal Securities and Investment Company Acts, and in addition, perhaps, the state Blue Sky Laws.⁶³ Thus it is possible that such a company

60. See the following articles and comments, all of which conclude that a variable annuity is more like insurance than a security, and, therefore, should not be subject to regulation by the Securities and Exchange Commission: Becker, *Variable Annuity Contracts: Insurance or Securities?*, 1958 INS. L. J. 612; Day and Melnikoff, *The Variable Annuity as a Life Insurance Company Product*, 10 J. AM. Soc'y C. L. U. 45 (1955); Day, *A Variable Annuity Is Not a "Security,"* 32 NOTRE DAME LAW. 642 (1957); Schechter, *Variable Annuities — Boon or Bane?*, 1956 INS. L. J. 674; Note, *The Classification and Regulation of Variable Annuities*, 42 MINN. L. REV. 1115 (1958); Note, *Regulation and Taxation of the Variable Annuity*, 33 ST. JOHN'S L. REV. 118 (1958); Note, *Variable Annuity; Security or Annuity?*, 43 VA. L. REV. 699 (1957); Comment, 33 N. Y. U. L. REV. 76 (1958). Compare the following article by the counsel for the NASD giving the history and background of the litigation and presenting the opposite view: Dorsey, *The Place of "Variable Annuities" in Law and Economics*, 34 NOTRE DAME LAW. 489 (1959).

61. For some unknown reason the insurance companies seem to be opposed to federal regulation, and have expressed the fear that federal regulation of variable annuities might be the first step toward regulation of the entire insurance business. Long, *The Variable Annuity: A Common Stock Investment Scheme*, 1956 INS. L. J. 393, 401. See also McConnell, *State Regulation v. State Regulation plus Regulation by Multiple, Decentralized, Independent Federal Agencies*, *Id.* at 697.

62. See LOSS, *SECURITIES REGULATION* ch. II (1951); LOSS AND COWETT, *BLUE SKY LAWS* ch. VI (1958); Smith, *State "Blue Sky" Laws and the Federal Securities Acts*, 34 MICH. L. REV. 1135 (1936); Smith, *The Relation of Federal and State Securities Laws*, 4 LAW & CONTEMP. PROB. 241 (1937); Wright, *Correlation of State Blue Sky Laws and the Federal Securities Acts*, 26 CORNELL L. Q. 258 (1941).

63. The Uniform Securities Act as originally drafted specifically excepted insurance and endowment policies and annuity contracts where the company promised to pay a fixed-dollar amount. § 401 (1) and § 402 (a) (5). This language was used so as not to exempt variable annuities. Commissioners Note, § 401 (1) and § 402 (a) (5). See LOSS AND COWETT, *BLUE SKY LAWS* 350-51 (1958). However,

might have to comply with regulations issued by nearly one hundred different administrative agencies. This seems an intolerable burden to impose on any business. The alternative is federal regulation of all interstate insurance activities including variable annuities. By having one regulatory body it would be possible to eliminate the overlapping, varying, and often inconsistent policies and regulations now promulgated by the various state agencies. Uniform and consistent policies and regulations could be provided; a conscious and intelligent choice could be made as to the type of regulations which should be imposed and whether the emphasis should be on disclosure, regulation of the details of operations, or both. And once such policies were adopted there would be uniformity in enforcement across the country; all persons would receive the benefits and protections afforded by the regulations.⁶⁴

It seems, therefore, in view of the unsatisfactory situation which has resulted from the decisions in the variable annuities case, that Congress should re-examine the whole problem of the regulation of insurance companies and the business of insurance and make a conscious and considered determination whether to leave such regulation with the states or to place it under a federal board and whether to include variable annuities or treat them as securities. This is an important matter of policy and should be determined by Congress after proper investigation and deliberation rather than incidentally as the result of a five to four decision by the Supreme Court in a case in which the real and basic question and the issues of policy were not before the court.

the act was subsequently amended (1958) so as to leave the question whether variable annuities should be regulated as securities or insurance to the determination of each state enacting the uniform act. See HANDBOOK OF THE NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS 135, 257-58 (1958).

