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REGULATION OF VARIABLE LIFE INSURANCE

*Tamar Frankel**

I. Introduction

On November 29, 1971 the American Life Convention and Life Insurance Association of America filed a petition with the Securities and Exchange Commission (SEC) to exempt certain variable life insurance policies and separate accounts funding them from the provisions of the federal securities acts.¹ The petition had been preceded by informal negotiations by the insurance industry for a decision by the SEC "not to assert jurisdiction" over such policies and accounts.² The Commission's staff declined to recommend primarily because the staff felt that other interested parties ought to be heard before a determination was made which might adversely affect them.³ After lengthy hearings the Commission decided that the securities acts should apply to variable life insurance policies. The Commission further determined to exempt certain policies from the provisions of the Investment Company Act of 1940 and the Investment Advisers Act of 1940.⁴ This article discusses the nature of variable life insurance policies, the problems concerning their regulation, and the implications of the Commission's decision.

A. Variable Life Insurance

Variable life insurance policies are novel in this country. The proclaimed purpose of the policies is to provide, in addition to conventional insurance, protection from loss of the purchasing power of the dollar. They are alleged to be a hedge against inflation.⁵ Whether or not these policies can fully achieve this

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1 For notice of hearings see, SEC Securities Act Release No. 5234, Securities Exchange Act Release No. 9494, Investment Company Act Release No. 6999, Investment Advisers Act Release No. 310 (Feb. 15, 1972). BNA SEC. REG. L. REP., no. 147, at A-16 (1972).

2 Gustin, *Details Industry Task Force Dealings With SEC On Variable Life Products*, The National Underwriter, Mar. 27, 1971, no. 13 at 1, 9.

3 SEC Securities Act Release No. 5175; Investment Company Act Release No. 6662 (Aug. 5, 1971). The insurance industry favored a rule making proceeding to which the staff agreed. See Report of the Division of Investment Management Regulations, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* (1972) [hereinafter cited as Staff Report].

4 Letter of SEC chairman William J. Casey to Counsel for the petitioners, January 31, 1973. The exemptions granted under rules 3c-4 and 202-1 are now under attack by Wellington Management Co. in the D.C. Circuit Court of Appeals File No. 73-1188 (Feb. 20, 1973).

5 This claim was questioned by the investment industry. It was admitted by witnesses that in order to obtain appreciation of 3 per cent a year (to keep pace with inflation) the insurance companies would have to earn 13-23 per cent in their investments. See Testimony of Henry Walker, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC*, 1029 (1972) [hereinafter cited as *SEC Hearings*]. Tr. 1029. Memorandum of the Mutual Group at 10, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* 1589, 1028, 1416 (1972) [hereinafter cited as Memorandum of Phillips].

purpose, they might afford to policyholders the opportunity to participate in the growth of the country's economy.

The policies resemble conventional insurance.⁶ Premiums and death benefits are calculated on the basis of age, health, and, sometimes, sex of the insured. Furthermore, the policies are based on the same scheme as conventional level premium life insurance. In the early years of the policies the insurance company collects premiums which are far in excess of the cost of insurance. This excess is in fact advanced by the policyholder to cover the cost of insurance in later years, when the premiums will not be sufficient. Monies so prepaid by policyholders are invested by the insurance company for the benefit of the policyholders. Therefore, the higher the benefit, the lower the cost of insurance to the policyholder.

The basic difference between conventional and variable life insurance lies in the nature and terms of this benefit. In conventional life insurance⁷ the benefit is calculated on the basis of a fixed assumed interest, whether or not investments of the insurance company produce sufficient income. The company risks the loss through unwise or unlucky investments or through downturn of the economy generally. The policyholder risks only that the company will not be able to honor its obligations. Strict state regulation has rendered this hazard minimal.

In variable life insurance the reserves of the policies are placed in a separate account and invested in equity securities. The dollar amount of the premiums, or death benefits, or both (depending on the terms of the policies), is affected by the investment performance of the separate account.⁸ The policyholder shares in the profits of the investment. He has a chance to receive more than a fixed assumed interest rate. However, he takes the chance that the profits will be lower than the assumed rate of return, in which case the payments affected by investment performance (variable payments) will be lower than the same payments over a previous period of years. (The insurance company, however, guarantees that the death benefits will not be reduced below a certain minimum.)

Policy purchasers were satisfied with the low-risk investment that insurance offered. But they were dissatisfied with the low-yield assumed interest that accompanied it. This dissatisfaction grew with inflation. Mainly as a result of this discontent, the insurance industry steadily lost its share of the savings-dollars of

6 For a definition of insurance see Denenberg, *The Legal Definition of Insurance*, XXX J. Ins. 319 (1963) reprinted in *ESSAYS IN THE THEORY OF RISK AND INSURANCE* 210 (J. Hammond ed. 1968).

7 For a full description of conventional life insurance and the level premium plan see W. VANCE, *INSURANCE* 71 (3rd ed. 1951); J. MACLEAN, *LIFE INSURANCE* 13-15 (9th ed. 1962), 1 J. APPLEMAN, *INSURANCE LAW & PRACTICE* § 3 (1965). Memorandum of the Investment Company Institute at 8-23, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* (1972) [hereinafter cited as Memorandum of Silver].

8 The calculation follows this pattern: The policies assume a certain rate of return; say 3½ per cent, on investments. If the net profits on investments are higher than the assumed rate of return, the payments that are affected by the investment performance will be higher than the same payments over a previous period of years, though not necessarily in proportion to the amount of profits. The same formula is used to measure the effect of investment performance for all policies; but companies use different formulas. In some policies the formula affects the death benefits. In others, the formula affects the reserves funding the policies. In the first instance death benefits will fluctuate more than in the second instance. Variable

the public.⁹ During the past twenty years the insurance industry has increasingly attempted to enter into the equity investment market. This effort began in the 1950's with the offer of variable annuities in connection with pension plans. It culminated in variable life insurance.

B. Federal Regulation of Variable Life Insurance

The question of whether variable life insurance policies are subject to the securities acts is of great importance to the insurance and investment industries because regulation, or lack of it, affects their competitive positions. The question is also important to the states because they have an interest in taxing and regulating insurance. The question is equally important to investors. Variable insurance might replace a large proportion of life insurance and of mutual fund shares as an investment medium.

Generally speaking, with regard to variable life insurance, the basic issue involving the 1933 and the 1934 securities Acts is whether the policies are "securities." The 1940 Act involves the question of whether the separate accounts are "investment companies." The application of the securities acts to a hybrid insurance policy is difficult. However, the application of the 1940 Act raises more problems. The petitioners themselves were reconciled to a greater measure of disclosure.¹⁰ As to the antifraud provisions in the 1933 and the 1934 Acts it was understood by the parties that they would apply. Since insurance companies that sell variable annuities have already entered the self-regulatory organization of broker-dealers organized under the 1934 Act and have made many of the adjustments necessary to conduct brokerage businesses, the application of the 1934 Act would in all probability not be unduly burdensome. Neither Act interferes with the operation of the company's insurance business. The 1940 Act, on the other hand, regulates the activities of the account itself and determines such questions as who controls investments in the account, and how much sales load may be charged to purchasers. The application or nonapplication of the 1940 Act may have a more serious effect on either industry.

The success of marketing mutual fund shares and of insurance policies depends as much on the good graces of the salesmen as on the objective attraction of the product.¹¹ Higher commissions may divert mutual fund sales forces to

payments may also be affected by the method and date of valuation of the assets in the account, by the amount of money reserved for future taxes, and by the amount of deductible expenses. In policies that carry variable benefits but permit the policyholder to pay a fixed dollar premium (even if at the time of payment the investment performance of the account is higher than that of the previous year), the formula includes an adjustment factor to take this into account. Variable payments may also be affected by the magnitude of assumed rate of interest because increases in payments are made only if the investment performance exceeds the assumed interest. *SEC Hearings, supra* note 5, presentation by Harry Walker at 10; presentation by John C. Fraser at 4; presentation by Arthur L. Blakeslee III at 10, 11. For a detailed description of variable life insurance policies and their potential development see *VARIABLE LIFE INSURANCE: CURRENT ISSUES AND DEVELOPMENTS* (Olson and Winklevoss eds. 1971); 22 *SOCIETY OF ACTUARIES TRANSACTIONS* pt. 2, D 144 (1970).

⁹ Memorandum of Silver, *supra* note 7, at 3.

¹⁰ The petition to the SEC was based on the assumption that most states will adopt a Model Act and Model Regulations. The Model Regulations require that each purchaser be given a minipropectus along the lines of a prospectus under the 1933 Act.

¹¹ SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H. DOC. NO. 95, 88th Cong., 1st Sess., pt. 4, at 110 (1963) [herein-

variable life insurance. On the other hand, lower commissions may discourage the sale of variable life insurance in favor of conventional policies. A great deal depends on how the public will view variable life insurance. If it is considered a variation of an insurance policy, then commissions for both must be equal, or the marketing of the new product will fail. If variable life insurance is accepted as an alternative to mutual fund shares, then the investment industry might suffer if commissions on variable life are higher.

The ability of the insurance industry to offer variable life insurance as proposed may well depend on who will control investments. Since the insurance company guarantees a fixed amount of death benefits regardless of the separate account investment results, the company must have some control over investment policies. Under the 1940 Act, in theory at least, this control is with the shareholders.¹²

One should also bear in mind that the variable life insurance policy seems like an attractive alternative to a mutual fund share. The policy can be described as the best possible investment: it purports to serve as a hedge against inflation, it offers participation in the growth of the economy, utilization of excellent investment advisory service, plus diversification of investment, and, to top it all, protection for the beneficiaries in the event of premature death. No wonder the investment industry is concerned. In addition, inflation and other factors are slowing the growth of conventional life insurance. Most life insurance companies are convinced that their future lies with variable products. The stakes are therefore high.

C. *The Regulation of Variable Annuities*

The effort of the insurance industry to enter the equities investment market began in the 1950's with the offer of variable annuities. Conventional annuities, like conventional insurance, promise a fixed return on funds which are prepaid by the contractholders, and impose the investment risk on the insurance company. Since insurance laws require the company to invest its reserves in low risk, and therefore, low income investments, the promised—or assumed—interest to contractholders is also low.¹³

In order to obtain a higher income for contractholders state laws permitted insurance companies to invest the reserves in equity securities, and to pay the full gain to the contractholders. But the contractholders bore the investment risk, the risk that the income and value of the securities will decline. In variable annuities the investment risk conventionally borne by the insurance company was shifted to the contractholders.

after cited as SEC REPORT]. No-load funds, funds that sell their shares directly to the public without the benefit of salesman's services, constitute a small fraction of the industry, measured by assets. The growth of these funds is more rapid as compared to load funds, and is a function of the growing sophistication of investors. Yet the average investor still pays 8.5 per cent commission to the load fund rather than look for a no-load fund.

¹² See p. 1079 *infra*.

¹³ In insurance policies low assumed interest means higher cost of insurance to the policyholder. In annuities, low assumed interest means lower annuity payments.

In *SEC v. Variable Life Insurance Company*¹⁴ the Supreme Court held that variable annuities were securities within the meaning of the federal securities acts. The Court found that these annuities were not insurance policies and annuity contracts, which the securities acts exempt.¹⁵ Since the investment risk was borne by the contractholders, the annuities were deemed to be investment contracts presenting the evils that the securities acts were designed to protect against. State laws that classified and regulated variable annuities as insurance did not adequately protect purchasers against these evils.¹⁶

A few years later, United Benefit Life Insurance Company attempted unsuccessfully to devise a variable annuity that would be exempt from the federal securities acts. The contract contained two periods. In the first—the pay-in period—payments were made to the insurance company, which invested the funds in equity securities at the risk of the contractholder. During this period and up to its termination the contractholder could receive the value of his invested payments on demand. In the second period—the pay-out period—the insurance company paid the contractholder an annuity for life. This annuity was made in fixed dollar amounts.¹⁷ In addition, if the contractholder wished to receive his savings during the pay-in period, the insurance company assured him a guaranteed minimum.

The Supreme Court held in *SEC v. United Benefit Life Insurance Company*¹⁸ that the annuity was a security. First, the pay-in and pay-out periods were severable.¹⁹ The pay-out period involved some insurance because the insurance company promised to make payments to the contractholder throughout his life. This part of the annuity was an exempt insurance contract. The pay-in period involved no insurance and was pure investment. This part of the annuity did not become an exempt insurance policy simply by being tacked to an insurance arrangement. Second, for qualification as an insurance policy, the investment risk of the insurance company should be significant. A guarantee of a minimum payment, which guarantee would in all probability never result in a liability to the insurance company,²⁰ was, in the Court's opinion, not sufficient to convert an investment into an insurance policy. By the same token, the Court added in dictum, a guaranteed minimum funded by conservative investments (nonguaranteed amount invested in equity securities at the risk of the contractholder) was not sufficient to characterize the investment as an insurance contract.

14 359 U.S. 65 (1959).

15 § 3(a)(8) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(8) (1970); 1 L. Loss, *SECURITIES REGULATION* 497 (2d ed. 1961).

16 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 78 (1959).

17 *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967).

18 *Id.*

19 Payment for these annuities was usually made by installments during a long period of time, "pay-in period," ending with the retirement of the employee. At that point he could either accept the cash accumulated or choose an annuity for a fixed number of years, or an annuity for life. The period during which the annuity is paid is called the "pay-out period." For a description of variable annuities see Frankel, *Variable Annuities, Variable Insurance and Separate Accounts*, 51 B.U.L. Rev. 177, 188 (1971) [hereinafter cited as Frankel].

20 In the light of stock market past performance in the last 80 years with the exception of the depression era, the guarantee would have never come into effect. *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 209 n.12 (1967).

In sum, the determination of whether variable annuities are securities²¹ regulated by the federal securities acts, or insurance contracts which are exempted from the acts, depends on: (a) the extent to which the investment risk is divided between the contractholder and the insurance company, (b) the extent to which the contract deviates from conventional insurance so as to expose purchasers to dangers similar to those which face purchasers of securities, (c) the degree of relevant protection offered by state insurance laws,²² and (d) the form and manner in which the contract is advertised and sold. If the contract is advertised for its investment opportunities, it may be classified as an investment contract.²³ Under these tests individual variable annuities were held to be securities.

II. Status of Variable Life Insurance Policies as Securities

The petition of the insurance industry to the SEC requested an exemption of variable life insurance policies from the securities acts without conceding that the policies were securities. The industry sought to avoid a decision on that issue. However, the Commission's jurisdiction rested on the classification of the policies as securities. In addition, a major consideration in granting an exemption is the need for investor protection. This is also a factor in determining whether the policies are securities. The question was therefore extensively discussed and the Commission held that variable life insurance policies are securities.

The petition was restricted to policies that answer four conditions. The petitioners explained that these conditions would limit the investment component in the policies and ensure the predominance of their insurance characteristics.²⁴ Two conditions were designed to eliminate from the definition policies that would permit a large portion of the premiums to be allocated to investment instead of insurance coverage. The first condition was that the policies should be whole-life policies. Endowment policies were excluded because they contain a heavy investment component in terms of dollars. It is unclear why term policies that contain almost no investment were also excluded (perhaps because they do not contain a sufficient investment component). The proposed variable policies are based on level premium life insurance and scheme. Hence, the

²¹ Except when specifically exempted by the Commission or under § 3(c)(11) of the 1940 Act.

²² SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 77-8 (1959) (Brennan J., concurring).

²³ *Id.* See also SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 212 (1967).

²⁴ Rule 3c-4 under the Investment Company Act adopted in SEC Investment Company Act of 1940 Release No. 7644 (Jan. 30, 1973).

Rule 3c-4. Definition of "Insurance Company" for Purposes of Section 3(c)(3) of the Act.

(a) The term "insurance company," in Section 3(c)(3) of the Act, shall include a separate account established and maintained by an insurance company

(1) the assets of which separate account are derived solely from the sale of variable life insurance policies, as herein defined, and advances made by the insurance company in connection with the operation of such separate account, and

(2) which separate account is not used for variable annuity contracts or for the investment of funds corresponding to dividend accumulations or other policy liabilities not involving life contingencies.

(b) For the purpose of this rule, a "variable life insurance policy" shall mean any policy of insurance issued by an insurance company which, so long as pre-

petitioners argued, they were predominantly "insurance."²⁵ The investment industry claimed that the investment-dollar component in level premium life insurance was sufficiently large to constitute the policy a security under the circumstances.²⁶ The second condition was that the amount payable as a minimum should be not less than a stated multiple of the gross premiums.²⁷ The petitioners explained that since older persons pay higher premiums for the same insurance coverage, the premiums on which the guaranteed face amount is computed should be adjusted to reflect the higher cost. This device, the petitioner stated, would also preclude payment of premiums over a shorter period of time,²⁸ which would also result in a larger investment. In the opinion of the investment industry and of the SEC staff, the proposed rule did not produce the claimed results.²⁹ The number of years over which premiums could be paid and the

miums are paid when due, provides a death benefit which varies to reflect the investment experience of a separate account established and maintained by such insurance company and

- (1) provides for life insurance coverage for the whole of life, and the mortality and expense risks thereunder are assumed by such insurance company;
- (2) provides for an initial stated amount of death benefit and guarantees payment of a death benefit at least equal to such amount;
- (3) provides that the amount payable upon the death of the insured under such policy in any year will be no less than a minimum multiple of the gross premium payable in that year (exclusive of that portion allocable to any incidental insurance benefit) by a person who meets standard underwriting requirements, as shown in the following table:

Issue Ages	Multiples
0-5	80
6-10	71
11-15	63
16-20	55
21-25	47
26-30	40
31-35	33
36-40	27
41-45	21
46-50	15
51-55	13
56-60	11
61-65	9
66-70	8
71 and over	7;

and (4) in its entirety is a life insurance contract subject to regulation under the insurance laws of any State in which such policy is offered, including all required approvals by the insurance commissioner of such State.

25 Memorandum of Petitioners at 8, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* (1972) [hereinafter cited as Memorandum of Kroll].

26 Memorandum of Phillips, *supra* note 5, at 45. In the first year only 9 per cent of the premium of the policy of New York Life represents the cost of insurance. 62 per cent of the premium under the policy of New York Life is prepaid.

At no time does the cost of insurance amount to more than 31 per cent of the premium. Memorandum of Silver, *supra* note 7, at 18-20.