64. Where the regulation is left to the states there are bound to be variations in the statutory provisions, and perhaps, even greater variation in the manner in which the statutes and regulations are enforced. See PATTERSON, ESSENTIALS OF INSURANCE LAW § 1 at 1 (2d ed. 1957) where Professor Patterson says: "One cannot speak of a single set of regulations of insurers, but only of 49 separate sets." And speaking of legislative control, he states: "The quality of draftsmanship in insurance legislation still varies considerably as between the several states. . . . State legislation regulates not only hundreds of interstate insurers doing business across state lines but also thousands of small mutual insurers that do business only in one state. For the latter, diversity of legislation presents no problem, but for the interstate insurers it is troublesome. A company doing business in 48 states must be licensed in each of those states and must comply with the requirements of each." *Id.* at 8-9. In reference to the problem of federal versus state control, he says: "The chief threat to the continuance of state regulation comes from the low standards of regulation and the lax or inefficient methods of supervision of some states." *Id.* at 6. This is a particularly difficult problem where companies advertise and solicit business from persons in states where they are not licensed to do business. The states "have as yet found no effective way to protect their residents against such practices." *Id.* at 6. According to the NASD, VALIC will "receive and process applications received by mail direct from an applicant" in those states in which it is not licensed. NASD's brief 5, SEC v. VALIC, 79 Sup. Ct. 618 (1959).

IMPLEMENTATION OF THE VALIC DECISION.*

CHARLES T. SHEA †

THE SUPREME COURT'S 1959 *VALIC* decision¹ concludes at least one pleasant speculation, that variable annuity contracts issued by insurance companies, and the insurance companies which issue them, are not amenable to regulation by the SEC. Speaking for the majority, Justice Douglas held that the variable annuity contract issued by VALIC — the Variable Annuity Life Insurance Company — was a "security" within the meaning of the Securities Act of 1933,² and that the company was an "investment company" within the meaning of the Investment Company Act of 1940.³ The exemptions⁴ found in both Acts for "insurance" and "insurance companies" did not apply to VALIC or its product, said the Court. Hence the conclusion that the SEC had jurisdiction to regulate.

The difficult and thorny problem which the SEC now comes to is how it ought to regulate a company organized and chartered not as an "investment company" but as an insurance company. A part of the problem obviously is how to fit the company's product — a retirement income contract, personal to its holder and which dies with him — into a regulatory pattern geared to marketable securities, fungible shares evidencing a property interest. The problem is raised specially by VALIC's and EALIC's applications for exemption from provisions of the Investment Company Act of 1940, on which the SEC has as yet in December, 1959, not ruled.

Before coming to that question, a preliminary look at the variable annuity and at the structure and *modus operandi* of VALIC and its twin, EALIC,⁵ is probably required.

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† Assistant Counsel, New England Mutual Life Insurance Company. A.B. 1943, Williams College; LL.B. 1950, Harvard University.

1. SEC v. Variable Annuity Life Ins. Co., 79 Sup. Ct. 618 (1959). The decision will be referred to in the text of this discussion as the *VALIC* case.

2. 79 Sup. Ct. 619, 623 (1959).

3. *Ibid.*

4. Securities Act of 1933, 48 STAT. 74, 15 U.S.C. § 77c (a) (8); §§ 3 (c) (3), 2 (a) (17), Investment Company Act of 1940, 54 STAT. 789, 15 U.S.C. §§ 80a (3) (c) (3), 80a (2) (a) (17).

5. The Equity Annuity Life Insurance Company. EALIC's product is fundamentally the same as VALIC's. The SEC proceeded against EALIC at the same time as it proceeded against VALIC; the actions were heard together and decided in the VALIC case.

The variable annuity, like most other things, can be more easily understood by comparing it with something which it is not, in this case, a "conventional" annuity. The conventional annuity promises the holder a series of fixed, periodic payments, specific in amount, continuing for life or some shorter period.⁶ In substance, the insurer accepts a principal sum from the annuitant, and undertakes to liquidate it completely over the period, paying the annuitant level, equal amounts, consisting partly of principal and partly of income upon the balance of principal from time to time remaining.⁷ The initial calculation, which determines how much each level payment will be, depends on three factors: the amount of principal involved, the assumed earnings rate, and the period of time over which payments are to continue. The insurer assumes the investment risk, *i.e.*, that its earnings will not be as great as the rate it assumed in making its calculation. It also assumes a mortality risk: if the annuity is for life, the insurer takes the risk that the annuitant will outlive the mortality predicted for him.

The variable annuity differs from the conventional annuity in that the insurer's promise is not to pay a specified number of dollars on each periodic payment date, but to pay instead the then value of a fixed, specified number of "units" which is a reporting device purely. The variable annuity assumes the same mortality risk as the conventional annuity, if payments are to continue for life, but cannot be said to assume the investment risk, *i.e.*, that the dollar value of principal will remain intact, or that earnings will equal any particular rate. As earnings exceed the interest assumption the insurer made in writing the contract, or as there is capital appreciation, the value of the units increases and so does each periodic payment, and the converse is also true. The end result is a series of fluctuating payments, which reflect the rise or fall of earnings and the rise or fall in the value of the investments underlying the contract.⁸

During the premium paying (or "pay-in") period, the purchaser of the variable annuity assumes the same kind of investment risk as he does during the benefit (or "pay-out") period: his premium remains the same throughout the pay-in period, but the number of "accumulation units" which he purchases with each premium payment depends upon the value of the insurer's investments at the time of premium payment.⁹ During the pay-in period the purchaser is more

6. VANCE ON INSURANCE 1020 (3d ed. 1951).

7. *Ibid.*

8. See Morrisey, *Dispute Over the Variable Annuity*, 35 HARV. BUS. REV. 75 (1957).

9. For a general discussion see Mearns, *The "Securities" Concept: Variable Annuities*, 45 VA. L. REV. 831, 833-38 (1959), and Morrisey, note 8 *supra*.

than anything else buying a pro rata share in an invested fund, and the value of the interest he acquires with each purchase varies with the value of the investment portfolio.

From what has been said, the hybrid character of the variable annuity is clear enough. Once the insurance feature — the assumption of mortality risk — is eliminated, there remains a pure “security.” However, the critical point is that under the VALIC-EALIC contract, the insurance feature is central to the plan. The entire object and purpose of the contract is to provide a retirement income vehicle incorporating an absolute guarantee against the contingency that the payee will outlive his capital resources. Given the mortality element, it is also clear why VALIC and EALIC chose to organize as insurance companies. It was the only course open to them under the District of Columbia’s statute, and very probably, it would have been the only course open to them had they organized in any other jurisdiction. That result follows because the business of issuing contracts based on life contingencies and mortality risks is the business of insurance, and non-insurance companies are disabled, as a matter of state law, from engaging in that business.¹⁰

It is against that background that the SEC must regulate. At this writing the central question is to what extent can or ought the Commission to disregard the insurance character of the transaction and its contractual nature and assimilate VALIC and VALIC’s product to the product of an open-end management company.¹¹

THE SECURITIES ACT OF 1933.

The Securities Act of 1933¹² presents no fundamental difficulties, and it is not here that the problem arises of whether to force some basic readjustment of the insurance features of the contract. The central provision of the act — section 5 — prohibits the issue of securities unless the issuer has filed a registration statement with the Commission, and unless the purchaser of those securities is furnished a prospectus which adequately describes the nature of the security and of the issuer’s business.¹³ The purpose of the act is to force disclosure,

10. In a number of states, by statute, the issue of annuity contracts is comprehended within definitions of what constitutes the business of “life insurance.” For a typical statute, see N.Y. INS. LAW § 46. The same results have been reached elsewhere by case law. The question is apparently open in some jurisdictions.

11. As the concurring opinion in the *VALIC* decision points out (79 Sup. Ct. at 629, 633 n.34) there are compelling analogies. There are similarities too, however, to “Face Amount Certificate” companies and to “Unit Investment Trusts.” See the Investment Company Act of 1940, 54 STAT. 789, 15 U.S.C. §§ 80a (4) (1), (4) (2) (1940).

12. 48 STAT. 74, 15 U.S.C. § 77 (1933).

13. Securities Act of 1933, §§ 5-8 and Schedule A.

thus putting in the purchaser's hands enough information to enable him to act intelligently.¹⁴ Informed judgment is the objective. The requirements for a registration statement and a prospectus can be met by VALIC in the same way as they are now met by open-end investment trusts which are continuously offering new shares: by periodic refiling and up-dating of the prospectus.¹⁵ These requirements are singularly apposite, considering the nature of VALIC's contract. As has been noted earlier in this discussion, during the pay-in period, the interest of the variable contract holder closely resembles that of the mutual fund share purchaser who is buying his shares under a long-term periodic payment plan. The former can "surrender"; the latter can "redeem." With each level payment both are purchasing a share in an underlying portfolio of securities whose value fluctuates. There are distinctions in status between the two, of course, but the similarities are more significant than the differences. Both are more nearly "investors" than anything else, and that suggests that the disclosure provisions which are appropriate for the true security are likewise appropriate for the hybrid.