27 Memorandum of Kroll, *supra* note 25, at 8. Proposed Rule 3c-4.

28 Memorandum of Kroll, *supra* note 25, at 9.

29 Memorandum of Phillips, *supra* note 5, at 47-48. *See contra*, Memorandum of Kroll, *supra* note 25, at 8, 9.

assumed interest may be reduced to increase the investment leverage; even without these devices, the proposed rule would permit a company to charge for a variable policy double the premiums charged for a conventional policy of the same face amount and apply the excess to investments.³⁰

Apparently, in order to escape the definition of a security based on policyholders' investment risk, the proposed policies should be for an initially stated amount, and death benefits should be guaranteed to be not less than that amount. However, the cash surrender value need not be guaranteed. The industry pointed out that the death-benefit guarantee represented a real and substantial investment risk for the company. This risk was greater than in conventional life insurance because all the assets funding the reserves are invested in equity securities; greater than in the variable annuity, because the insurance obligation is assumed immediately upon the first premium payment; and greater than in the annuity of *United Benefit* because the "policy has a significant minimum or floor."³¹ The company might lose on its investment guarantee if the investment performance was unfavorable when the mortality experience is standard. Loss may be even greater if the investment performance is more favorable than that of the general account when the mortality experience is unfavorable.

The SEC staff and the investment industry questioned the significance of the guarantee. They pointed out that mortality experience was very rarely unfavorable,³² that the charges for the risk involving the guarantee were very low,³³ and that the insurance company would establish an additional contingency fund to be invested in conservative investments. The risk to the insurance company, they argued, was negligible.³⁴ In addition, the guarantee did not cover the cash surrender value.

The last characteristics of the policy dealt with the issue of adequate protection. First, it required that the entire policy be a life insurance contract, and second, it required that the policy be subject to regulation under the state insurance laws. Thus, by assuring that the policy was a life insurance policy, so the reasoning seems to have been, the protection of state regulation would, by definition, be satisfactory.

As to the first characteristic, the insurance industry emphasized that the proposed policies were predominantly insurance contracts because the insurance company assumed mortality risks by their pooling and distribution, as in conventional life insurance policies. Furthermore, the policies contained the usual nonforfeiture, loan, grace, reinstatement and noncontestability features.³⁵ According to the investment industry it was immaterial that the policies contained an insurance arrangement.³⁶ Such policies could still be securities depending on how they differed from conventional insurance.

30 Memorandum of Kroll, *supra* note 25, at 18.

31 Memorandum of Kroll, *supra* note 25, at 27.

32 Memorandum of Phillips, *supra* note 5, at 45; Staff Report, *supra* note 3, at 93.

33 Eight cents per \$1,000. Memorandum of Phillips, *supra* note 5, at 46; Staff Report, *supra* note 3, at 94.

34 The first two features of the scheme may indicate a low risk. The last feature may indicate the reverse, that the insurance company cannot cover its risk from charges alone, and must reserve its own funds.

35 Memorandum of Kroll, *supra* note 25, at 23.

36 Memorandum of Silver, *supra* note 7, at 25-26.

A basic deviation of variable life insurance from conventional insurance is that policyholders bear the entire investment risk with respect to the cash surrender value. Since their right to loans depends on the amount of cash value, the right is partially dependent on the investment performance of the account.³⁷ This feature raises a preliminary question of whether the investment component in the policy should be viewed separately, as the pay-in period in variable annuities was viewed separately from the pay-out period in the *United Benefit* case. If we consider the investment component without regard to the rest of the policy it is difficult to distinguish it from an ordinary investment contract or not to characterize it as a security. It was argued by the investment industry that the only difference between the cash surrender value in a variable life insurance policy and the pay-in period in variable annuities is that in the annuities the pay-in period precedes the pay-out period, whereas in a variable policy the investment is accumulated simultaneously with the insurance coverage.³⁸

It is submitted that in level premium policies, the insurance and investment components should not be viewed separately. First, the investment component in the level premium policy is an essential and integral part of the insurance scheme.³⁹ If the investment part is eliminated, if the cash value is withdrawn, the insurance coverage is extinguished. No analogy can be drawn to variable annuities. The annuity is not dependent on the pay-in period, (except to the extent that the insurance company is bound in the future to the annuity rates at the date of the beginning of the pay-in period). In addition, lapses of policies affect the whole insurance scheme and may change the mortality experience of the group.⁴⁰ There is no such effect in annuities.

When the variable policy is considered as a whole, the policyholders bear all the investment risk regarding the cash value, and the insurance company bears the major part of the risk regarding the death benefit. As to death benefits it is arguable that policyholders bear some part of the investment risk with respect to it, because their premiums are higher as compared with premiums of the conventional life insurance policy bearing the guaranteed face amount. What is, then, the relationship between the insurance and investment components in the policies and which of them is predominant?

The investment industry described the policies as interests in a pool of securities, redeemable as cash surrender value, to which an insurance protection is attached, at a cost of a fraction of the premiums. The insurance industry described the policies as regular insurance policies, at assumed interest of 3 per cent or more, which offer their holders benefits keyed to the investment performance of an investment fund, above a guaranteed death benefit. The cash sur-

37 Staff Report, *supra* note 3, at 92.

38 Memorandum of Silver, *supra* note 7, at 16.

The I.C.I. argued, in this writer's opinion, erroneously that the payments in the pay-in period are calculated according to mortality tables, as in life insurance. The correct view is that only the annuity payments, not the periodic payments, are so calculated.

39 Memorandum of Kroll, *supra* note 25, at n.8 & n.9.

40 S. HUEBNER & K. BLACK, *LIFE INSURANCE* 404 (7th ed. 1969) [hereinafter cited as HUEBNER & BLACK].

render values were relegated to a subordinate position on the assumption that people purchase insurance for insurance protection.

The accuracy of these descriptions depends on the importance of cash surrender values in the policies, and on how variable policies will be sold and how they will be viewed by the purchasing public. Cash surrender value is an important feature of life insurance policies. Regardless of how cash surrender is viewed by purchasers, more than 50 per cent of the purchasers⁴¹ of conventional life insurance lapse or surrender their policies. There is no reason to assume that the experience in variable life insurance will be different. The investment risk carried by policyholders in variable life policies is therefore substantial.

Usually, economic arrangements have a predominant purpose which answers specific needs. The primary purpose of insurance is to create an estate when savings alone will not suffice. Theoretically, at least, the cash surrender value is therefore of secondary importance. On the other hand, mutual fund shares are purchased as investment for appreciation and enjoyment in the investor's lifetime. The purpose for which a particular investor buys an instrument is usually immaterial to the characterization of the instrument. Thus, the intent of a purchaser of mutual fund shares to create an estate in the hope that he would live long enough to save and invest does not convert the shares into an insurance contract. Conversely, the intent of a purchaser of a policy to utilize the loan provisions or cash surrender value of a policy does not create an investment contract. But if the policy is changed intrinsically, if the cash surrender value and other investment aspects become so prominent that they overshadow the insurance protection, if the main purpose of the economic arrangement—the creation of an estate—is merged with investment, then the policy might be deemed to offer both, because the average man might purchase such a policy for both purposes—creation of an estate and investment. Here the intent of the "average purchaser" is relevant.

Insurance policies were exempt from securities regulation so long as their nature and paramount purpose were clear. But the public does not have the same conception of the nature and purpose of variable policies. Furthermore, the policies are uniquely prone to misrepresentation of their nature. For example, the purchase of a conventional policy for its cash surrender value only is unlikely. But once a policy is presented as an investment device, a hedge against inflation, or a "guaranteed investment," a person might well be moved to purchase the policy for its investment features. Indeed, if the optimal investment is maximum profits at minimum risk, the variable policy seems to be it. It combines security and stability of insurance with profits through investments.⁴² The description of variable policies as a variation on the insurance theme is therefore unconvincing.

The National Association of Insurance Commissioners argued that variable

41 Staff Report, *supra* note 3, at 90.

42 For this reason insurers use every opportunity to describe policies as investments. They are tempted to liken the policies to stock, to liken premiums to a withdrawable fund, and to liken the position of a policyholder to that of a stockholder. These descriptions are sometimes forbidden by statute, e.g., ILL. INS. DEPT. REG. 9.09 (11.63); COLO. REV. STAT. ANN. § 72-3-16 (1964).

policies are merely a further development of the conventional participating policies, and that they should be treated as such for the purpose of securities regulation.⁴³ It is submitted that the description does not bear closer scrutiny unless the word "participating" is used in a metaphorical sense only, in which case the resemblance ends with the name. First, the industry indicated that it proposes to sell participating and nonparticipating variable policies. This means that variable features are not an extension of participation but a new feature altogether. Second, the departures of variable policies from conventional participating policies are many and basic, so much so that variable policies resemble in many aspects mutual fund shares rather than participating policies. For example, in participating policies the insurance company bears the investment risk resulting from investment decision and general economic adversities. In variable policies, the policyholders bear this type of risk at least with respect to the cash surrender value.⁴⁴ In participating policies the dividend, once declared, belongs to the policyholder. In variable policies the right to comparable dividends, the additional death benefits, may disappear at any time before actual payment is made. In participating policies, the directors of the insurance company decide whether dividends will be paid at all, and if so, the amount of the dividends to be paid. In variable policies, management has limited discretion to determine if and how much will be paid under the policies as a result of investment performance because payments are determined according to a formula that is fixed and applies automatically. In participating policies, dividends are in fact returned excess premiums. The dividends represent profits of insurance business, although some profits may come from investments. Variable policy payments stem from investments, mostly in equity securities. Last, in participating policies the insurance company does not offer investment advisory services and does not charge a fee calculated as a percentage of the assets of a segregated fund. In variable policies, like the investment adviser in a mutual fund, the insurance company does. All these features distinguish variable policies from participating policies and make their resemblance to mutual fund shares more pronounced. The cumulative effect of all the features of the proposed policies led this writer to the conclusion that they should not be considered to be insurance contracts.⁴⁵

As to the second aspect concerning investor protection, the insurance industry argued that state regulation would afford purchasers of these policies ade-

43 Memorandum of the National Association of Insurance Commissioners at 8, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* (1972). [Hereinafter cited as NAIG Brief]. The same contention was made unsuccessfully in the case of variable annuities. *SEC v. Variable Annuity Life Ins. Co.* 359 U.S. 65, 89-90 (1959) (Brennan, J., concurring).

44 The fact that a minimum of the death benefit is guaranteed does not necessarily preclude the characterization of the transaction as an investment contract and a security. In *Tcherepnin v. Knight*, 389 U.S. 332 (1967) withdrawable share capital was only partially risk capital and could be withdrawn under Illinois statute [ILL. REV. STAT. ch. 32, § 773 (1963)]. The shares bore investment risk only after other accounts. The Court held that these shares were securities, because they participated in a common enterprise, a moneylending operation, which was dependent on the success and skill of management. *Tcherepnin v. Knight*, 389 U.S. 332, 338 (1967).

45 This writer testified in the SEC Hearings to this effect. *SEC Hearings, supra* note 5, at 2100, 2107.

quate protection. It is submitted that state insurance laws would not be an adequate substitute for the Securities Act of 1933 and the Securities Exchange Act of 1934. This conclusion was reached by the Supreme Court in the case of variable annuities.⁴⁶

The petition was based on the assumption that most states would adopt a Model Law and Model Regulation. The Model Regulation contained a provision for a mini-prospectus.⁴⁷ In addition it was assumed that the antifraud provisions of the 1933 and 1934 acts⁴⁸ would apply. These two safeguards would be in addition to present state regulation.

State laws protect purchasers by requiring that policies be filed with insurance agencies, by prohibiting fraudulent practices, and by applying the common law of fraud and misrepresentation to the sale of policies. As to filing, the proposed Model Regulations require the company to file "a general description of the kinds of variable contracts it [the company] intends to issue"⁴⁹ and to follow filing requirements otherwise applicable under existing statutes "to the extent appropriate."⁵⁰ In 1968, forty-six states and the District of Columbia required some form of filing of contracts⁵¹ and permitted sale after approval⁵² or after the expiration of a certain period unless disapproved.⁵³ Many laws specifically require filing of variable contract forms with insurance agencies.⁵⁴

State insurance regulation of policy forms varies greatly. It seems that generally the main concern of insurance commissioners is to insure the inclusion of statutory mandatory provisions in the policies. Minnesota⁵⁵ and New Jersey⁵⁶ permit the Commissioner to disapprove contracts that do not comply with the law, or contain provisions that are unjust, unfair, inequitable, ambiguous or misleading. New York permits the Superintendent to disapprove a policy form that is unfair, unjust and inequitable.⁵⁷ It is worthy of note that only New Hampshire requires disclosure in addition to direct regulation.⁵⁸ The supervision of state authorities over filed policy forms is not an effective substitute for an informed decision by purchasers.

As to insurance statutory antifraud provisions, as early as 1947 the National Association of Insurance Commissioners promulgated a Model Unfair Trade

46 SEC v. Variable Annuity Co. 359 U.S. 65, 78-79 (1959) (Brennan, J., concurring).

47 See note 68 *infra*.

48 Formally, however, the petitioners argued against any application of the acts. Memorandum of Kroll, *supra* note 25, at 55.

49 PROPOSED MODEL VARIABLE CONTRACT REGULATIONS, Art. III, § 3 attached to the Petition, *In the Matter of American Life Convention and Life Insurance Association of America, Hearings Before the SEC* (1972) [hereinafter cited as MODEL REGULATIONS].

50 *Id.*, Art. V.

51 Jones, *State Regulation of Policy Form Content*, ASS'N OF LIFE INS. COUNSEL PROCEEDINGS, 773, 775-777 (1967-68).

52 See, e.g., N.Y. INS. LAW § 154 (McKinney 1966). The Superintendent may disapprove a policy form if "it contains provisions which are unjust, unfair, or unequitable." It is not clear whether the Superintendent approaches his role, as the California Commissioner of Corporations used to, by evaluating the investment arrangement in lieu of and for the investor, for example, by regulating investment fees.

53 See, e.g., N.J. STAT. ANN. § 17B:25-18 (Supp. 1971).

54 See, e.g., MASS. GEN. LAWS ch. 175, § 132G (Supp. 1971).

55 MINN. STAT. ANN. § 61A.18 (1968).

56 N.J. STAT. ANN. § 17B:25-18 (Supp. 1971).

57 N.Y. INS. LAW § 154 (McKinney 1966).

58 N.H. REV. STAT. ANN. § 408:52 (1968) (applicable to variable annuities).

Practices Act. Many of the Act's provisions are similar to those of the Federal Trade Commission Act.⁵⁹ In addition, the Act prohibits certain practices which are peculiar to the insurance business. All states and the District of Columbia have adopted the Act or enacted similar provisions in their insurance statutes.

The Model Trade Unfair Practices Act differs from the antifraud provisions of the Exchange Act of 1934 in three aspects: first, fraud and misrepresentation in these statutes were interpreted according to the common law concepts of fraud, deceit and misrepresentation.⁶⁰ Second, enforcement of the provisions of the law is by a fine and/or imprisonment,⁶¹ or by injunctive relief applied for by state authorities. In addition, the state agency may issue a cease and desist order or use its power to revoke or suspend the certificate of authority of the insurer or the license of the selling agent. Violations of the unfair trade practices laws do not, it seems, give rise to a private right of action.⁶²

As to the common law of misrepresentation in the sale of insurance policies, the law is neither clear nor uniform, especially with respect to available remedies.⁶³ In addition, it is doubtful whether policyholders could successfully sue as a class on misrepresentation or misleading statements in the sales literature or in the policies,⁶⁴ in marked contrast to class actions under the antifraud provisions of the 1934 Act.⁶⁵

59 Regulation has not been found as effective as the Federal Trade Commission Act. Note, *Regulation of Insurance Advertising Practices: A Jurisdictional Inquiry*, 67 YALE L.J. 452, 458-64 (1958). 11 NAIC PROCEEDINGS 341, 355 (1971).

60 See, e.g., N.Y. INS. LAW §§ 273, 127 (McKinney Supp. 1972). Violation of section 127 was dealt with in *McLaughlin v. Hepburn*, 185 Misc. 290, 54 N.Y.S.2d 912 (1945) but the remedy was based on fraud and breach of contract. See also *Brandt v. Beha*, 217 App. Div. 644, 216 N.Y.S. 178 (1926). See also N.Y. INS. LAW § 211 (McKinney 1966). In California misrepresentation must be intentional. CAL. INS. CODE ANN. § 790.03 (1972), (replacing § 780 (1955), interpreted in *Collins v. Caminetti*, 24 Cal. 2d 766, 151 P.2d 105, 154 A.L.R. 1141 (1944)).

61 See Note, *Regulation of Insurance Advertising Practices: A Jurisdictional Inquiry*, 67 YALE L. J. 452, 459 n. 31, 465 n. 54 (1958).

62 The writer has not found a case in which a private right of action based on violations of state insurance laws was recognized. Decisions point the other way. State insurance agencies are deemed to possess primary jurisdiction even when policyholders are given a specific statutory right of action. E.g., *Gordon v. Hardware Mutual Casualty Company*, 281 N.E.2d 573 (Mass. 1972); *Southern Cal. Title Co. v. Great Western Financial Corp.*, 60 Cal. Rptr. 114, 124-25 (1967); *Clifford v. Metropolitan Life Ins. Co.*, 264 App. Div. 168, 34 N.Y.S.2d 693 (1942).

63 3 L. LOSS, SECURITIES REGULATION 1624 (on remedies), 1430 (on fraud), (2d ed. 1961). See note 60 *supra*. R. KEETON, BASIC INSURANCE ch. 5 (1960); see also *Morris, Waiver and Estoppel in Insurance Policy Litigation*, 105 U. PA. L. REV. 925 (1957) emphasizing the changing attitude of courts towards insurance contracts "from a service safely bought only by sophisticated businessmen to a commodity bought with confidence by untrained consumers." *Id.*

64 If reliance by plaintiff members of the class has to be proved, then a class action is virtually precluded.

65 *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970). This holding virtually eliminates the requirement of proof of reliance by plaintiff members of a class, in favor of an objective test of materiality.