THE INVESTMENT COMPANY ACT OF 1940.

The Investment Company Act of 1940¹⁶ is a different proposition, and it is here that we come to basic questions of whether and to what extent the insurance features of the VALIC contract are incompatible with the regulatory framework devised for investment securities. The most fundamental question under the act is the extent to which the variable contract is to be considered a "share of stock," and like such a contract's closest counterpart under the 1940 act, rendered immune from all risks which are non-investment in character. The problem is directly created by the insurance features of the variable contract, *i.e.*, the indigenous mortality risk in any annuity contract based on life contingencies, and the additional mortality risk created by some of the VALIC contracts, which incorporate conventional decreasing term life insurance in specified dollar amounts. Both of these insurance risks, it will be remembered, are assumed by the insurer, not the variable contract holder. Hence the problem, for under traditional

14. Loss, *SECURITIES REGULATION* 83-84 (1951).

15. See Motley, Jackson and Barnard, *Federal Regulation of Investment Companies Since 1940* 63 *HARV. L. REV.* 1134, 1143 (1950).

16. 54 *STAT.* 789, 15 *U.S.C.* § 80a (1940). As an aside, it should perhaps be noted that investment companies are required to register both under the Securities Act of 1933 and under the Investment Company Act of 1940. As a practical matter, a company accomplishes registration under the 1933 Act by what amounts to up-dating information furnished in its registration under the 1940 Act.

notions of insurance law, those claims are debt claims upon all of the assets of the insurer.¹⁷ In simplest terms, all of the insurer's assets stand as surety for the payment of the risks it has assumed, and in the variable annuity contract that means at once the creation of a species of debt claims which are senior to the equity elements of the contract. Those mortality claims can be considered "senior securities," which are prohibited for open-end companies under the act.¹⁸

Concretely, the variable contract holder's interest, both during the pay-in period and during the benefit-paying period, is subject to diminution if the insurer's mortality experience differs widely from what the insurer assumed when it made the contract. VALIC's contract carries conventional decreasing term life insurance on premium payers during the early years of the pay-in period. As an extreme case, if all of those insureds were annihilated in a catastrophe of some kind, the gap between dollar insurance reserves and cash claims for insurance death benefits could be made up only from the insurer's remaining assets, *i.e.*, surplus plus the assets funding annuity contracts then in the benefit-paying stage. Similarly, if large numbers of annuitants outlived their predicted mortality, the gap between expected and actual mortality would have to be made up from the interests of other annuitants and, more remotely, from the assets standing behind contracts then still in the pay-in stage.

Regardless of whether the risk is large or small that either of those events could occur, it is evident that it is a risk of some kind. Bearing in mind the purpose of the 1940 act to insulate mutual fund shareholders from all risks save those inherent in investment judgment, the problem then becomes one of the degree of protection needed for the variable contract holder and how to provide it. There are several possible answers. One proposed by the SEC in the early fall of 1959 entailed a multi-corporate structure: one corporation to handle funds collected during the pay-in period, a second to handle funds during the pay-out period, a third, a conventional insurance company, to accept the mortality risks, and perhaps a fourth to handle compensation of agents and employees. The advantages of this arrangement are evident, provided one's aim is to re-create the VALIC-EALIC contract in the mold and fashion of a "security" and to incorporate the same or approximately

17. Broadly speaking, insurance contracts, including annuities, are promises to pay money; they are debt claims, conditional only upon the occurrence of specified events. The promise to pay would be less than the guarantee required by state statutes if the promisees or some of them could be remanded only to a particular fund for the satisfaction of their claims.

18. Investment Company Act of 1940, 54 STAT. 789, 15 U.S.C. § 80a (18) (f) 1940.

the same protections for the security element that the 1940 act affords. Its logical flaw is that it assumes that the insurance features are not integral to the plan, and then proceeds to the next stage, which is to prevent the twain from ever meeting. As a solution, it would assure that the variable contract would forever remain a dog's breakfast of disparate patches and pieces, neither "insurance" nor "investment" nor a combination of both. The incongruity becomes obvious when it is remembered that both the majority and the concurring opinions in the *VALIC* decision tell us that the fact of federal regulation does not import that an admittedly new form must be stuffed into an existing pattern or not at all.¹⁹

A second solution is one suggested by *VALIC* and *EALIC* as a counter to the multi-corporate proposal. It entailed (1) reinsurance of the mortality risk present in the decreasing term life coverage present under some of the *VALIC-EALIC* contracts, and (2) on *VALIC*'s part it entailed an effort to demonstrate that, because of *VALIC*'s conservative mortality assumptions, there was no practical risk that the effect of adverse mortality during the benefit-paying period could ever be so gross as to impair the interests of the contract holders.²⁰ As an expedient, the first part of this proposal has superficial appeal. It loses all logical appeal when it is remembered that if these risks are reinsurable, they could have been written separately and in another company in the first place; ergo, why not require them to be thus from the beginning? That puts us back with the first solution which entails complete divorce of the insurance elements from the equity or investment elements. Further, the second part of the solution is inconsistent with the first. If there is a risk that adverse mortality in the pay-out phase will impinge upon the interests of the contract holders, why is that a less acute risk than the pure life insurance risk? Why not require both the life insurance risk and the annuity mortality risk to be reinsured if they are an insurance risk which can be measured? The answer to both questions is that it would do fundamental violence to the distinguishing feature of *VALIC* and *EALIC*. Both are insurance companies and both issue contracts containing a basic insurance element, *i.e.*, a mortality risk. If that is eliminated there is little visible reason to issue the contract as an insurance contract or for an insurance company to issue it, for the insurance features are gone.

19. See 79 Sup. Ct. at 622, 633 (1959).

20. See *VALIC*'s amended application pursuant to § 6 (c) of the 1940 act for exemptions from the act, p. 23. (In the Matter of The Variable Annuity Life Insurance Company of America, S.E.C. Docket No. 812-1244.)

A third possible solution has been suggested in testimony before the SEC.²¹ It entails segregation of all of the assets dedicated to the variable contract, and unlike the present New Jersey segregated fund variable annuity statute,²² contemplates that none of those assets are to be chargeable with the mortality risk inherent in the contract. In effect, that solution envisages reinsurance of the mortality risk, but inside the same insurance company rather than outside. This proposal has the practical disadvantage from an insurance company's standpoint of requiring basic enabling legislation not only in the insurer's state of domicile, but in each state where it proposes to issue variable contracts²³ for the "segregated fund" concept is basically alien to insurance law. However, the solution preserves in all important respects the integrity of the contract first offered by VALIC and EALIC. Moreover, it sharpens the distinction between the "insurance" element and the "investment" element, and what is more important, meets fully, in this writer's opinion, the protective standards embodied in the Investment Company Act of 1940.

However palatable that approach may be, the fourth and the most obvious alternative is to grant an exemption from section 18 of the 1940 act to the extent necessary to permit all mortality risk to remain technically senior to the underlying interests of the contract holders, and without reinsuring to any greater extent than common practice in the insurance industry dictates.²⁴ That is defensible on the ground that the "insurance" element in the contract must be presumed to be adequately funded and to all intents and purposes without risk to the contract holder. The actuarial assumptions used in the

21. *Id.* para. 17, p. 15, and see OFFICIAL REPORT of the proceedings before the SEC on that application at 218-19.

22. N.J. Laws, ch. 123 (1959).

23. The problem is one of obtaining authority in a given state to do two things: (1) to issue contracts with a conventional insurance element which have a claim on something less than all of the assets of the insurer, and (2) to issue contracts wherein the conventional insurance element is severed from all other elements. This latter item of course raises the question of whether a company issuing such contracts is an "insurance" company at all and whether its product is "insurance." It is readily conceivable that such company organized in state *A* with appropriate power to segregate would be treated as an "insurance" company there and regulated as such, and at the same time be treated as an "investment" company in state *B*, and regulated as such there. Pending such enabling legislation, the company might well be denied entry to do business by state *C*, on the ground that it was an "insurance" company proposing to do a non-insurance business.

24. Recently formed companies customarily reinsure some specified percentage of all new life insurance business to protect themselves against the risk inherent in having only a relatively few insured lives to deal with. In addition, most companies, regardless of size, reinsure that portion of any given policy which exceeds the company's limits of retention. Further, many companies reinsure a portion of all of their substandard cases. Probably no company reinsures annuity contracts, though most companies will decline to issue an annuity contract on a single life in excess of some specified limit. The limits vary from company to company.