Variable life insurance policies may present difficult questions under Rule 23 of the Federal Rules of Civil Procedure. There may be some question as to whether policyholders of policies funded by the same account constitute a class. See generally 3B MOORE'S FEDERAL PRACTICE, ¶ 23.04 at 23-25 (2d ed. 1969). Even if they are a class, there may be doubts as to their coextensive interest. Rescission, for example, may not be in the interest of some policyholders, but may be in the interest of others. See generally *id.* ¶ 23.07(2). See, e.g., *Gordon v. Aetna Life Ins. Co.* 467 F.2d 717 (D.C. Cir. 1971) (common questions were not found in an action on a group insurance policy for damages and a declaration that certain expenses fall within the coverage of the policy). The decision was criticized as to the finding that there was no common question. 3B Moore, *supra* ¶ 23-327 (Supp. 1972).

Let us assume that the insurance agent violated state law by failing to give the insured a mini-prospectus. The investment index of the separate account falls by 50 per cent and the policyholder wishes to cancel the policy. Under the 1933 Act the sale of the policy is a violation of § 5 for which the remedy of rescission is readily available.⁶⁶ In all probability the omission to provide the mini-prospectus is not by itself a violation of the antifraud provisions of the 1934 Act. Under state insurance laws the situation is far from clear. This writer searched in vain for a case that held a policy voidable at the instance of the insured, so long as there were no misleading statements.⁶⁷ The purchaser's remedy is to complain to the insurance authorities and his only consolation is that the insurance company might be fined or that it might lose its certificate of authority.

Even if the purchaser received a mini-prospectus, the quality and extent of the information would fall short of a § 10 prospectus.⁶⁸ Also, it is doubtful whether the mini-prospectus will be considered as a part of the policy. In New

⁶⁶ § 12(1); 15 U.S.C. § 77(1) (1970).

⁶⁷ Statutory law may have additional provisions. New York, for example, permits a policyholder who was misled by incomplete comparisons between policies, to sue the violator for the commission that he had received. N.Y. INS. LAW § 127 (McKinney 1966). The insurer who induced a sale of a policy by misleading statements or omissions in comparisons of policies may be sued for the amount of premiums and any other compensation that it had received in connection with the sale. *Id.* at § 211. It is not at all clear that this prospectus or information will form part of the policy. Therefore, any information in the prospectus which conflicts with the terms of the policy might be held to be an estimate or an illustration which is not binding on the insurer. 29 N.Y. JUR. *Insurance* § 638 (1963).

⁶⁸ The mini prospectus proposed by the insurance industry is contained in the MODEL VARIABLE CONTRACT REGULATION, *supra* note 49.

The following information shall be furnished to an applicant for a contract of variable life insurance prior to execution of the application:

- (a) A summary description of the insurance company and its principal activities.
- (b) A summary explanation in non-technical terms of the principal variable features of the contract and of the manner in which any variable benefits reflect the investment experience of a separate account.
- (c) A brief description of the investment policy for the separate account with respect to such contract.
- (d) A list of investments in the separate account as of a date not earlier than the end of the last year for which an annual statement has been filed with the Commissioner of the state of domicile.
- (e) Summary financial statements of the insurance company and such separate account based upon the last annual statement filed with such Commissioner, except that for a period of four months after the filing of any annual statement the summary required hereby may be based upon the annual statement, immediately preceding such last annual statement, filed with such Commissioner.

The insurance company may include such additional information as it deems appropriate. A copy of the statement containing the foregoing information shall be filed with such Commissioner prior to any use thereof, and shall be subject to disapproval if found to be inaccurate or misleading.

Compare Summary of the provisions of Form S-1, the Registration Statement under the Securities Act of 1933, which requires the following information: Distribution spread; detailed plan of distribution; use of proceeds to registrant; sale otherwise than for cash; capital structure; summary of earnings; organization of registrant; parents of registrant; description of business and property; organization within 5 years; pending legal proceedings; capital stock; long-term debt and other securities being registered; directors and executive officers; and their remuneration; options to purchase securities; principal holders of securities; interest of management and others in certain transactions; financial statements; marketing arrangements; other expenses of issuance and distribution; relationship with registrant of experts named in statement; sales to special parties; recent sales of unregistered securities; subsidiaries of registrant; franchises and concessions; indemnification of directors and officers; treatment of proceeds from stock being registered; and financial statements and exhibits.

York, for example, prospectuses which are not referred to in the policy do not form part of the contract,⁶⁹ although when the advertisements were knowingly false, they have been regarded as rendering the company liable to one who acted upon the statements.⁷⁰ It should be noted that (for the purchaser) the crucial time for disclosure is before the purchaser signs the application to the insurance company. This application is deemed to be an offer to which the policy constitutes acceptance.⁷¹

The whole proposal is fraught with legal uncertainties.⁷² The extent of the protection of the mini-prospectus is unclear. On the other hand, experience with variable annuities shows that the application of the 1933 Act to variable products will not raise serious difficulties for the industry.⁷³ The Securities Act of 1933 and the Securities Exchange Act of 1934⁷⁴ should therefore apply to variable insurance. As previously mentioned, the Commission so held.

III. The Applicability of the Investment Company Act of 1940

The application of the Investment Company Act of 1940 to variable life insurance raises three questions: first, whether separate accounts which fund variable life insurance policies are investment companies within the meaning of the Investment Company Act of 1940; second, whether state insurance laws conflict with the provisions of the 1940 Act; and third, whether the McCarran-Ferguson Insurance Regulation Act, which prohibits federal statutes from impairing state laws regulating the business of insurance, limits the applicability of the 1940 Act.

A. Interpretation of the 1940 Act: Variable Life Insurance Separate Accounts Are Investment Companies and Not Insurance Companies

Separate accounts invest, reinvest, and trade in securities. 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;

. . . (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . on an unconsolidated basis.⁷⁵

69 Fowler v. Metropolitan Life Ins. Co., 116 N.Y. 389, 22 N.E. 576 (1889); 29 N.Y. JUR. Insurance § 638 (1963).

70 Rohrschneider v. Knickerbocker Life Ins. Co., 76 N.Y. 216 (1879).

71 12 APPLEMAN, INSURANCE LAW AND PRACTICE § 7156, at 224 (1943).

72 See notes 60 & 63 *supra*.

73 Sections 11 and 12 might require some interpretative adjustments when the investment performance follows an investment factor rather than unit value. But the same is true of variable annuities. Furthermore, the SEC rather than state insurance agencies has the expertise and tradition of administering this type of regulation. It should also be emphasized that blue sky laws do not usually apply to variable insurance products. Between state blue sky administration and the SEC, the latter is probably also the choice of the insurance industry.

74 The staff argued that by engaging more actively in the securities markets insurance companies are in a position to affect the market and should therefore be regulated. Staff Report, *supra* note 3, at 50-54.

75 § 3(a)(1),(3); 15 U.S.C. § 80a-3(a)(1),(3) (1970).

If variable insurance policies are securities, then accounts which fund them are issuers.⁷⁶ They are therefore investment companies.

The 1940 Act excepts insurance companies from the definition of investment companies.⁷⁷ In 1963 the SEC held in the *Matter of Prudential Insurance Company*,⁷⁸ that separate accounts, established by such excepted insurance companies to issue variable annuities, were not themselves insurance companies. The Third Circuit upheld the decision.⁷⁹ But when the same questions came before the Supreme Court, in another case, the Court said:

[T]he provisions of that Act [the 1940 Act] are substantive and go well beyond the disclosure requirements of the Securities Act. Thus the question whether the fund may be separated from United's other activities and considered an investment company is a difficult one. . . . An investigation into the relationship between the "Flexible Fund" and United's insurance business, as well as an investigation of the possible conflicts between state and federal regulation, is required for a proper resolution. The SEC has requested us to remand the case for further consideration of this issue, and in view of its complexity, we deem this the wisest course.⁸⁰

The case never reached the Supreme Court again. The insurance industry argued that the SEC decision in *Prudential* is not applicable to variable life insurance policies, because the investment and insurance components are inseparable,⁸¹ and the separate accounts that fund the policies are a part of the insurance company's business, and not a separate investment business. These arguments were made in *Prudential* in connection with variable annuities. SEC's answer there was that investors in variable annuities need securities-protection and that the insurance company was the creator of another company, the account in which it sold interests.⁸² Furthermore, at the SEC Hearings the staff argued that the fact that the shareholders and policyholders were interested in the performance of the account did not preclude the applicability of the 1940 Act.⁸³

The 1940 Act defines a separate account as:

. . . an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.⁸⁴

76 Issuer is defined in § 2(a)(22); 15 U.S.C. § 80a-2(a)(22) (1970). See generally Frankel, *supra* note 19, at 231.

77 § 3(c)(3); 15 U.S.C. § 80a-3(c)(3) (1970).

78 *In re The Prudential Ins. Co.*, 41 S.E.C. 335 (1963), *aff'd* 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

79 *Prudential Ins. Co. v. SEC*, 326 F.2d 383 (3d Cir. 1964).

80 *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 212 (1967). The petitioners argued that this statement cast doubt on the status of separate accounts as investment companies. Memorandum of Kroll at 45-46. The investment industry emphasized that the Supreme Court simply did not decide the issue upon a recommendation of the SEC. Reply Memorandum of Phillips, SEC Hearings, *supra* note 5, at 32. Staff Report, *supra* note 3, at 113.

81 Memorandum of Kroll, *supra* note 25, at 46.

82 41 S.E.C. 335 (1963).

83 Staff Report, *supra* note 3, at 116-17.

84 § 2(a)(37); 15 U.S.C. § 80a-2(a)(37) (1970).

Separate accounts perform a dual role. They are depositories of the reserves funding variable life insurance policies, and they are also a device to keep separate the assets of the separate account, and measure the investment performance of these assets. The first role is part of the insurance company's business; the second role is investment business. The classification of separate accounts is a federal question.⁸⁵ State law does not govern here, and thus it is of little assistance.⁸⁶

An insurance company is defined in the Act as "a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance . . . and which is subject to supervision by the insurance commissioner or a similar official or agency of a State. . . ."⁸⁷ A separate account is not organized as an insurance company,⁸⁸ nor does it comply with state laws' conditions for doing insurance business. An account is not organized as a separate entity under state law.⁸⁹ It is a tool used by an insurance company to carry on its insurance business.⁹⁰ Yet the primary and predominant business of a separate account is securities investments.

The question of what is "primary business" has been discussed frequently in connection with another section of the Act⁹¹ that exempts, either automatically or by order of the Commission, certain investment companies from the Act. One condition for exemption is that the company be "primarily engaged" in a business other than investment.

In evaluating the extent of the noninvestment business of a company, the Commission compares the assets used in investment and noninvestment business,⁹² the ratio of investment income to noninvestment income,⁹³ the purpose for which the corporation was established, and the history of its operations.⁹⁴ Cases which tested primary business by assets and income dealt with assets used exclusively for one purpose or another. Since the assets in a separate account serve both investment and insurance purposes, the tests of investment-insurance ratio are inconclusive.

Purposes and history of the corporation are more helpful criteria. These criteria were applied in the somewhat analogous case of *In re Filbert Corp.*⁹⁵

85 SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); *Modern Life and Accident Ins. Co. v. C.I.R.*, 420 F.2d 36 (7th Cir. 1970). (For the purposes of the Internal Revenue Code, state law definition of a mutual insurance company does not control.)

86 Frankel, *supra* note 19, at 238, 248-51.

87 § 2(a)(17); 15 U.S.C. § 80a-2(a)(17) (1970).

88 See Frankel, *supra* note 19, at 255, 259.

89 *Id.* at 256.

90 *Id.* at 248-49.

91 § 3(b)(2); 15 U.S.C. § 80a-3(b)(2) (1970).

92 In the Matter of M.A. Hanna Co., 10 S.E.C. 581 (1941) (examination of the amount of assets and source of income from mining operations as compared to investments); In the Matter of International Bank, SEC Investment Company Act Release No. 3986 (June 4, 1964) (over 2/3 of assets and income came from banking companies); In the Matter of Business Property Associates, 12 S.E.C. 845 (1943) (test was ownership of assets and source of income). See also SEC v. S&P. Nat. Corp., 360 F.2d 741 (2d Cir. 1966). (Investments in real estate were small in comparison with the total amount of assets invested in securities; under this test the company was not primarily engaged in real estate.)

93 *Id.*

94 In the Matter of M.A. Hanna Co., 10 S.E.C. 581 (1941); *Bankers Sec. Corp. v. S.E.C.*, 146 F.2d 88 (3rd Cir. 1944).

95 15 S.E.C. 667 (1944).

Three closely held companies wished to enable their employees to invest in the companies' shares. The issue was whether a corporation organized by the employees for this purpose was an investment company. The argument seemed to be that the primary business of the corporation was other than investment, because it served a function within the employer companies' operations, such as providing incentives to employees. The Commission looked to the immediate purpose of the corporation, and concluded that the corporation was an investment company. The purpose was to "provide an investment medium for the employees of the several companies. . . . It is apparent that Filbert's existence [employee company] is not necessary for the operation of the general business of the enterprises. . . ."96 By the same token, separate accounts are not necessary for the operation of the business of issuing variable life insurance policies, although they may be helpful. Accounts are established to separate and segregate the investment business in equity securities from the other investments of the insurance company and to facilitate separate accounting of such investments.⁹⁷ If the primary business of separate accounts is determined according to the purpose for which they were established, the accounts are not insurance companies.⁹⁸

Another relevant test is the need for investor protection. Insurance companies were excepted from the definition of an investment company even though they invested and reinvested in securities.⁹⁹ It was felt that policyholders did not need the protection of the 1940 Act because insurance companies invested at their own risk. In addition, rigorous state regulation prevented financial irresponsibility that could arise from the issuance of long-term debt securities, as in the case of face amount certificate companies. On the other hand, when policyholders assume the investment risk, the Supreme Court held that state supervision is not a substitute for the protection of the 1940 Act.¹⁰⁰

Separate accounts funding variable life insurance are similar to mutual funds and may pose some of the problems that the 1940 Act was designed to solve. Policyholders bear part of the investment risk; payments under the policies are automatically affected by the investment results of the account; cash values, like the redemption price, depend on the value of the underlying securities in the account; the investment performance of the account will, no doubt, serve as an important sales feature in competition with mutual funds; last, the insurance company charges a percentage of the assets in the account for investment advice.

It is true that the insurance company, unlike a mutual fund, has a stake in the account's investment policies because it provides policyholders with guaranteed death benefits, the company's other assets back its insurance obligations

96 *Id.* at 672.

97 Frankel, *supra* note 19, at 248-49.

98 For a similar reasoning see Frankel, *supra* note 19, at 378-80, with respect to definition of insurance companies under the federal Bankruptcy Act. For an analysis of mutual companies for the purpose of classification under the Internal Revenue Code, an analysis which included an examination of the company's purposes as announced by it, see *Modern Life & Accident Ins. Co. v. C.I.R.*, 420 F.2d 36 (7th Cir. 1970).

99 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 74 (1959) (Brennan J. concurring). See *Hearings Before Subcom. of the Senate Comm. on Banking & Currency on S. 3580*, 76th Cong., 3d Sess., at 181 (1940).

100 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 90-91 (1959).

to policyholders, and the account's assets are also the reserves for the policies.¹⁰¹ Nevertheless, these characteristics are not sufficient to eliminate potential abuses which are present in the variable insurance separate account. If state insurance laws do not afford adequate alternatives to federal regulation,¹⁰² the 1940 Act applies to separate accounts, and the insurance companies exception should not apply to them. The Commission held that separate accounts are investment companies. It also held that separate accounts are not insurance companies.

B. Separate Accounts Are Open-End Investment Companies — Variable Life Insurance Policies Are Not Periodic Payment Plan Certificates

The 1940 Act contains special provisions regulating companies that offer and sell redeemable securities (open-end investment companies or mutual funds).¹⁰³ The Act also regulates the sale of mutual fund shares by installments (periodic payment plan certificates).¹⁰⁴ It is therefore important to determine whether variable life insurance policies are redeemable securities or periodic payment plan certificates, or both, and hence subject with their accounts to additional regulation.¹⁰⁵

1. REDEEMABLE SECURITIES

There are two ways to determine whether variable policies are redeemable securities: one is by comparing and distinguishing the features of these legal arrangements, and the other is by comparing the need for investor protection to which the two arrangements give rise.

The first approach leads to the conclusion that variable life insurance policies are neither redeemable securities nor periodic payment plan certificates.¹⁰⁶ The SEC staff argued that the terms of the policies satisfy the definition of redeemable securities in that nonforfeiture provisions permit the holder to present his policy, and obtain his proportionate share of the assets of the account. However, the argument does not recognize the fact that the policyholder must surrender not

¹⁰¹ Frankel, *supra* note 19, at 317-18.

¹⁰² See pp. 1081 *infra*, as to § 15; and pp. 1071-72 *infra*, as to § 22(c).

¹⁰³ § 5(a)(1); 15 U.S.C. § 80a-5(a)(1) (1970). Redeemable security is defined as "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." § 2(a)(32); 15 U.S.C. § 80a-2(a)(32) (1970).

¹⁰⁴ § 2(a)(27); 15 U.S.C. § 80a-2(a)(27) (1970). A periodic payment plan certificate is defined as:

(A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in clause (A) have upon completing the periodic payments for which such securities provide.

¹⁰⁵ See §§ 11, 12(b), 12(d)(1)(B), 18(f), 22, 24(b), 24(c), 24(f); 15 U.S.C. §§ 80a-11, 12(b), 12(d)(1)(B), 18(f), 22, 24(b), 24(e), 24(f) (1970).

¹⁰⁶ Frankel, *supra* note 19, at 386-87.

only his right to cash value but the whole policy. The surrender of a policy means the surrender of insurance coverage, which may be valuable.¹⁰⁷ It is not clear whether cash value is synonymous with the policyholder's "proportionate share" of the account's assets. At present, a policy has no cash value for the first few years of its life. Arguably, the cash surrender value could constitute a "proportionate share." Another view is that cash surrender value ought to constitute the full proportionate share of the policyholder in the reserve. This view ventures into the insurance field, and may be too simplistic. Lapses affect remaining policyholders as such, in addition to their participation in investments of the separate account. The better view seems to this writer to be that the payment of cash value is not redemption within the meaning of the 1940 Act, because surrender of the policy is more than surrender of the investment contract which it contains.

On the other hand, the second approach to the problem, based on the need of investors for the protection of the federal acts,¹⁰⁸ indicates that variable policies are indeed redeemable securities, and that the accounts that issue them should be deemed to be open-end investment companies.

The special regulation of mutual funds is the result of some unique features of these companies. The redeemable securities which mutual funds sell¹⁰⁹ raised special problems. Valuation of assets for the purpose of establishing redemption price was inaccurate and redemption price was not promptly paid. In addition, the investment adviser generated high-pressure sales techniques because its fee was based on the value of the company's assets. Aggressive salesmanship led to undesirable practices, such as misleading advertisement. Since mutual fund shares are ordinarily "sold rather than bought," the key factor in successful marketing is the compensation of salesmen. Companies therefore permitted exorbitant sales commissions.¹¹⁰

The purpose of the 1940 Act regulation is to curb these abuses. Mutual funds must price their shares according to the value of the underlying portfolio, pursuant to prescribed valuation methods.¹¹¹ Companies must redeem the shares within seven days of demand.¹¹² The Commission supervises sales literature,¹¹³ and projections based on past performance are prohibited.¹¹⁴ The rate of commissions that purchasers pay is controlled and must not be "excessive."¹¹⁵

The abuses inherent in the sale of redeemable securities are also inherent in the sale of variable life insurance policies. First, insurance is also sold rather than bought. The insurance industry also caters to salesmen by offering high commissions, rather than to purchasers by reducing insurance cost. Further, invest-

107 *E.g.*, if the insured became in the meantime uninsurable.

108 *See* SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959). *See also* SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 210, 211 (1967).

109 § 2(a)(32); 15 U.S.C. § 80a-2(a)(32) (1970).

110 SEC REPORT, *supra* note 11, at 95-95, 196; *Hearings H.R. 9510 & H.R. 9511 Before the Subcom. on Commerce & Fin. of the House Com. on Inter. & Foreign Commerce*, 90th Cong., 1st Sess., pt. 1, at 49 (1967) [hereinafter cited as *Mutual Fund Hearings*].

111 § 2(a)(41); 15 U.S.C. § 80a-2(a)(41) (1970); 17 C.F.R. § 270. 22c-1 (1972).

112 § 22(e), 15 U.S.C. § 80a-22(e) (1970).

113 § 24(b), 15 U.S.C. § 80a-24(b) (1970).

114 17 C.F.R. § 271.2621 (1972).

115 § 22(a)(1); 15 U.S.C. § 80a-22(a)(1) (1970).

ment occupies an important role in the policies. There is no reason to assume that the insurance industry will not make the most of the investment performance of its accounts, and use investment results as a prominent sales feature. The potential for abuse in the sale of variable life insurance policies is greater than in the sale of mutual fund shares since investment might be confused with protection and security which insurance offers. Purchasers might be led to believe that investment with insurance companies is "safer" than with other investment media. Since commissions to salesmen are calculated as part of the premiums, purchasers of insurance are unable to compare commissions charged to them by various companies for the same product. As to redemptions, there is similar need for protection in connection with valuation and measuring of investment performance. In addition, the need for prompt payment of cash surrender value is similar to the need for prompt redemptions.¹¹⁶ The second approach leads to the conclusion that the protection offered by the 1940 Act is relevant to variable life insurance except where federal regulation is rendered unnecessary by adequate state protection.

2. PERIODIC PAYMENT PLAN CERTIFICATES

Section 27 of the 1940 Act regulates the purchases of periodic payment plan certificates.¹¹⁷ The buyers of these certificates are usually small unsophisticated investors. They generally pay a high sales load and most of it is paid in advance (front-end load). If installment payments are not continued, as in many cases they are not, purchasers lose the front-end load. The least experienced and smallest investors therefore lose the most.¹¹⁸

The 1940 Act requires that periodic payment plan certificates be redeemable, regardless of contract provisions.¹¹⁹ The load is limited to 9 per cent,¹²⁰ and the front-end load is limited to various percentages of actual payments.¹²¹ The company must repay part of the front-end load if the purchaser surrenders his certificate at an early stage. Purchasers must receive notice specifying all charges and expenses, whereupon they have an opportunity to terminate the contract before starting payment.¹²²

Level premium life insurance posed some similar problems. Nothing in the law of contracts required an insurance company to pay holders of lapsed policies the savings that they had accumulated. Originally, the companies argued that withdrawing policyholders should receive nothing because life insurance was designed to give protection from loss only in the event of death; the savings of

116 On the question of liquidity separate accounts may be subject to different requirements. The amount of death benefits plus demands for cash surrender value may be different than anticipated redemptions in mutual funds. Separate accounts may therefore need either more or less ready cash.

117 § 2(a)(27); 15 U.S.C. § 80a-2(a)(27) (1970). See *Mutual Fund Hearings*, *supra* note 110, at 114.

118 See generally SEC REPORT, *supra* note 11, at 169-204, 187 (statistics on lapsed contracts).

119 § 27(c)(1); 15 U.S.C. § 80a-27(c)(1) (1970).

120 § 27(a)(1); 15 U.S.C. § 80a-27(a)(1) (1970).

121 § 27(a)(h); 15 U.S.C. § 80a-27(a)(h) (1970).

122 § 27(e), 15 U.S.C. § 80a-27(e) (1970).

the withdrawing policyholders should be divided among the remaining policyholders through reduced premiums. This harsh view has been completely abandoned.¹²³ All fifty states and the District of Columbia require the company to provide minimum nonforfeiture benefits to the withdrawing policyholder.¹²⁴

Statutory minimum nonforfeiture benefits are below what most insurance companies offer. In this area, competition plays a role. Even so, nonforfeiture benefits offer less than the full reserve funding of the policy.¹²⁵ This amount would have been the equivalent of redemption price under the 1940 Act. If this measure were adopted, the remaining policyholders would have borne the unliquidated acquisition expenses of the policies.¹²⁶

Various reasons are offered for giving policyholders less than their full savings.¹²⁷ First, policyholders may utilize the privilege during times of economic depression and thereby endanger the financial position of the insurance company to the detriment of the remaining policyholders. Second, withdrawals force the company to adopt a more conservative investment policy to keep a portion of the assets liquid. Third, nonforfeiture privilege tends to create an adverse mortality selection because healthy policyholders in need of money will lapse their policies more readily than policyholders whose health is failing. Some writers argue that withdrawing policyholders should continue to make contribution to

123 HUEBNER & BLACK, *supra* note 40, at 401-3. 3A. APPLEMAN, *supra* note 71, at § 1864. *Meyers v. State Farm Life Ins. Co.*, 416 S.W.2d 10 (1967); *Fayman v. Franklin Life Ins. Co.*, 386 S.W.2d 52 (1965) (the purpose of nonforfeiture statutes was to prevent unfair situations in which insurance companies could keep all of the net value of a lapsed life policy).

124 For explanation of computations of cash value under the Standard Non-Forfeiture Act, see HUEBNER & BLACK, *supra* note 40, at 407-15. J. MACLEAN, *LIFE INSURANCE* 180-83 (9th ed. 1962), N. KRUEGER & L. WAGGONER, *THE LIFE INSURANCE POLICY CONTRACT* 196-98 (1953). ALA. CODE Tit. 28, § 373 (1958); ALASKA STAT. § 21.45.300 (1968); ARIZ. REV. STAT. ANN. § 20-1231 (1956); ARK. STAT. ANN. § 66-3327 (ii) (1966); CAL. INS. CODE § 10159.1 - 10163 (Supp. 1971); COLO. REV. STAT. ANN. §§ 72-A-2 to -19 - 7 (1963); DEL. CODE ANN. Tit. 18 § 2929 (1971); D. C. CODE ENCYCL. ANN. § 35 - 705b (1968); FLA. STAT. ANN. § 627.0225 (Supp. 1971); GA. CODE ANN. § 56-2504 (1971); HAWAII REV. STAT. § 431-561 (1968); IDAHO CODE ANN. § 41-1927 (12) (Supp. 1971); ILL. ANN. STAT. ch. 73, § 841.2 (1965); IND. ANN. STAT. § 39-4206b, 39-4208c (1965); IOWA CODE ANN. § 508.37 (1973); KAN. STAT. ANN. § 40-428 (Supp. 1971); KY. REV. STAT. ANN. §§ 304.15-310 to -360 (1971); LA. REV. STAT. ANN. § 22:168 (Supp. 1972); ME. REV. STAT. ANN. tit. 24-A, §§ 2524-34 (1971); MD. ANN. CODE art. 48A, § 414 (1972); MASS. GEN. LAWS ANN. ch. 175, §§ 144, 146 (1958); MICH. STAT. ANN. § 24.14060 (Supp. 1972); MINN. STAT. ANN. § 61A.24 (1968); MISS. CODE ANN. § 5669-03 (Supp. 1972); MO. ANN. STAT. §§ 376.630, 376.670 (1968); MONT. REV. CODE ANN. § 40-3831 (Supp. 1971); NEB. REV. STAT. §§ 44-407 to - 407.09 (1968); NEV. REV. STAT. tit. 57, §§ 688A.290 - .360 (1971); N.H. REV. STAT. ANN. §§ 409:1 - :8 (1968); N.J. STAT. ANN. § 17B:25-19 (Supp. 1971); N.M. STAT. ANN. § 58-8-3 (Supp. 1971); N.Y. INS. LAW § 208-a (McKinney 1966); N.C. GEN. STAT. § 58-201.2 (1965); N.D. CENT. CODE § 26-03-26 (1970); OHIO REV. CODE ANN. § 3915.07 (Page 1971); OKLA. STAT. ANN. tit. 36, § 4029 (Supp. 1972); ORE. REV. STAT. §§ 743.204 - 743.222 (1971); PA. STAT. ANN. tit. 40, § 510.1 (Supp. 1971); R.I. GEN. LAWS ANN. § 27-4-15 (1968); S.C. CODE ANN. §§ 37-171 to -175.7 (Supp. 1971); S.D. COMP. LAWS ANN. §§ 58-15-31 to -43 (1967); TENN. CODE ANN. § 56-1113 (1968); TEX. INS. CODE art. 3.44a (Supp. 1972); UTAH CODE ANN. § 31-22-13(2) (1966); VT. STAT. ANN. tit. 8, §§ 3741 - 49 (1971); VA. CODE ANN. § 38.1-461 to -468.2 (1970); WASH. REV. CODE ANN. § 48.23.350 (Supp. 1972); W. VA. CODE § 33-13-30 (1966); WISC. STAT. ANN. § 206.181 (Supp. 1972); WYO. STAT. ANN. § 26.1-364 (1957).

125 HUEBNER & BLACK, *supra* note 40, at 402. This amount is all the premiums paid (less dividends) plus assumed interest less a pro rata share of the policyholder of death claims and average expenses of the company.

126 *Id.* at 403.

127 *Id.* at 404.

the special contingency fund of the company, like the remaining policyholders. In addition, the prevailing philosophy is that the cost of marketing and handling the surrendered policy should be deducted from the amount due to the policyholder.

Both insurance and mutual funds industries follow the principle that the purchaser alone should bear the sales-load. In mutual funds the payment of sales commissions is not considered a legitimate fund expense¹²⁸ because such a payment would directly affect the share value, and because, so the argument runs, increase in fund assets through sales is not one of the fund's purposes. Insurance companies have more flexibility. The shareholders of the company are only indirectly affected by payment of sales commissions. The only possible concern to nonparticipating policyholders would be that the payments might endanger the financial stability of the company. Commissions may, but need not, affect participating policies, because they might affect the dividends. Hence, state insurance laws usually permit insurance companies to pay and finance sales commissions from their general accounts. The laws of three states impose an overall limitation on the amounts which insurance companies may spend on salesmen to ensure that these payments will not deplete the companies' resources.

Even though both industries charge the sales-load to the purchaser, the sales-load on insurance policies differs from that on mutual fund shares in two aspects. The 1940 Act limits the load and front-end load that may be charged on periodic payment plan certificates, whereas insurance statutes dealing with the subject limit the amount which the insurance company may pay its salesmen. Second, the amount which state insurance laws permit far exceeds the limitation of the 1940 Act.¹²⁹ The result is that in most cases a policy has a cash value equal to the reserves (the investment component) only after nine years, and that a policyholder will lose all or part of his investment if the policy is lapsed during this period. A purchaser of a periodic payment plan certificate, on the other hand, would lose upon lapse of his plan in the first year only 15 per cent of his investment.¹³⁰ Furthermore, even though the insurance industry argues that lapses are less compatible with insurance policies than with investments—because in insurance the investment is forced and earmarked for a specific use—this argument flies in the face of the staggering percentage of lapses of policies in their early years.¹³¹ In the last analysis, insurance salesmen receive higher commissions than their brethren who sell mutual fund shares, and policyholders pay the difference.

Notwithstanding these facts, it seems to the writer that the protection of § 27 regarding load should not apply to variable policies without further research. First, when cash value is not available the policyholders usually receive, after the first year of the policy, a substitute paid-up policy. It may also be

128 *Moses v. Burgin*, 445 F.2d 369, 374 (1st Cir. 1971), *cert. denied*, 404 U.S. 994 (1971). The decision was based on the charter provision that upon sale of its shares the company receives their full asset value.

129 Some companies spend more than 100 per cent of the first year's premium on sales expenses out of which 55 per cent may be paid to the salesman.

130 § 27(d); 15 U.S.C. § 80a-27(d) (1970).

131 Memorandum of Phillips, *supra* note 5, at 31. In the first year of the policy termination may range from 15 per cent to 25 per cent. 10 per cent of the remaining policyholders terminate their policies in the second year of the policy; an aggregate of 44 per cent terminate by the end of the fifth year, 53 per cent by the end of the tenth year.

argued that whether or not variable policyholders take an investment risk is not necessarily relevant to the amount of the load. In addition, the services and qualification of salesmen of variable life insurance might merit different compensation. Moreover, the usual purchase of mutual fund shares is for cash, not by installments, whereas the normal life insurance policy is for annual level premiums rather than a single premium. Savings in life insurance is accumulation of sufficient funds to cover death benefits in later years. To replace annual premiums with a single premium is to lay out more money in advance, rather than to pay for shares that can be delivered now. Finally, if § 27 applied only to the investment component in the premiums of variable policies, the company could charge the rest of its front-end load and commissions under the insurance rate and thus avoid the limitation. If the section applied to the whole amount of premium, the section would directly regulate the sale of life insurance.

As to the right under § 27 to terminate the contract without losses, insurance laws grant a similar right to the unsophisticated purchasers of industrial policies, by permitting them to cancel the policies within two to three weeks for the full amount of their premiums.¹³² Conventional policyholders do not get this protection.

It may be argued that variable policyholders need, for their protection, the right to terminate their policies upon perusal of the charges and costs to them, although it is difficult to see the difference between variable and conventional policies in this respect. It may also be wise and desirable to give variable life insurance policyholders termination rights. They are more sophisticated than the purchasers of industrial policies, but they might be as ignorant and gullible with respect to a novel product such as this. However, the purpose of the 1940 Act was to enable purchasers to examine, free of sales pressure, all charges and expenses in connection with the sale. The purpose did not extend to other features of the contract, complex as they might be. It would therefore be inappropriate to apply these provisions to variable insurance without express congressional intent.

Another aspect of the problem, and perhaps the real issue in this matter, is the competitive position of the three products: mutual fund shares, conventional life insurance, and variable life insurance. That it is socially desirable to provide the public with as many alternative modes of investments as possible, is presumed to be axiomatic. It follows that to the extent that a mode of investment is offered by a certain industry, the welfare of that industry is in the public interest. As equally axiomatic is the principle that healthy competition among members of an industry and among industries offering alternative investments is in the public interest. It is therefore important to keep the competitive position of the insurance and investment industries and their various products reasonably balanced. The difficulty in applying § 27 to variable life insurance stems from the unknown nature of the variable insurance policy and from the fact that the key to successful sale of mutual fund shares and insurance policies is in the hands of the

¹³² R. KEETON, *BASIC INSURANCE LAW* 55 (1960). During this period the policyholders are covered. The premiums are usually very low at weekly payments. Purchasers of these policies are usually factory workers; hence their name. J. MACLEAN, *LIFE INSURANCE* 413 (9th ed. 1962).

salesmen. It is interesting to note that although only about a third of the mutual funds are sold by installments, subject to § 27 of the 1940 Act, the industry has been selling shares for cash at the same rate of commissions as the maximum permitted under § 27, namely, about 8.5 per cent. Mutual fund salesmen, therefore, have less incentive to prefer periodic payment plan certificates to cash transactions.¹³³ In the insurance field, companies use commissions to promote products that they favor and to demote products that they do not. If variable life is considered by the public as an alternative to life insurance, the Commission might hand a disincentive to insurance salesmen by applying the limitations of § 27, and determine in advance the fate of the policy. On the other hand, if the public considers mutual funds and variable life policies as interchangeable, mutual fund salesmen might be directed to the sale of variable life insurance if § 27 is not applied. The answer may be in the manner in which the policies will be advertised and sold, and in full or partial competition among salesmen.¹³⁴

Proponents of the investment industry suggested that the high load on insurance policies reflects the higher value which society places on life insurance as compared with mere investments. This idea leads us back to the question of how much insurance is variable life insurance. There is consensus that the policies have sufficiently redeeming features to warrant their sale to the public. But their place on the list of socially desirable economic arrangements is open to debate. If the place depends on public evaluation, then the sales commissions should be subject to free competition with full and clear disclosure to investors. Past experience shows that since incentive to the salesmen is crucial to the marketing of shares and policies, free competition is hard to achieve. But because today's public is more sophisticated and educated, free competition among salesmen and members of the investment and insurance industries may result in placing commission levels where they ought to be.

In any event, before identical rules apply to mutual fund shares and variable insurance a closer examination of the expenses and competitive positions of the two industries and their products should be made.

IV. Rules Governing the Relationship Between State Insurance Laws and the Investment Company Act

A. General Background

If separate accounts are open-end investment companies, they are subject to regulation by state insurance laws and by the 1940 Act. The relationship between federal and state laws is governed by the Supremacy Clause. The 1940 Act expressly preserves state laws,¹³⁵ provided that the two do not conflict. How-

¹³³ The front-end load, however, still provides an incentive for salesmen to prefer periodic payment plans.