VALIC and EALIC contracts, and the reserves behind those assumptions, are precisely the same as in the case of insurance companies issuing conventional contracts. It is true that there is a "risk" that those mortality assumptions will prove wrong, but the mathematical probability, and perhaps even the mathematical certainty, is that they will not. On that basis it can be said with practical certainty that there is no "risk" to the variable contract holder from adverse mortality, and the way to properly recognize that fact is to permit the insurance feature to remain where VALIC and EALIC put it, as an integral part of their contracts and of their funding scheme. To do otherwise immediately transforms the variable annuity into something it was not before, for by isolating the investment element, one creates thereby a true "security." That is fundamentally at odds with the notion of the variable annuity contract as originally conceived, and it is fundamentally at odds with the notion that variable annuities are properly issued by life insurance companies.

This issue — of whether the security element must in any and all events be divorced from other elements — is the central one and the one which carries the most important consequences. There are however a number of other difficult problems under the 1940 act, and they deserve mention, however summary, in a discussion of this kind. The first arises under section 18(i) of the Investment Company Act of 1940.

SHAREHOLDERS AND VOTING RIGHTS.

Section 18(i) of the 1940 act prohibits a registered investment company from issuing non-voting stock, and requires all shares to have equal voting rights. It is a requirement which plagued VALIC and EALIC, and will create the same problems for any stock life insurance company which proposes to issue variable contracts. Likewise, it will plague mutual life insurance companies for some of the same reasons.

The problem the stock company faces is obvious: the interests of the variable contract holders are "shares of stock" within 18(i), if we subscribe to Justice Brennan's views.²⁵ Consequently, they must be given the right to vote on some approximate parity with any outstanding conventional common or preferred stock the company has. VALIC and EALIC met that problem by asking for an exemption from the section, on condition that they would award voting rights to

25. See 79 Sup. Ct. at 632, 633, n. 34 (1959).

the variable contract holders in accordance with their financial stake in the enterprise at the time of voting. The suggested plan gave each variable contract holder (other than holders of group contracts) as many votes as the cash surrender value of his contract (valued as of the time of the vote) would purchase of voting common.²⁶ VALIC also asked for exemption from the section to the extent necessary to enable it to comply with the mandate of the District of Columbia statute — organic corporate law for both VALIC and EALIC — that the holders of group contracts were to be permitted but one vote each.²⁷ It seems a foregone conclusion that the SEC will grant the exemption asked for even though it denies any semblance of voting parity to group contract holders. The plan as proposed possesses the positive virtue of conferring voting powers on the majority of contract holders on a workable, equitable basis, and in doing so it complies substantially with one basic purpose of the act, *i.e.*, to assure “shareholders” an adequate voice in deciding questions of basic corporate policy.²⁸

Mutual companies will not have the problem of producing voting parity as between variable contracts and outstanding voting stock. They may, however, if they are organized in some jurisdiction other than the District, have great difficulty in producing parity as among variable contract holders and among these contract holders vis-à-vis holders of conventional annuity contracts and life insurance policies. A number of state insurance statutes limit the voting rights of group contract holders just as the District's does, but more importantly, there are provisions in some state statutes to the effect that each domestic mutual company policyholder has but one vote.²⁹ Under statutes in other states, voting rights are granted to policyholders not on the basis of the reserve value of the contract but in terms of face amount of insurance.³⁰ For annuity holders the formula is sometimes based on the dollar amount of annuity income the contract will produce.³¹ When the VALIC proposal under 18(i) is stirred in with these requirements and applied to a company which is actively issuing both variable annuity contracts and a considerable volume of conventional life insurance and conventional annuities, the prospects are dismaying,

26. See VALIC's amended application, note 20 *supra*.

27. D.C. CODE ANN. § 35-525 (1951). Though it can be argued that the section applies only to policies issued by mutual companies, it appears clear that it must apply to all group contracts issued by any insurance company, including a stock insurance company.

28. See LOSS, SECURITIES REGULATION 100 (1951).

29. For example: N.Y. INS. LAW § 198 (1), (2); WIS. STAT. § 201.04 (3) (Supp. 1957).

30. MASS. ANN. LAWS c. 175, § 94 (1952).

31. *Ibid.*

even assuming a segregated fund as the repository of assets relating to the variable contracts.³²

THE PROBLEM OF SELF-DEALING.