¹³⁴ See SEC Investment Company Act Release No. 7475 (Nov. 3, 1972); SEC Investment Company Act Release No. 7555 (Dec. 8, 1972) (Proposal to permit competition among salesmen of mutual fund shares).

¹³⁵ § 50; 15 U.S.C. § 80a-50 (1971). 1 L. LOSS, SECURITIES REGULATION 155-56 (2d ed. 1961). § 18 of the Securities Act of 1933 is similar. With respect to this section, it has been held that since Congress did not limit the application of the Securities Act to interstate

ever, in 1945 Congress passed the McCarran-Ferguson Insurance Regulation Act [hereinafter the McCarran-Ferguson, or McCarran Act]¹³⁶ which gives a special status to state laws regulating the business of insurance. In searching for the applicable law, therefore, the first question is whether the 1940 Act and state laws conflict so as to preclude, under federal law, concurrent application of both laws. The second question, regardless of the answer to the first, is whether the McCarran-Ferguson Act applies.

When state law is stricter than the federal act the two may conflict. In *Investors Diversified Services v. Diggles*¹³⁷ the Supreme Court of Wisconsin held that a state law which requires a face-amount certificate company to deposit with a state agency \$500,000 conflicted with the provisions of § 28(b) of the 1940 Act that specifies the type of investments in which the company may maintain its reserves. State law rendered illegal some investments which federal law did not prohibit. The court saw such a clear conflict "as to require no citation of authority," but added that state law might also place an undue burden on interstate commerce and therefore be constitutionally objectionable. The decision was criticized on the grounds that the case may not have presented a real conflict, since the state statute required a deposit, and the federal act did not, and further that company could comply with both statutes.¹³⁸

In *Crosby v. Weil*¹³⁹ the Supreme Court of Illinois considered the validity of an Illinois statute that imposed stricter civil remedies for securities' violations than those provided in the Securities Act of 1933. "It is entirely possible" said the court, "that a security which the Securities Exchange Commission would authorize to be sold could not be sold in Illinois under the Illinois law."¹⁴⁰ The court noted that when the 1933 Act was passed state laws existed and since Congress expressly preserved state laws, they are presumably not in conflict with the securities act, or are deemed preserved by Congress. The transaction was local, and the state law was not clearly repugnant to federal law since it would not have a detrimental effect on the national regulatory policy declared by the federal securities acts.

When state law produces a result which is contrary to the policy of the federal act, a conflict arises. In *Public Service Commission of New York v. Securities and Exchange Commission*¹⁴¹ it was held that the SEC could exercise its power under the Public Utility Company Act of 1935 without first obtaining a state commission's approval. The power of the SEC was to require a plan not

commerce, concurrent state and federal jurisdiction is permitted. *SEC v. Timetrust, Inc.*, 28 F. Supp. 34, 41 (N.D. Cal. 1939). See also *Independence Shares Corp. v. Deckert*, 108 F.2d 51, 56 (3d Cir. 1939), *rev'd on other grounds*, 311 U.S. 282 (1940); Frankel, *supra* note 19, at 288.

136 15 U.S.C. §§ 1011-15 (1970).

137 272 Wis. 66, 74 N.W.2d 805 (1956).

138 1 L. Loss, *SECURITIES REGULATION* 157 n. 95 (2d ed. 1961).

139 382 Ill. 538, 48 N.E.2d 386 (1943); Annot., 145 A.L.R. 1252 (1943). The case dealt with the Securities Act of 1933, but the same rationale applies to the 1940 Act. *Travelers Health Ass'n v. Commonwealth*, 188 Va. 877, 51 S.E.2d 263 (1949), *aff'd* 339 U.S. 643 (1950); *First Nat'l Savings Foundation, Inc. v. Samp*, 274 Wisc. 118, 80 N.W.2d 249 (1956).

140 *Crosby v. Weil*, 382 Ill. 538, 543, 48 N.E.2d 386, 389 (1943).

141 166 F.2d 784 (2d Cir. 1948).

only to approve or permit it.¹⁴² A state commission should not through its power of approval, exercise a veto and weaken the impact of federal law. State law had to yield.

It is submitted that state law that imposes an additional duty on a company is not in conflict with federal law unless unduly burdensome.¹⁴³ As to insurance laws, it seems that the McCarran-Ferguson Act has removed the last mentioned limitation.¹⁴⁴ When federal law leaves certain options to a company and state law limits or eliminates some of the options, there is no conflict unless the federal law is designed to encourage the exercise of the options. There seems to be no reason to prevent states from requiring or forbidding actions which the companies are free to do or to abstain from doing. Thus, there is no conflict between the 1940 Act that requires unseasoned investment companies to have a net worth of \$100,000 and state law that requires a higher minimum net worth.¹⁴⁵ There is no conflict between state law that prohibits underwriting activities by accounts, and the 1940 Act that only restricts these activities.¹⁴⁶ The thrust of the federal provision is to provide safeguards for investors. Additional safeguards do not conflict.

When state law frees a company from a prohibition or a requirement of federal law, a conflict exists. Thus, when state law permits investments in another investment company beyond the federal maximum,¹⁴⁷ or allows a company to disenfranchise policyholders that under federal law should have a vote,¹⁴⁸ state law has to yield.¹⁴⁹

In some areas state laws supplement the 1940 Act. The 1940 Act does not prescribe a full organizational scheme for investment companies. These questions are governed by state laws, subject to specific federal provisions.¹⁵⁰ Thus, the 1940 Act provision that contractholders have a vote does not conflict with state insurance laws that give insurance commissioners the power to remove dis-

142 § 11(e) imposed on the "SEC the 'duty' of ascertaining how far holding companies can be 'simplified' . . . and vests it with power to accomplish these ends." *Id.* at 787. If the prior approval of the state authority to issue the securities is required, then the SEC would have to dismiss the proceeding under one section and start under another. The court refused to give to § 11(e) this interpretation. *Id.*

143 *E.g.*, *Perez v. Campbell*, 402 U.S. 637, 644 (1971). (An Arizona statute providing that bankruptcy of an adjudged negligent driver does not release him from liability for the judgment held to conflict with the federal Bankruptcy Act that declares bankrupts are released from prior debts. The conflict stems from the purposes of statutes because the state act is aimed at providing leverage for collection of damage.); *Powers v. McCullough*, 258 Iowa 738, 140 N.W.2d 378, 383 (1966) (State statute which required an employer to report certain accidents to state authority did not conflict with the monthly reporting of railroad accidents to the Interstate Commerce Commission under the federal statute because the employer could comply with both, Congress did not intend to preempt the field, and there was no undue burden on interstate commerce.); *see also* G. GUNTEER & N. DOWLING, *CASES AND MATERIALS ON CONSTITUTIONAL LAW* ch. 8, § 2 (8th ed. 1970).

144 *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408 (1946).

145 *See* p. 1072 *infra*.

146 *See* p. 1076 *infra*.

147 § 12(d)(1); 15 U.S.C. § 80a-12(d)(1) (1970). *See* p. 1077 *infra*.

148 Even here there is no real conflict if state law does not require a company to invest more than the federally permitted percentage.

149 *See* p. 1081 *infra*.

150 National banks offer an appropriate contrast. The constitution of the banks is carefully spelled out in the federal law. State law is therefore sparingly applied. *See* *Rogers v. First Nat. Bank of St. George*, 410 F.2d 579 (4th Cir. 1969). A statute requiring the setting of the record date prior to a shareholders' meeting concerning the merger of national banks would

qualified management.¹⁵¹ As a matter of interpretation of the 1940 Act, state law should apply.

As noted, the relationship between state and federal law with respect to insurance is specifically governed by the McCarran-Ferguson Act. The history of insurance regulation and the events that preceded the Act are a necessary and fascinating introduction to any discussion of the Act.¹⁵²

Insurance regulation began about one hundred and twenty years ago when the several states started to tax and regulate insurance companies. The insurance industry resisted state regulation on the constitutional ground that state taxation unduly burdens interstate commerce. In *Paul v. Virginia*¹⁵³ the Supreme Court held that the states could tax and regulate insurance business because the business was not interstate commerce. For the next seventy-five years, it was assumed on that ground¹⁵⁴ that insurance was exclusively within state control. During that period state regulation helped preserve the industry's solvency, eliminated fly-by-night operations, and thereby strengthened the public image of the industry.¹⁵⁵ However, during that period insurance companies became major taxpayers in many states and acquired influence commensurate with their contributions. This influence occasionally affected state regulation of objectionable insurance practices. Some insurance companies used coercion, boycott, and combinations to maintain monopoly, price fixing and exorbitant premiums. These practices brought about the intervention of the federal government. For the first time in the history of insurance regulation the Attorney General of the United States brought suit against a powerful organization of insurance companies for violations of federal antitrust laws. The Supreme Court held in *United States v. South-Eastern Underwriters Association*¹⁵⁶ that federal antitrust laws applied to the business of insurance, because insurance is interstate commerce for the purposes of federal jurisdiction.

The case raised an uproar. While the case was still pending there were some

conflict with the terms of a federal statute requiring only that the vote be ratified and confirmed by affirmative vote of two thirds of the shares and South Carolina statute could not be the basis of invalidating the vote for merger merely because no record date was kept. See also Frankel, *supra* note 19 at 261-63.

151 § 18(i); 15 U.S.C. § 80a-18(i) (1970). See the definition of a company, § 2(a) (8); 15 U.S.C. § 80a-2(a) (8) (1970) and § 16; 15 U.S.C. § 80a-16 (1970).

152 As to the McCarran Act and history of insurance regulation see generally Woodroof, *Annuities Regulation in a Changing Society*, 7 CAL. WES. L. REV. 307 (1971); see also Stern, *The McCarran Act—Twenty Years After*, 1966 ABA SECTION OF INS., NEG., & COMPENSATION LAW 302, Mertz, *The First Twenty Years—A Case Law Commentary on Insurance Regulation Under the Commerce Clause*, Nat. Ass'n of Independent Insurers (1965); Maloney, *Federal Regulation of Insurance*, 1968 INS. L.J. 363.

153 75 U.S. (8 Wall.) 168 (1868).

154 "The business of insurance is not commerce." *Hooper v. California*, 155 U.S. 648, 655 (1895); *New York Life Ins. Co. v. Deer Lodge County*, 231 U.S. 495, 503-04, 510 (1913). See *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533, 544 n. 18 (1944); *Colgate v. Harvey*, 296 U.S. 404, 432 (1935); *Bothwell v. Buckbee, Mears Co.*, 275 U.S. 274, 276-77 (1927); *National Union Fire Ins. Co. v. Wanberg*, 260 U.S. 71, 75 (1922); *Northwestern Mut. Life Ins. Co. v. Wisconsin*, 247 U.S. 132 (1918); *Nutting v. Massachusetts*, 183 U.S. 553 (1902); *New York Life Ins. Co. v. Cravens*, 178 U.S. 389, 401 (1900); *Noble v. Mitchell*, 164 U.S. 367, 370 (1896); *Philadelphia Fire Ass'n v. New York*, 119 U.S. 110, 118 (1886); *Liverpool Ins. Co. v. Massachusetts*, 77 U.S. (10 Wall.) 566, 573 (1870); *Ducat v. Chicago*, 77 U.S. (10 Wall.) 410, 415 (1870).

155 Bredon, *Insurance—the Regulation Phase*, 22 CONN. B.J. 149 (1948).

156 322 U.S. 533 (1944).

attempts to oust the Supreme Court's jurisdiction over insurance companies.¹⁵⁷ After the decision the attempts were directed at exempting insurance mainly from federal antitrust laws. Both the states and the insurance companies exerted pressure. Their supporters argued that the decision created chaos¹⁵⁸ because insurance companies refused to pay taxes on which the states depended for revenue,¹⁵⁹ and that federal intervention was unwarranted since the states have effectively regulated the insurance industry, as proven in the depression era.¹⁶⁰ The opponents of exclusive state regulation of insurance conceded that the states had effectively preserved the financial condition of insurance companies. This group did not demand federal regulation of insurance; it argued for concurrent regulation, especially in the area of antitrust laws.¹⁶¹

B. Interpretation of the McCarran-Ferguson Act

The McCarran Act deals specifically with a number of federal statutes and their application to insurance. As to other federal statutes § 2(b) of the Act provides:

No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance: *Provided*, that . . . the Sherman Act, and . . . the Clayton Act, and . . . the Federal Trade Commission Act, . . . shall be applicable to the business of insurance to the extent that such business is not regulated by State law.¹⁶²

1. "UNLESS SUCH ACT *specifically relates* TO THE BUSINESS OF INSURANCE . . ."

It is submitted that the Investment Company Act is not an Act that "specifically relates to the business of insurance." To be sure, the Act refers to the busi-

¹⁵⁷ The *South-Eastern Underwriters* case prompted insurance companies to argue that the federal government is seeking control over the regulation of the industry. For 75 years the Supreme Court upheld the power of states to regulate and tax insurance companies on the ground that insurance was not commerce. To many this statement meant that the Commerce Clause did not apply to insurance and hence, that congressional authority was limited. Even before the decision was made, there were attempts to limit the jurisdiction of Congress, to reestablish the exclusive power of states to regulate and tax insurance. When these attempts failed, bills were introduced to exempt insurance from specific federal statutes, especially the antitrust federal legislation. 90 CONG. REC. 6450 (1944) (remarks of Senator LaFollette).

¹⁵⁸ 91 CONG. REC. 1093 (1945) (remarks of Congressman Sumners).

¹⁵⁹ The advocates of state regulation aimed at a bill that would go as far as possible in overruling the *Underwriters* case on the grounds that the decision shakes the foundation of state taxing power. 91 CONG. REC. 1087 (1945) "The insurance commissioners and many of the insurance companies have been in very great doubt as to how they could operate at this time with respect to matters of collection of premiums, . . . and many other aspects of the business. Therefore, it seems very desirable that somewhere in this measure there should be a statement that the right of the States to regulate and to collect taxes should not be terminated or should not be repealed by implication." 91 CONG. REC. 482 (1945) (remarks of Senator Radcliffe).

¹⁶⁰ For a blistering attack of federal regulation see 90 CONG. REC. 6418 (1944) (remarks of Mr. Allen).

¹⁶¹ Senator Radcliffe pointed to the enormous powers of insurance companies and to the change of heart of insurance companies, who at the beginning of the century clamoured for federal regulation and now wanted state regulation. 91 CONG. REC. 782 (1945).

¹⁶² 15 U.S.C. § 1012(b) (1970).

ness of insurance: it excepts an insurance company from the definition of an investment company;¹⁶³ it expressly reserves the powers of insurance agencies in connection with investment companies' holdings of insurance companies' stock;¹⁶⁴ it expressly requires registration¹⁶⁵ of insurance contracts issued by investment companies, even though insurance contracts are exempt from registration under the Securities Act of 1933.¹⁶⁶ On the basis of these provisions the SEC argued before the Supreme Court in *SEC v. Variable Annuity Life Insurance Company*¹⁶⁷ that the 1940 Act "specifically relates" to the business of insurance.¹⁶⁸ It does not seem that the Supreme Court accepted this argument. Without referring to this argument, Justice Douglas for the majority, envisioned possible impairment by the 1940 Act of state insurance laws.¹⁶⁹ In *SEC v. United Benefit Life Insurance Company*¹⁷⁰ the Court voiced the same concern.¹⁷¹

According to the legislative history of the McCarran Act, a federal act "specifically relates" when it applies by its terms to insurance business even though it invalidates state insurance law.¹⁷² The intent of this provision was to avoid inadvertent federal encroachment on state insurance legislation.¹⁷³ Therefore, the mere existence of sections that are, by their terms, applicable to in-

163 § 2(a)(17); 15 U.S.C. § 80a-2(a)(17) (1970) (defining insurance companies); § 3(c)(3); 15 U.S.C. § 80a-3(c)(3) (1970) (excepting insurance companies from the definition of an investment company).

164 § 12(g); 15 U.S.C. § 80a-12(g) (1970).

165 § 24(d); 15 U.S.C. § 80a-24(d) (1970).

166 § 3(a)(8); 15 U.S.C. § 77c(a)(8) (1970).

167 Brief for the Petitioner at 60-61, *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

168 §§ 3(c)(3) and 2(a)(17) in the 1940 Act "make it clear that a company which is within the definition of an investment company and which is engaged in the writing of insurance but not primarily and predominantly so engaged is subject to regulation under the Investment Company Act. . . ." *Id.* This argument may be strengthened on the ground that "specific" is not necessarily "express." BLACK'S LEGAL DICTIONARY 1571 (Rev'd 4th ed. 1968) defines *specific* as "precisely formulated or restricted; definite; explicit; of an exact or particular nature."

169 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 68 (1959).

170 387 U.S. 202 (1967). The Court held that an "insurance policy" in the 1940 Act was "insurance business" in the McCarran Act. Variable annuities, being securities, were not the business of insurance.

171 *Id.* at 212. It should be mentioned, however, that the Court remanded upon the request of the SEC.

172 The first version of the McCarran-Ferguson Bill (S. 340, introduced by Senator Ferguson on January 25, 1945, 91 CONG. REC. 478-9) used the expression "so provides." There is no explanation for the change of language in the final version from "so provides" to "relates to the business of insurance." It seems that the purpose of the change was only to clarify the meaning. Senator Ferguson explained these words as follows:

If there is on the books of the United States a legislative act which relates to interstate commerce, if the act does not specifically relate to insurance, it would not apply at the present time. . . . If Congress should tomorrow pass a law relating to interstate commerce, and should not specifically apply the law to the business of insurance, it would not be an implied repeal of this bill, and this bill would not be affected, because the Congress had not, under subdivision (b), said that the new law specifically applied to insurance.

Id. at 481. The Act applied to past, as well as future, legislation. 91 CONG. REC. 1087 (1945). "No existing law and no future law should, by mere implication, be applied to the business of insurance." (Affirmed by Senator Ferguson on question of Senator O'Mahoney). 91 CONG. REC. 1487 (1945).

173 Senator Ferguson: "We wanted to make sure that the Congress, in its wisdom, would act specifically with reference to insurance in enacting the law." 91 CONG. REC. 1487 (1945). "We are removing ourselves from the field as far as possible. No act of Congress governing interstate commerce shall apply to insurance unless the act specifically so states." 91 CONG. REC. 1090 (1945) (statement of Mr. Gwynne of Iowa).

surance, is not sufficient to satisfy the "specifically related" requirement with respect to other sections of the Act that impair state insurance laws, but are silent as to their applicability to the business of insurance.

In 1970 Congress passed extensive amendments to the 1940 Act.¹⁷⁴ Among the amendments are two provisions specifically concerning separate accounts: one defining separate accounts,¹⁷⁵ and the other excepting from the definition of an "investment company" separate accounts which hold assets derived solely from tax qualified plans.¹⁷⁶ The question is whether Congress extended the Investment Company Act to nonexcepted separate accounts, either as defined in the 1970 Amendments or as interpreted by the Commission in *Prudential*.¹⁷⁷ The second question is whether, by the 1970 Amendments, the 1940 Act "specifically relates" to the "business of insurance" within the meaning of the McCarran Act. It is doubtful whether the two sections in the 1970 Amendments support a positive answer.

No inference can be drawn from the definitional section in the 1970 Amendments Act. This definition is very wide. It covers all accounts used in insurance business including accounts that are not investment companies even by the criteria established in the *Prudential* case.¹⁷⁸ It is inconceivable that Congress intended all accounts as defined to be subject to the Act. The legislative history of this section supports the same conclusion. According to the House and Senate Reports the purpose of this section was to give a "definitional base" to the exclusion of excepted accounts.¹⁷⁹ As to § 3(c)(11) excluding certain separate accounts from the definition of an investment company, it is doubtful whether this section can be interpreted to mean the reverse, that other, nonqualified separate accounts are investment companies. At most, the enactment of the section can be evidence that Congress was generally aware of the Commission's assertion of authority over separate accounts, and did not act upon the matter.

In a long line of cases the Supreme Court held that when Congress reenacts a statute, a long-standing, undisturbed and uncontested interpretation by an administrative agency in charge of administering the statute will be given effect. A somewhat similar rule exists in connection with judicial interpretation. The rule has been questioned,¹⁸⁰ but the Supreme Court continues to apply it.¹⁸¹ The rationale of the rule seems to be that congressional silence may be interpreted as

174 Investment Company Amendments Act of 1970, 84 Stat. 1413 (1970).

175 § 2(a)(37); 15 U.S.C. § 80a-2(a)(37) (1970):

An account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company.

176 § 3(c)(11); 15 U.S.C. § 80a-3(c)(11) (1970).

177 See Frankel, *supra* note 19, at 231-34.

178 *In re Prudential Ins. Co.*, 41 S.E.C. 335 (1963).

179 HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 1970 ACT, H.R. REP. NO. 1388, 91st Cong., 2d Sess. 15 (1970). See also SENATE COMM. ON BANKING AND CURRENCY, INV. CO. AMENDMENTS ACT OF 1969, S. REP. NO. 184, 91st Cong., 1st Sess. 22 (1969).

180 Griswold, *A Summary of the Regulation Problem*, 54 HARV. L. REV. 398, 400 (1941). See also reservations expressed by K. DAVIS, ADMINISTRATIVE LAW TEXT, § 5.07, at 93 (1959) and Supp. 1971.

181 See, e.g., *Blau v. Lehman*, 368 U.S. 403 (1962).

speaking in circumstances which should have prompted Congress to speak out. One of these circumstances is congressional awareness of the administrative or judicial interpretation.¹⁸² Another is consensus among the affected interested parties, the administrative agency or the courts.¹⁸³

In the case at hand there was no long-standing administrative or judicial interpretation¹⁸⁴ but the exclusion section¹⁸⁵ shows that Congress was aware of, and seriously considered, the Commission's interpretation regarding excluded separate accounts.¹⁸⁶ On the other hand, with regard to nonexcepted separate accounts there is no discussion, no request for changes,¹⁸⁷ no decision to leave or deal with the problem.

Congressional approval is rarely implied from total inaction.¹⁸⁸ But it may be implied from re-enactment as well as other actions.¹⁸⁹ Courts have expressed doubts as to the validity of drawing inferences from the unspoken legislative word. The legislature may refrain from acting for a variety of reasons which are unconnected with the merits of the case.¹⁹⁰ Most courts consider the rule as

182 The interpretations must be long-standing. It has been held that a short term administrative interpretation of a reenacted section does not give it the effect of law. *See* Ten-Broek, *Interpretative Administrative Action and the Lawmaker's Will*, 20 ORE. L. REV. 206, 219 (1941).

183 *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *Cammarano v. U.S.*, 358 U.S. 498, 512 (1959).

184 The Prudential decision was handed down by the Commission in 1963. *In re Prudential Ins. Co.*, 41 S.E.C. 335 (1963), *aff'd* 326 F.2d 383 (3rd Cir.), *cert. denied*, 377 U.S. 953 (1964). Congressional hearings on the Mutual Fund Amendments Bill began in 1967. *Hearings on H.R. 9510, H.R. 9511 Before the Subcomm. on Commerce and Finance of the Committee on Interstate and Foreign Commerce*, 89th Cong., 1st Sess. pts. 1 and 2 (1967). The Supreme Court left the door open for further discussion. *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202, 212 (1967). The industry refrained, by and large, from registering under the 1940 Act, and most of the accounts used by the industry were claimed to be excepted from the Act. SEC INSTITUTIONAL INVESTOR STUDY REPORT OF SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 2, at 646, 648 (1971). Of 197 accounts, only 2.4 per cent of the reporting assets were registered under the Act. *See also* Frankel, *supra* note 19, at 385. Consensus cannot be proved in this case.

185 § 3(a)(11); 15 U.S.C. § 80(a)-3(a)(11) (1970).

186 (a) *Hearings on S.34, and S.296 Before the Committee on Banking and Currency*, 91st Cong., 1st Sess., at 32, 33, 46, 47, 48, 50, 51 (1969). (b) *Hearings on H.R. 11995, H.R. 13754, H.R. 14737 Before the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., at 139, 179, 465, 499, 500, 501 (1967). (c) H.R. REP. No. 1382, 91st Cong., 2d Sess., 18, 54 (1970). (d) S. REP. No. 1351, 90th Cong., 2d Sess., 10, 20 (1968). (e) S. REP. No. 184, 91st Cong., 1st Sess., 12, 22 (1969).

187 (a) *Hearings on H.R. 11995, H.R. 13754, H.R. 14737 Before the Subcommittee on Commerce and Finance of the Committee on Interstate And Foreign Commerce*, 91st Cong., 1st Sess., at 139, 179 (1967). (b) H.R. REP. No. 1382, 91st Cong., 2d Sess. at 54 (1970). (c) The industry did not ask for a change beyond an exemption of qualified plans. *Hearings on S.34 and S.296 Before the Committee on Banking and Currency*, 91st Cong., 1st Sess., at 46, 48, 49, 50, 51, 52 (1969).

188 The Supreme Court in *Blau v. Lehman*, 368 U.S. 403 (1962) held that such an awareness of an administrative position and of a 1952 court decision, as reported by the Commission, interpreting § 16 of the Securities Exchange Act of 1934, plus absence of congressional action pointed to the establishment of a binding interpretation. In that case, however, Congress had refused in the original legislative session to adopt the interpretation urged in this case. In addition, it seems that the majority did not accept the new interpretation which the Commission was urging upon it. In any event, it is submitted that the sweeping statements should not apply in this case. Inference from inaction was rejected in *Jones v. Liberty Glass Co.*, 332 U.S. 524 (1947); see also *Cammarano v. United States*, 358 U.S. 498, 510 (1959).

189 *E.g.*, *Winston v. United States*, 305 F.2d 253 (2d Cir. 1962). There is a strong dissent by Chief Judge Lumbard and Judges Friendly and Kaufman. *See also* *Girouard v. United States*, 328 U.S. 61, 69 (1946).

190 *Berry v. Branner*, 245 Ore. 307, 421 P.2d 996, 998 (1966): "The practicalities of the legislative process furnish many reasons for the lack of success of a measure other than leg-

a rule of interpretation,¹⁹¹ even though the courts have characterized congressional action as giving administrative interpretation, "the effect of law,"¹⁹² "legislative approval,"¹⁹³ or "acceptance"¹⁹⁴ or "adoption."¹⁹⁵ This language does not mean that the administrative or judicial interpretation becomes law that could not be changed except by Congress.¹⁹⁶

In the writer's opinion the hearings on the Mutual Fund Bill do not close the door for judicial decision on the matter. As an aid to interpretation they show, at most, that Congress was aware of the *Prudential* decision, that it did not address itself, and was not asked to address itself, to the status of other than excepted accounts under the 1940 Act,¹⁹⁷ that Congress may have left the further

islative dislike for the principle involved in the legislation." See also *Duncan v. Railroad, Retirement Board*, 375 F.2d 915, 919 (4th Cir. 1967): "True, long standing administrative interpretation of a statute, acquiesced in by all interested parties, may form the basis for an inference that the administrative interpretation is correct. However, courts are properly chary of equating mere inaction with approval. . . ."

191 The Supreme Court permitted an administrative agency to change its long-standing regulations that had weathered congressional reenactment, *Mass. Trustees v. United States*, 377 U.S. 235, 241-42 (1963); to the same effect, *Automobile Club v. Comm'r*, 230 F.2d 585, 598-99 (6th Cir. 1956); especially when there was no evidence that Congress addressed itself to the question, *Mass. Trustees v. United States*, 377 U.S. 235, 241 (1963); and when new circumstances justified the change, *American Trucking v. A.T. & Santa Fe Rly Co.*, 387 U.S. 397 (1967). The attention of Congress was drawn to the problem, and relief was asked. When legislation was pending, the industry asked that action be withheld until the agency made a determination. When the agency acted to grant relief, deviating from twenty-five years of consistent interpretation, the court said:

We do not regard this as legislative history demonstrating a congressional construction of the meaning of the statute, nor do we find . . . evidence of an administrative interpretation of the Act which should tilt the scales against the correctness of the Commission's conclusions as to its authority. . . . The advocacy of legislation by an administrative agency—and even the assertion of the need for it to accomplish a desired result—is an unsure and unreliable, and not a highly desirable, guide to statutory construction.

Id. at 417-18. It was also held by the Court of Appeals for the District of Columbia Circuit that when Congress re-enacted a statute without considering a particular point or referring to it, re-enactment cannot be given controlling weight to an originally "erroneous administrative interpretation." *Kristensen v. McGrath*, 179 F.2d 796, 804 (D.C. Cir. 1949), and to the same effect, *East Brewton Materials, Inc. v. State*, 45 Ala. 584, 233 So.2d 751 (1970). The Supreme Court has on various occasions restated its power to overrule its own "erroneous" decisions, notwithstanding re-enactment of the statute on which the decisions rested without a change. In *James v. United States*, 366 U.S. 213, 220 (1961). The Court overruled its own decisions of fifteen years' standing that embezzled funds should not be included in the declaration of income tax of the year in which they were misappropriated. ". . . the fact that Congress has remained silent or has re-enacted a statute . . . or that congressional attempts to amend a rule announced by this Court have failed, does not necessarily debar us from re-examining and correcting . . . errors." *Id.*

192 *Comm'r v. Estate of Noel*, 380 U.S. 678, 682 (1965): "a long standing administrative interpretation, applying to a substantially re-enacted statute, is deemed to have received congressional approval and has the effect of law." *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110, 115 (1939).

193 *United States v. Dakota—Montana Oil Co.*, 288 U.S. 459, 466 (1933); *Toilet Goods Ass'n v. Gardner*, 278 F. Supp. 786 (S.D.N.Y. 1968).

194 *NLRB v. Gullett Gin Co.*, 340 U.S. 361 (1951).

195 *United States v. Cerecedo Hermanos y Compania*, 209 U.S. 337 (1907).

196 The rule is one of interpretation. "While it [the rule] is useful at times in resolving statutory ambiguities, it does not mean that the prior construction has become so embedded in the law that only Congress can effect a change." *Helvering v. Reynolds*, 313 U.S. 428, 432 (1941).

197 The issue of whether banks were permitted to establish commingled funds, which was raised, was left to the courts. This does not mean that the fate of nonqualified separate accounts would have been the same. The position of the insurance and banking industries may have been different, the considerations regarding the McCarran Act may have been different from those

development of the law to the Commission and the courts,¹⁹⁸ and, perhaps, that Congress recognizes the principle that separate accounts funding variable annuities are entities that could be regulated by the 1940 Act.

Since Congress did not deliberate on the question of nonexcepted accounts or on accounts funding variable life insurance, the exception of § 3(c)(11) is not sufficient to classify the whole 1940 Act as "specifically related" to the business of insurance. The questions which the McCarran Act poses are therefore not foreclosed.

2. "No Act OF CONGRESS SHALL BE CONSTRUED TO INVALIDATE . . . ANY LAW ENACTED BY ANY STATE . . . FOR THE PURPOSE OF REGULATING THE BUSINESS OF INSURANCE . . ."

The language of the McCarran Act covers all acts of Congress. Nonetheless the SEC argued that Congress did not intend to cover all federal statutes which apply to insurance companies but only those which apply solely on the basis of the Commerce Clause.¹⁹⁹

The purpose of the McCarran Act, the Commission reasoned, was to allay doubts raised by the decision of the Supreme Court in *United States v. South-Eastern Underwriters Association*,²⁰⁰ which resulted in applying to insurance federal acts based on the Commerce Clause. The Act declares that state regulation of insurance is desirable as a matter of federal policy,²⁰¹ prohibits certain federal statutes from impairing state laws regulating insurance²⁰² unless they specifically apply, and enumerates certain federal statutes which are not to apply if the states preempt the field.²⁰³ The Commission argued that legislative history shows that Congress intended to preserve, but not to add to, the power of states to regulate insurance.²⁰⁴ In view of this legislative history, the SEC argued that federal statutes which had regulated insurance before the *South-Eastern Underwriters* case are not subject to the limitations of the McCarran Act.

regarding the Glass-Steagal Act. See 4 L. LOSS, *SECURITIES REGULATION* 2538-49 (Supp. 1969). Frankel, *supra* note 19, at 236 n. 29.

198 *Id.*

199 Brief for Petitioner at 22-23, *SEC v. National Sec. Inc.*, 393 U.S. 453 (1969). Presumably this argument was rejected because the main thrust of the decision is that the application of the securities acts to the solicitation of shareholders' votes for a merger of two insurance companies does not directly impair state insurance law, ergo, the securities acts are subject to the McCarran Act limitations when the business of insurance is involved.

200 322 U.S. 533 (1944). See Note, *A Year of S.E.U.A.*, 23 *CHL-KENT L. REV.* 317, 319 (1945).

201 15 U.S.C. § 1011 (1970): "Congress declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation of such business by the several States."

202 15 U.S.C. § 1012(b) (1970): "(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance. . . ."

203 15 U.S.C. § 1012(b) (1970): ". . . *Provided*, that after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law."

204 H.R. REP. No. 143, 79th Cong., 1st Sess. 1 (1945). Frankel, *supra* note 19, at 210.

There is language in some decisions to support this contention. In *United States v. Sylvanus*²⁰⁵ the court said that "it was not the intent of the Congress, by its passage of the McCarran Act, to surrender control of the use of the mails. . . ." And therefore even though the Mail Fraud Act did not specifically apply to insurance business, the limitations of the McCarran Act were inoperative. In *Langdeau v. United States*²⁰⁶ the court stated that nothing in the McCarran Act indicates that the United States has given a state authority to extinguish a tax obligation or debt due the United States, even though the debt was due from an insolvent insurance company. In *Sears Roebuck v. All States Life Insurance Company*²⁰⁷ the court concluded "that there is nothing in the McCarran Act that limits the right of the owner of a trade or service name to seek redress in the federal courts merely because the approval of the name of the infringing insurance company is part of the duties of the state board. The real purpose of the McCarran Act" said the court, "is too well known to permit us to extend its prohibitions to this situation. . . ." ²⁰⁸

Nevertheless, this reasoning is not decisive. First, each decision alleged other grounds, tending to show compliance with the McCarran Act, such as that the state statute in question did not regulate the business of insurance,²⁰⁹ or that the federal statute did not impair state law,²¹⁰ or that the facts did not warrant a judgment.²¹¹ Some of these additional reasons are in logical conflict with the ground that the federal statute is not subject to the constraints of the McCarran Act. In such a case it is irrelevant whether the federal act impairs the state statute or otherwise complies with the limitation of the McCarran Act. This writer has found no case in which a decision was based solely on the ground that the federal statute was outside the McCarran Act.²¹² Second, the purpose of the McCarran Act was not only to remove doubts as to whether state regulation of insurance is permissible. Legislative history indicates that Congress considered the wider question of who should have the primary responsibility for regulating insurance.²¹³ There were arguments between the advocates of concurrent federal and state regulation and the advocates of exclusive state regula-

205 *United States v. Sylvanus*, 192 F.2d 96, 100 (7th Cir. 1951). See also *Zachman v. Erwin*, 186 F. Supp. 691 (S.D. Tex. 1960).

206 363 S.W.2d 327, 331-32 (Tex. Civ. App. 1962).

207 246 F.2d 161, 172 (5th Cir. 1957). See also *Paris v. Metropolitan Life Ins. Co.*, 68 F. Supp. 64 (S.D.N.Y.) *rev'd on other grounds* 167 F.2d 834 (1946) *cert. denied*, 335 U.S. 827 (1947).

208 246 F.2d 161, 172 (5th Cir. 1957).

209 *United States v. Sylvanus*, 192 F.2d 96, 100 (7th Cir. 1951): "The charge is not that the corporate charter should be ignored or that the administrative officers of Illinois may not perform their statutory duties and supervise and regulate the company's insurance business in Illinois, but goes to the use of the mails, over which the Congress has, by the Constitution, paramount power and authority." *Langdeau v. United States*, 363 S.W.2d 327, 330 (Tex. Civ. App. 1962): "With respect to [state law] . . . we are of the opinion that it does not regulate the business of insurance. It regulates the claims for wages of employees of an insurer which is in receivership. It is for their benefit and in their aid alone. It lends no help to the continuance of the business of insurance by the Company."

210 *Paris v. Metropolitan Life Ins. Co.*, 68 F. Supp. 64, 67-68 (S.D.N.Y. 1946).

211 *Sears Roebuck v. All States Life Ins. Co.* 246 F.2d 161, 172 (5th Cir. 1957).