A different set of problems arise under sections 17(a) (3) and 17(d) of the 1940 act. Section 17(a) (3) prohibits any "affiliated person" or "promoter" of a registered investment company to borrow from the company. Section 17(d) (and the SEC's rule 17d-1) prohibit a registered investment company from participating in any joint venture with any "affiliated person" or "principal underwriter." The objective of these provisions, in fact of section 17 as a whole, was to prevent self-dealing by investment company management and by those connected with the underwriting and distribution phases of the business.³³ Absent exemption by the SEC,³⁴ these provisions would prevent loans to agents, general agents and to employees. That would be novel and inconvenient for any company accustomed to the common (and completely proper) pattern of commission advances to agents which is found in the insurance industry scheme of compensation. Production bonuses are also common in the insurance industry, at least for those companies which do not do business in the state of New York.³⁵ It should not be disabling or crippling, however, to have to adopt some different method of compensation if required by the SEC. It may be noted as an aside that if the supposed danger in allowing loans and production bonuses is that they may be so excessive as to impinge upon and perhaps impair the interests of the variable contract holders, that risk can be eliminated by the same segregated fund solution outlined above.³⁶

32. Assume a mutual life company with authority to issue variable annuities under a segregated fund of the type mentioned in VALIC's hearing before the SEC, cited *supra* note 21. Might it be necessary to provide the variable contract holders with voting rights based on the respective values of their interests in the segregated fund, but only with respect to the segregated fund and its operation, plus other voting rights (the same as those of other policyholders) in the general affairs of the company? If any such plan is developed, it would logically require separate management and a separate board of directors for the segregated fund.

33. LOSS, SECURITIES REGULATION 99 (1951).

34. Section 17 (b) authorizes exemption from 17 (a) on a showing by an applicant that the proposed transaction is "reasonable and fair," that it is consistent with the company's policies as recited in its registration statement, and that it does not violate the general purpose of the act. 54 STAT. 789, 15 U.S.C. § 80a (17) (a), (17) (b).

35. See N.Y. INS. LAW § 213 (8) which purports to prohibit such compensation both in New York and elsewhere. This section is thought to apply to all companies, domestic and foreign, doing business in New York.

36. This point is emphasized throughout the hearings on VALIC's and EALIC's application for exemption from section 17. Since preparation of this paper, a bill has been introduced in Congress to amend the District's Insurance Law and provide for such segregation. As the writer construes the bill, the "security" element is severed completely from all mortality risks and from all expenses of every kind.

CONCLUSION.

This resume is hardly intended to be exhaustive of the areas of difference between VALIC and EALIC and the SEC nor on the kind and degree of compliance to be exacted under the 1940 act. In its amended application to the SEC,³⁷ VALIC asked for complete or limited exemption from some eight important sections of the act besides those mentioned here.³⁸ Those requests all address questions of greater or lesser difficulty. A reasonable solution for all of them lies in regarding EALIC and VALIC not as investment companies doing a spurious insurance business, but as insurance companies doing a mixed insurance-security business. As insurance companies, all aspects of their operations are already regulated under a mature and well-considered system. They should be expected to conform with the requirements of the federal acts where appropriate to the investment operation, but only after fully considering the extent to which the purposes of the federal act have already been satisfied by the organic provisions of the state insurance statute and by its enforcement in the hands of the state's deputies. What the SEC will do remains to be seen.

Editor's Note

The SEC's ruling on the issues discussed on this article was handed down in February, 1960, following preparation of the article. (SEC, Investment Company Act Release 2978, 25 February 1960). In most major respects, the requests of VALIC and EALIC for exemptions from the Investment Company Act of 1940 were granted — with modifications of greater or lesser magnitude. Among the important points covered by the ruling, the "senior securities" problem under section 18(f) was disposed of by granting an exemption on condition that the companies reinsure all conventional life and disability insurance risks with other companies. In addition, VALIC was required to eliminate an issue of senior stock from its capital structure. With regard to voting rights under section 18(i), the Commission approved the plan put forward by VALIC for producing voting parity as between common stockholders and the holders of variable contracts. However, the Commission apparently regards the variable annuity as a "security" despite its insurance features. It required VALIC and EALIC to use securities terminology in place of insurance terminology in descriptive material and in some instances in the policy itself.

37. See note 20 *supra*.

38. §§ 7, 8, 9 (a) (2) and (3), 17 (f), 22 (e), 24 (d), 27(a) and (c) (2).

For a discussion of pertinent sections of the 1940 and 1933 acts, see Crichton, *Registration of the Offering of Variable Annuity Contracts*, Legal Section, American Life Convention, 1959.