212 Except, perhaps, *Maryland Cas. Co. v. Cushing*, 347 U.S. 409, 413 (1954). See also *Id.*, at 437, 438 (dissenting opinion).

213 H.R. REP. NO. 143 79th Cong. 1st Sess. (1945) states: "The purpose of the bill is twofold: (1) To declare that the continued regulation and taxation by the several States of the business of insurance is in the public interest. . . ."

tion. § 2(b) was not subject to a controversy. All factions agreed that the states ought to continue their conventional regulation.²¹⁴ From this it follows, in my opinion, that all acts of Congress should be construed according to the dictates of the McCarran Act.

3. "NO ACT OF CONGRESS SHALL BE CONSTRUED TO INVALIDATE, IMPAIR, OR SUPERSEDE ANY LAW ENACTED BY ANY STATE FOR THE PURPOSE OF REGULATING THE *business of insurance*. . . ."

The McCarran Act protects only state laws that regulate insurance business. The Act speaks of the "business of insurance", not of insurance companies.²¹⁵ In 1959 the SEC argued before the Supreme Court that a company which is not an "insurance company" excepted under the 1940 Act does not conduct the business of insurance under the McCarran Act because the two expressions are synonymous.²¹⁶ The Supreme Court did not comment and decided on the basis of another ground.²¹⁷

A question under the McCarran Act would arise only when a company conducts a "business of insurance" as defined in the McCarran Act, but does not qualify as an "insurance company" excepted from the 1940 Act.²¹⁸ Such a problem did not arise until 1963, when the Securities and Exchange Commission held in the *Matter of Prudential Insurance Company*, that a separate account funding variable annuities was not an insurance company, nor a part of the

214 Oppenheimer, *Insurance and the Antitrust Laws*, 1961 *INS. L. J.* 807, 816-17. "Obviously Congress' purpose was broadly to give support to the existing and future state systems for regulating and taxing the business of insurance. This was done in two ways. One was by removing obstructions which might be thought to flow its own power, whether dormant or exercised, except as otherwise expressly provided in the Act itself or in future legislation. The other was by declaring expressly and affirmatively that continued state regulation and taxation of this business is in the public interest. . . ." *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 429-30 (1946). See also Kimball & Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Retrospect*, 56 *MICH. L. REV.* 545, 555 (1958); Note, *A Year of S.E.U.A.*, 23 *CHI.-KENT L. REV.* 317 (1945) on the history of the McCarran-Ferguson Act.

215 "Insurance companies may do many things which are subject to paramount federal regulation; only when they are engaged in the 'business of insurance' does . . . [the McCarran Act] apply." *SEC v. National Sec. Inc.*, 393 U.S. 453, 459-60 (1969). See also *Langdeau v. United States*, 363 S.W.2d 327, 331 (Tex. Civ. App. 1962). See generally, Note, *Insurance Mergers and the Clayton Act* 78 *YALE L. J.* 1404, 1411-1417 (1969).

216 *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

217 *Id.* at 68. The decision was based on the ground that the definition of an insurance contract is the same in the securities acts and the McCarran Act.

218 In the case of *In re Fidelity Assur. Ass'n*, 42 F. Supp. 973 (S.D.W. Va. 1941) the company amended its charter to enable it to issue insurance policies. The amendment was made to qualify the company as an insurance company under the 1940 Act, in order to escape the more rigorous requirements of the act. However, the question before the court was not whether the company had succeeded in doing so but whether the company was an insurance company within the meaning of the Bankruptcy Act, so as to escape federal jurisdiction under that statute. After the passage of the McCarran Act the author has found no case in which such a situation arose; in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) the Supreme Court held that "the question common to the exemption provisions of the Securities Act and the Investment Company Act and to § 2(b) of the McCarran-Ferguson Act is whether the respondents are issuing contracts of insurance." *Id.* at 68. The Court did not answer positively the argument of the SEC that the exemption for insurance companies as defined in the 1940 Act and the "business of insurance" as mentioned in the McCarran Act were synonymous. Brief of SEC at 15, *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959).

activities of an insurance company, but an investment company, and therefore subject to the Investment Company Act. The decision was affirmed by the Third Circuit.²¹⁹ However, in a later case the Supreme Court refrained from deciding the issue. The Court found the question to be a difficult one and remanded upon the request of the SEC for further deliberation.²²⁰ Proceedings were discontinued by the parties. The question of whether or not the separate account was an insurance company remained unanswered by the Supreme Court.²²¹

There is no general definition of the business of insurance. One judicial test is whether an activity was historically regulated by the states. Traditionally regulated activities, such as licensing of insurance companies to do business in the state, fixing of insurance rates, writing of policies, advertising and sale of policies, calculation of reserves, and the prevention of unfair trade practices by insurance companies in their dealings with each other and with the policyholders, were considered to be the business of insurance.²²² However, state laws regulating the organization of companies in general, as companies, are not laws regulating the business of insurance even if they apply to insurance companies.²²³

Some provisions of the 1940 Act fall into this category. For example, the 1940 Act prohibits a registered investment company from using a deceptive or misleading name.²²⁴ Many state laws have similar provisions.²²⁵ In any conflict between federal and state law, such as when state law's standards are more relaxed, state law should yield.

The same reasoning applies to the 1940 Act standard beyond which a

219 *In re Prudential Ins. Co.*, 41 S.E.C. 335 (1963), *aff'd*, 326 F.2d 383 (3rd Cir.), *cert. denied*, 377 U.S. 953 (1964).

220 *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), *rev'g*, 359 F.2d 619 (D.C. Cir. 1966).

221 See Frankel, *supra* note 19, at 234.

222 Brief for SEC at 18, 19, *SEC v. National Sec. Inc.*, 393 U.S. 453 (1969) citing *HUEBNER & BLACK*, *supra* note 40, at 680-98. A similar list was cited by the Supreme Court in *F.T.C. v. National Cas. Co.* 357 U.S. 560 (1958).

223 Wikler, *Insurance and the Antitrust Laws, A State Outlook*, 1963 *Ins. L. J.* 534, 536.

224 § 34(a),(b),(c); 15 U.S.C. § 80a-34(a),(b),(c) (1970).

225 ALA. CODE tit. 28, § 49 (Supp. 1969); ALASKA STAT. § 21.09.050 (1966); ARIZ. REV. STAT. ANN. §§ 20-218, 10-122 (1956); ARK. STAT. ANN. §§ 66-2205, 66-4205 (1966); CAL. CORP. CODE § 310 (1968); COLO. REV. STAT. ANN. § 72-1-15 (1963); CONN. GEN. STAT. ANN. § 33-287 (Supp. 1972); DEL. CODE ANN. tit. 18, § 509 (1970); D.C. CODE ENCYCL. ANN. § 35-601 (1968); FLA. STAT. ANN. § 624.024 (1968); GA. CODE ANN. § 56-318 (1970); HAWAII REV. STAT. § 431-101 (1968); IDAHO CODE ANN. § 41-311 (1961); ILL. ANN. STAT. ch. 73, §§ 619, 649(e) (1965); IND. ANN. STAT. § 39-3603 (1965); IOWA CODE ANN. § 504A.67 (Supp. 1972); KAN. STAT. ANN. § 40-203 (Supp. 1972); KY. REV. STAT. ANN. § 304.3-100 (1970); LA. REV. STAT. ANN. § 22:982-983 (Supp. 1972); ME. REV. STAT. ANN. tit. 24-A, § 408 (1971); MD. ANN. CODE art. 48A, § 45 (1972); MASS. GEN. LAW ANN. ch. 175 § 181 (1958); MICH. STAT. ANN. § 24.1454 (1972); MINN. STAT. ANN. § 47.23 (2) (1970); MISS. CODE ANN. §§ 5309-11 thru 14 (Supp. 1972); MO. ANN. STAT. § 375.196 (1968); MONT. REV. CODE ANN. § 40-2805 (1961); NEB. REV. STAT. § 44-352 (Supp. 1967); NEV. REV. STAT. tit. 57, § 628.030 (1967); N.H. REV. STAT. ANN. § 294:5 (1966); N.J. STAT. ANN. § 17B:18-4 (Supp. 1971); N.M. STAT. ANN. § 58-18-15 (1953); N.Y. INS. LAW § 50 (1966); N.C. GEN. STAT. § 58-33 (1965); N.D. CENT. CODE § 26-08-05 (1970); OHIO REV. CODE ANN. § 3907.02 (Page 1971); OKLA. STAT. ANN. tit. 36, § 620 (1958); ORE. REV. STAT. § 731.430 (1971); PA. STAT. ANN. tit. 40, § 421.1 (Supp. 1971); S.C. CODE ANN. § 37-108 (1962); S.D. CORP. LAWS ANN. §§ 58-6-14, 58-6-17 (1967); TENN. CODE ANN. § 48-105 (1964); TEXAS INS. CODE arts. 2.02, 11.01 (1963); UTAH CODE ANN. § 31-5-15 (1966); VT. STAT. ANN. tit. 11, § 46 (1971); VA. CODE ANN. § 13.1-104(b) (1964); WASH. REV. CODE ANN. § 48.05, 190 (1961); W. VA. CODE § 33-3-12 (1966); WISC. STAT. ANN. § 201.02(3) (1957); WYO. STAT. ANN. § 26.1-55 (1967).

director, officer, investment adviser and underwriter may not be indemnified.²²⁶ Here, again, some state laws provide for similar restrictions.²²⁷ Since indemnification relates primarily to the duties of management and only remotely to insurance business, state laws standards should yield if they are more relaxed than the federal law.

The test based on the nature of the regulated activity was inadequate when the same activity affected not only policyholders but also other parties, *e.g.*, shareholders. In such a situation the Supreme Court established an additional test.²²⁸ The business of insurance, it said, concerns the relationship between the insurance company and its policyholders, and the protection of policyholders. A merger between two insurance companies was therefore the business of insurance because of state interest in protecting policyholders. On the other hand, when the purpose of state regulation of insurance companies was to protect investors, the state was not regulating the business of insurance, even with respect to the merger mentioned above.²²⁹ Following this test, the 1940 Act provisions with respect to voting rights and proxy solicitation prevail over state laws regulating the same subject.²³⁰

²²⁶ § 17(h),(i); 15 U.S.C. § 80a-17(h),(i) (1970).

²²⁷ New York requires the insurance company to notify the Superintendent of Insurance before any director is indemnified. N.Y. INS. LAW § 62-a (McKinney, 1966). The New York provision is state law regulating insurance since it provides the Superintendent with the information necessary to perform these functions. But there is no conflict between the two provisions, since notification cannot be considered unduly burdensome. There is no impairment, since there is nothing in the 1940 Act that changes the New York law or its effect.

²²⁸ SEC v. National Sec. Inc., 393 U.S. 453 (1969).

²²⁹ *Id.* at 460. See also Langdeau v. United States, 363 S.W.2d 327 (Tex. Civ. App. 1962) (regulation in interest payment on debts of an insolvent insurance company is not the regulation of the business of insurance, because the main purpose of the state statute was to protect employees of insurance companies after they had ceased to do business). See also Hamilton Life Ins. Co. of N.Y. v. Republic Nat. Life Ins. Co., 408 F.2d 606 (2d Cir. 1969) (an insurance policy negotiated and executed in New York provided for arbitration of future differences. The domiciliary state of one of the parties to the contract did not permit arbitration of future disputes nor did state laws of both parties permit arbitration of allegations of fraud. Held that Federal Arbitration Act applied. State statutes dealing with the subject were not statutes regulating the business of insurance, but statutes regulating the method of handling contract disputes generally).

²³⁰ The question of whether variable contractholders have the exclusive right to elect the management of the separate account is difficult, and is discussed at pp. 1078-80 *infra*. Voting rights are dealt with in § 18(i); 15 U.S.C. § 80a-18(i) (1970). Frankel, *supra* note 19, at 297-303. Proxy rules are dealt with in § 20(a); 15 U.S.C. § 80-20(a) (1970). Frankel, *supra* note 19, at 303-4.

The right of contractholders to vote and the proxy rules relating to the voting should apply to variable life insurance policies, as a matter of federal law, because policyholders are not afforded by state law the protection of the act. The following states have no provisions regarding proxies: Alabama, Colorado, Connecticut, Indiana, Maryland, Ohio and Rhode Island.

The following state statutes refer proxy problems in mutual companies to their general corporation law, which permit proxies: DEL. CODE ANN. tit. 8, § 212 (1953); IOWA CODE ANN. § 496 A.32 (1962); MINN. STAT. ANN. § 301.26 (1968); NEV. REV. STAT. tit. 7, § 78.355 (1959); N.H. REV. STAT. ANN. § 294.86 (1968); VT. STAT. ANN. tit. 55, ch. 76 § 1879 (1971); VA. CODE ANN. § 13.1 - 32 (1970).

The following state statutes grant the right to vote by proxy to members of mutual companies: ALAS. STAT. § 21.69.290 (1966); ARIZ. REV. STAT. ANN. § 20-713 (1956); ARK. STAT. ANN. § 66-4217 (1966); CAL. INS. CODE § 4017 (Supp. 1971); D.C. CODE ENCYCL. ANN. § 35-501 (1968); FLA. STAT. ANN. § 628.221 (1960); GA. CODE ANN. § 56-1515 (1971); HAWAII REV. STAT. § 43-192 (1968); IDAHO CODE ANN. § 41-2834 (1961); ILL. ANN. STAT. ch. 73, § 654 (1965); KAN. STAT. ANN. § 40-502 (1964); KY. REV. STAT. ANN. § 304.24-210 (1970); LA. REV. STAT. ANN. § 22:127 (1959); ME. REV. STAT. ANN. tit. 24-A, § 3363 (1971); MASS. GEN. LAWS ANN. ch. 175, § 94 (1958); MO.

It may be argued that the question of whether policyholders or members of an insurance company ought to have voting rights is the regulation of the business of insurance, because it affects the balance of power between managements of insurance companies and their constituents. In answer it can be said that the business of insurance is involved only if it can be shown that a change of the balance of decision-making power within the insurance company weakens the policyholders' position. Even if this were so, impairment of state law by the federal act would be indirect and inconsequential. In any event, insurance laws that give voting power to shareholders of insurance companies, for their protection, must yield to the federal act that grants voting power to policyholders who are also investors, because the provision as to voting does not concern the business of insurance. Both federal and state laws deal here with the protection of different classes of investors. Federal law prevails.

ANN. STAT. § 375.191 (1968); MONT. REV. CODE ANN. § 40-4715 (1961); NEB. REV. STAT. § 44-210 (1968); N.J. STAT. ANN. § 17B:18-14 (Supp. 1971); N.M. STAT. ANN. § 58-18-17 (1962); N.C. GEN. STAT. § 58-94 (1965); N.D. CENT. CODE § 26-14-10 (1970); OKLA. STAT. ANN. tit. 36, § 2113 (1958); ORE. REV. STAT. § 732.470 (1971); PA. STAT. ANN. tit. 40, § 432 (1954); S.C. CODE ANN. § 37-375 (1962); S.D. COMP. LAWS ANN. § 58-5-41 (1967); TENN. CODE ANN. § 56-1607 (1968); TEX. INS. CODE art. 11.04 (1963); UTAH CODE ANN. § 31-9-15 (1966); WASH. REV. CODE ANN. § 48.09.150 (1961); W. VA. CODE § 33-5-9 (1966); WISC. STAT. ANN. § 206.02(2) (1957); WYO. STAT. ANN. § 26.1-481 (1967).

The state statutes below have provisions which generally provide for one vote per member unless otherwise stated: ARIZ. REV. STAT. ANN. § 20-713 (1956); CAL. INS. CODE § 4016 (Supp. 1971); CONN. GEN. STAT. ANN. § 38-1 (1969) ("Definitions" — Assume that directors are elected by policyholders); DEL. CODE ANN. tit. 18, § 702 (1970); HAWAII REV. STAT. § 431-189 (1968); IDAHO CODE ANN. § 41-2834 (1961); IND. ANN. STAT. § 39-423 (1965) (the section provides for election of directors by policyholders); KAN. STAT. ANN. § 40-502 (1964); KY. REV. STAT. ANN. § 304.24-210 (1970); LA. REV. STAT. ANN. § 22:127 (1959); ME. REV. STAT. ANN. tit. 24-A, § 3363 (1971); MASS. GEN. LAWS ANN. ch. 175 § 94 (1958) (one vote and one additional vote for each \$5000 of insurance in excess of the first \$5000. No more than 20 votes by proxy); MICH. STAT. ANN. § 24:15232 (1972); MINN. STAT. ANN. § 66A.07 (1968) (one vote per policy); MO. ANN. STAT. § 376.148 (1968); NEB. REV. STAT. § 44-210 (1968); N.J. STAT. ANN. § 17B:18-14 (Supp. 1971); N.M. STAT. ANN. § 58-18-17 (1962); N.Y. INS. LAW § 198 (McKinney 1966); N.C. GEN. STAT. § 58-94 (1965) (one vote per policy without opportunity for change); OHIO REV. CODE ANN. § 3941.07 (Page 1971); OKLA. STAT. ANN. tit. 36, § 2113 (1958); ORE. REV. STAT. § 732.470 (1971); PA. STAT. ANN. tit. 40, § 432 (1954); S.C. CODE ANN. § 37-373 (1962); S.D. COMP. LAWS ANN. § 58-5-41 (1967); TEX. INS. CODE art. 11.04 (1963) (one vote per \$500 of insurance); UTAH CODE ANN. § 31-9-15 (1966); WASH. REV. CODE ANN. § 48.09.120 (1961); W. VA. CODE § 33-5-9 (1966); WISC. STAT. ANN. § 201.02(3)(d) (Supp. 1972); WYO. STAT. ANN. § 26.1-481 (1967).

The states below have statutes which state that every member of a mutual insurance company shall be entitled to one vote or to a number of votes based upon the insurance in force, the number of policies held, or the amount of premium paid, as may be provided by the by-laws. ALASKA STAT. § 21.69.290 (1966); ARK. STAT. ANN. § 66-4217 (1966); COLO. REV. STAT. ANN. § 72-5-9 (1964); D.C. CODE ENCYCL. ANN. § 35-501 (1968); FLA. STAT. ANN. § 628.221 (1960); GA. CODE ANN. § 56-1515 (1971); ILL. ANN. STAT. ch. 73, § 654 (1965); MD. ANN. CODE art. 48A, § 258 (1972); MISS. CODE ANN. § 5794 (1957); MONT. REV. CODE ANN. § 46-4715 (1961); N.D. CENT. CODE § 26-14-09 (1970); TENN. CODE ANN. § 56-1606 (1968); VA. CODE ANN. § 38.1-77 (1970).

New York also provides that mutual companies must either elect the entire board of directors biennially, or divide the board into not more than three classes, each class to be elected annually. This tends to ensure continuity of management, but also entrenchment of management. N.Y. INS. LAWS § 198.1 (McKinney 1966); 29 N.Y. JUR. INSURANCE § 187 (1966).

Some states do not require notice of the meeting to be sent to members. Notices may be published in newspapers or printed on the policies or on premium receipts. MASS. GEN. LAWS ch. 175, § 76 (1958). The language of a notice is approximately this:

The Insured is hereby notified that by virtue of this policy he is a member of the _____ Insurance Company, and is entitled to vote either in person or by proxy at any or all meetings of said company. The Annual meetings are held at its home office on the day of _____ in each year, at _____ o'clock.

Another test to determine what is the business of insurance is whether the activities that federal law seeks to regulate are in furtherance of the company's insurance business. In *United States v. Meade*²³¹ an insurance agency issued and sold stock in order to raise funds for investments which the company's charter permitted. It was held that the sale of the stock was not insurance business, and was subject to the securities acts. The court did not deal with the question of whether the sale of stock to finance insurance operations would be insurance business. In this case the court found that investments in stocks of other issuers, and in real estate developments, as authorized by the corporate charter "[were] . . . remote from the business of insurance as intended by the McCarran Act."²³²

By analogy to stock issuance, the investment advisory services that an insurance company or its affiliates offer policyholders of variable insurance are not the business of insurance within the McCarran Act.

People in the insurance industry argue that investment advisory services are insurance business because in their conventional life insurance business, insurance companies have been investing the reserves and the policyholders bear the cost of these services. Moreover, insurance companies' expenditures and investments have been under state supervision for decades. Hence, a novel extension of the same activity is the business of insurance within the meaning of the McCarran Act. The argument seems logical and attractive at first blush, but not at a second, closer examination. In conventional insurance, investment activities are performed as part of the insurance operations and on the account of the insurance company. The policyholder pays a premium which covers part of the expenses of the company, including investment expenses. But he does not pay for investment advice. In calculating the amount of premiums, the insurance company takes into account many other expenses, for example, typing. In this context typing is the business of insurance. Yet, if an insurance company engaged in the business of offering typing services for profit, this business will not be deemed to be the business of insurance under the McCarran Act.

"Investment advice" in conventional policies is given at approximately cost. Advice in variable life insurance is given at a fee which is a percentage of the value of the assets. The profits of this arrangement inure to the insurance company. This fee structure gives rise to possible conflicts of interest and consequent evils that conventional insurance does not present, and conventional insurance regulation does not deal with. But federal law does. For example, the 1940 Act prohibits an investment adviser and its subsidiaries from accepting, as agents, compensation from any source for the purchase or sale of property, to or from an investment company, except in the course of their business as an underwriter or broker.²³³ Even though the philosophy of this provision is compatible with state insurance laws, no such provision exists in state laws. Many insurance laws prohibit officers and directors charged with the investments of the company from receiving fees or commissions in connection with the acquisition of

231 179 F. Supp. 868 (S.D. Ind. 1960).

232 *Id.* at 876.

233 § 17(e); 15 U.S.C. § 80a-17(e) (1970).

property or the sale of property or the grant of a loan by an insurance company.²³⁴ Some states permit payment if the officers act as agents.²³⁵ A similar prohibition does not apply to the insurance company, as such, in its relationship with its accounts. There is also no parallel in insurance laws to the 1940 Act

234 CONFLICT OF INTEREST.

Version 1.

Prohibited Pecuniary Interest of Officers. (a) Officers or directors or members of a committee or employee of a domestic issuer, charged with investments, shall not deposit or invest except in the insurer's name; shall not borrow funds of the insurer; shall not have a pecuniary interest in a loan, pledge or deposit, security, investment, sale, purchase exchange... or other similar transactions or property of the insurer. (b) Said person shall not take or receive to his own use a fee, brokerage commission or gift or other consideration, for or on account of any transaction by or on behalf of the insurer. No insurer may guarantee a financial obligation of its officers, or directors.

Version 2.

Director, officer or employee of the insurer shall not be financially interested in the business of the insurer nor shall such a person engage in any business or occupation interfering or inconsistent with the duties of his office or employment.

Version 3.

No director or officer should receive payment for negotiating, procuring or recommending a loan from the company, selling or aiding in a sale of stock or securities.

Version 4.

(a) Director, employee, officer, etc., may not be interested as principal, co-principal, agent or beneficiary in any such purchases or loans (misdemeanor). Applies to officer and director or other person having effective control (10% of the stock). (b) May not receive commissions with respect to particular risks insured by the insurer unless the commissions are paid pursuant to a contract filed and approved by the insurance department. But director, etc., may be an insurance agent. Violation of this section entails loss of certificate of authority.

Version 5.

Insurer may not invest in property or loan in which a director or officer has an interest. Director of insurance may approve under specified standards.

Version 6.

No unreasonable compensation. No compensation calculated as % of the premiums collected without the Commissioner's approval. ALASKA STAT. § 21.69.370 (1966) (version 1); ARIZ. REV. STAT. ANN. § 20-726 (1956) (version 1) (b) no guarantee of director's obligations by the company); ARK. STAT. ANN. § 66.4236 (1966) (version 1); CAL. INS. CODE § 1104 (Supp. 1971) (no loans to officers), *see also* §§ 1105, 1106 (Supp. 1971); CONN. GEN. STAT. ANN. § 38-142 (1969) (version 3); DEL. CODE ANN. tit. 18, § 4920 (1970) (version 1) § 4919 (no guarantee of director's obligations by the company); D.C. CODE ENCYCL. ANN. § 35-530 (1968) (version 1, version 3); FLA. STAT. ANN. § 628.255 (1972) (version 3); GA. CODE ANN. § 56-1533 (1971) (version 3, version 1); HAWAII REV. STAT. § 431-148 (1968) (version 2); IDAHO CODE ANN. § 41-2837 (1961) (version 1); ILL. ANN. STAT. ch. 73, § 736.2(2) (1965) (version 5); IND. ANN. STAT. § 39-3715 (1965) (no loans to officers and directors); IOWA CODE ANN. § 508.8 (Supp. 1973) (version 1, version 3); LA. REV. STAT. ANN. § 22:848 (1959) (version 5); ME. REV. STAT. ANN. tit. 24-A, § 3413 (1972) (version 1); MD. ANN. CODE art. 48A, § 267 (1972) (no loans to officers and directors except mortgage loans on residence used for habitation duly approved by the board. No advance for future services beyond one year. No guarantee of director's and officer's obligations by the company); MICH. STAT. ANN. § 24.15.252 (1972) (version 3, version 4(a)); MO. ANN. STAT. § 375.39 (1968) (use of funds for private gains is a felony); MONT. REV. CODE ANN. § 40-4723 (1961) (version 2); NEV. REV. STAT. tit. 57, § 693A.120 (1972) (version 1) (no guarantee of director's financial obligation by the company § 682.A.280 (1972); N.M. STAT. ANN. § 58-18-26 (1962) (no guarantee of loans of directors by the company; no fees for directors); N.Y. INS. LAW § 78a-78.6, .7 (McKinney Supp. 1972) (no loans to directors, and directors may not seal their office); ORE. REV. STAT. § 732.325 (1971) (version 3); OKLA. STAT. ANN. tit. 36, § 2126 (1958) (prohibited interest of officers and directors), § 6071 (Supp. 1972) (prohibition of payment of commissions to officers and directors of life companies); PA. STAT. ANN. tit. 40, § 507 (Supp. 1971) (version 3, version 4a); S.D. COMP. LAWS ANN. §§ 58-5-61, 58-5-62 (1967) (version 1); TENN. CODE ANN. §

provision that a broker, who is an affiliate of the fund, may only charge the fund a customary fee.²³⁶

This provision is irrelevant in conventional insurance, except that it might affect dividends, but it is imperative for the protection of variable life insurance policyholders. Expenses of investing and trading in securities directly affect the investment performance of the account, which in turn affects the investment arrangement in the policies. Even if there exists a legitimate state interest to protect policyholders, there is a stronger federal interest to protect investors.

4. "NO ACT OF CONGRESS SHALL BE CONSTRUED TO INVALIDATE . . . ANY LAW ENACTED BY ANY STATE FOR THE PURPOSE OF *regulating* THE BUSINESS OF INSURANCE, OR WHICH IMPOSES A FEE OR TAX UPON SUCH BUSINESS, . . . *Provided*, THAT . . . THE SHERMAN ACT, AND . . . THE CLAYTON ACT, AND . . . THE FEDERAL TRADE COMMISSION ACT, . . . SHALL BE APPLICABLE TO THE BUSINESS OF INSURANCE TO THE EXTENT THAT SUCH BUSINESS IS NOT REGULATED BY STATE LAW."

Two approaches that could be adopted to interpret the main paragraph of § 2(b): the first is based on the notion that state laws provide a comprehensive scheme of insurance regulation, and that if any federal statute or part of it is not compatible with this scheme the entire federal act should be excluded.²³⁷ The second approach is less sweeping. If a provision or a group of provisions impair state insurance regulation, then this part of the act should be excluded, but the rest of the act should apply. State regulation is also viewed narrowly. If specific subject matter is not within the McCarran Act, it cannot acquire a protected status just because state regulation covers a related area or provides a comprehensive scheme of regulation.

In the writer's view, the second approach is sounder. There is no reason for rejecting an entire federal act because part of it does not pass the McCarran Act test. Just as a section in the federal act that specifically applies to insurance should not result in the automatic application of the entire federal act to insurance, so existence of provisions that impair state law should not automatically result in the exclusion of the entire federal act.

The first approach that views state regulation in its entirety is also unacceptable. The McCarran Act establishes various relationships between federal and state laws. The first paragraph of § 2(b) deals with federal acts that are not specifically mentioned in other parts of the Act. It gives protection from federal impairment to state laws regulating the business of insurance, but does not preclude concurrent federal and state regulation. The proviso to this section

56-310 (1968) (version 1); TEX. INS. CODE art. 3.67, 3.68 (1963) (version 3); UTAH CODE ANN. § 31-7-6 (1966) (no guarantee of director's financial obligation by the company); VT. STAT. ANN. tit. 8, § 3469 (1971) (version 5); VA. CODE ANN. §§ 38.1-34 (version 3), 38.1-33 (1970) (no loans to officers); WASH. REV. CODE ANN. § 48.07.130 (1961) (version 1); W. VA. CODE § 33-4-17 (1966) (version 3); WYO. STAT. ANN. § 26.1-490 (1967) (version 1).

²³⁵ *Id.*

²³⁶ § 17(e)(2); 15 U.S.C. § 80a-17(e)(2) (1970).

²³⁷ This approach was urged on the SEC by the National Association of Insurance Commissioners. NAIC Brief, *supra* note 43, at 50. The association cited *Pennsylvania v. Nelson*, 350 U.S. 497, 502 (1955); *Rice v. Santa Fe Elevator Corp.*, 331 U.S. 218, 230 (1947).

deals with three specified federal acts. Only with respect to these acts is concurrent regulation precluded and state regulation permitted to preempt the field. The preemption approach of the proviso was rejected in the *United Benefit* case when the Supreme Court applied the Securities Act of 1933 to an old-line insurance company that issued hybrid insurance and investment products. This approach has no basis in the history of the McCarran Act. The main paragraph of § 2(b) was not designed to curb federal control of insurance. It was designed to ensure the continuation of state regulation of insurance. Federal law was to yield only when it weakened the impact of state law, unless Congress specifically indicated its intention to the contrary.

*SEC v. National Securities, Inc.*²³⁸ dealt with Arizona insurance law that required the approval of the insurance commissioner for merger of two insurance companies. The Supreme Court did not conclude that federal securities acts should yield to state law because state insurance regulation is comprehensive or because the regulation deals with insurance companies and is contained in insurance laws, or because there is a possibility that federal securities acts will result in declaring a merger approved by the insurance commission as invalid. Rather, the Court took the approach which this article follows. The Court examined the nature of state law, found that the very same action of the commissioner was both the regulation of insurance and the regulation of issuance of securities, which is not the regulation of insurance. Then the Court considered whether and to what extent the proxy rules of the 1934 Act impaired state regulation. The Court distinguished between direct federal intervention and indirect intervention through invalidation of the votes that led to the approval of the merger by the shareholders of the companies. The Court also distinguished between approval of the merger by permitting it and a mandatory requirement by the state agency. Further, the Court distinguished between "the sphere reserved primarily to the States by the McCarran-Ferguson Act" and a merger of insurance companies which is not within the primary sphere.

Piecemeal application of federal law is not repugnant to insurance regulation. For example, federal law might apply in states which do not regulate a specific activity but might be excluded in another state, which does regulate the activity. This was the result of *FTC v. Travelers Health Association*,²³⁹ which dealt with the proviso to § 2(b). Under that decision the Federal Trade Commission Act applied in states that could not constitutionally regulate certain activities of insurance companies even though the same activities were regulated in other states thereby excluding the federal act. The insurance industry has long been subject to such regulation. Just as the federal act must be scrutinized for its effect on state laws, so should state laws be examined to determine whether and to what extent any part of them is covered by the McCarran Act.

The literal meaning of "regulate" is "to govern or direct according to rule . . . to bring under the control of law. . . ."²⁴⁰ § 2(b) of the McCarran Act uses the term "regulate" in prohibiting federal acts from impairing state

238 393 U.S. 453 (1969).

239 362 U.S. 293 (1960).

240 WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1913 (1965).

legislation enacted "for the purpose of regulating the business of insurance"; and in the proviso, applying the Sherman, Clayton, and Federal Trade Commission Acts to the business of insurance only "to the extent that such business is not regulated by state law."

The term "regulate" was litigated mainly in connection with the proviso. Cases deal with two questions: the first is whether the mere passing of legislation is "regulation."²⁴¹ This question is not fully resolved. It seems that in order to constitute regulation, three conditions must be satisfied: there must be some legislation; this legislation must, by its own terms, impose a requirement for some form of conduct; and it must provide for some enforcement. As Senator McCarran explained in 1948:

Probably also the State law should be prohibitory rather than permissive. That is, it should prohibit the particular practice except in accordance with specified procedure and subject to State approval, rather than simply in terms permitting the practice in question.

Machinery should be provided for regulating the practice, and the law should designate an authority . . . to exercise the State regulatory power.²⁴²

The courts have followed the Senator's criteria. When state legislation is merely exemptive it is not deemed to be regulation.²⁴³ As to the extent of effectiveness, it has been argued by writers that regulation must include effective enforcement.²⁴⁴ Such an argument was rejected by the Supreme Court.²⁴⁵ Whether or not an act regulates must be determined according to its own terms. The courts will not examine the extent and effectiveness of its enforcement.²⁴⁶ On the other hand, if a state statute is passed merely as a device to preclude federal regulation under the proviso to § 2(b),²⁴⁷ or when a statute is a dead letter,²⁴⁸ such a statute will probably not qualify under the McCarran Act.

241 In the context of the main paragraph, the question is whether the mere passing of state legislation is sufficient to impose on federal statutes the constraints of the McCarran Act. There is no reason why the answer to these questions should not be the same.

242 McCarran, *Federal Control of Insurance: Moratorium Under Public Law 15 Expired July 1*, 34 ABA J 539, 542 (1948). *Allstate Ins. Co. v. Lanier*, 242 F. Supp. 73 (E.D.N.C. 1965), *aff'd*, 361 F.2d 870 (4th Cir.), *cert. denied*, 385 U.S. 930 (1966). For a discussion of this case see Atwell, *The McCarran-Ferguson Act—A Deceptive Panacea?*, 5 FORUM 339, 343 (1970). See also Curtis, *Antitrust Aspects of Mergers in the Life Insurance Industry—A Word of Caution*, 20 *Ass'n of Life Ins. Counsel Proceedings*, 483, 484-87 (1968); Note, *Applications of Federal Antitrust Laws to the Insurance Industry* 46 MINN. L. REV. 1088, 1093-97 (1962).

243 *In re Aviation Ins. Industry*, 183 F. Supp. 374 (S.D.N.Y. 1960). See also 33 A.B.A. ANTITRUST L. J. 33-4 (1967).

244 See Kimball & Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545, 574-76 (1958) (Analysis of legislative history of the McCarran Act to show that regulation means more than just enacting legislation). For an earlier argument see Note, *State Regulation of the Insurance Business and the Sherman Anti-Trust Act*, 96 U. PA. L. REV. 223, 228-29 (1947).

245 *FTC v. National Cas. Co.*, 357 U.S. 560 (1958).

246 See, e.g., *Fleming v. Travelers Indemnity Co.*, 324 F. Supp. 1404 (D. Mass. 1971) (Insurance Commissioner's failure in one case to set aside rates filed by a rating organization, rates which he did not deem to conform to statutory standards, was not evidence that the regulatory scheme was not substantially effective, regarding the proviso to § 2(b)).

247 See *FTC v. National Cas. Co.*, 357 U.S. 560, 564 (1958).

248 Senator McCarran, in another publication, stated that in addition to legislation an enforcement machinery must exist. McCarran, *Insurance as Commerce—After Four Years*, 23 NOTRE DAME LAWYER 299, 311 (1948).

There is no regulation when state law cannot be legally enforced. Since the McCarran Act did not grant, and could not grant, the states powers which they did not have under the Constitution, states cannot regulate insurance business over which the states have no personal jurisdiction.²⁴⁹ Even if personal jurisdiction could be constitutionally exercised, it was held that a state regulates if it has the power to enforce its legislation within its own boundaries. A remedy against the insurance company which is available in another state, such as the state of incorporation, is no "regulation."²⁵⁰

The second question raised in connection with the § 2(b) proviso is how specific must state regulation be in order to satisfy the "to the extent regulated" language in the proviso. The answer is not free from doubt. In *California League of Independent Insurance Producers v. Aetna Casualty & Surety Company*,²⁵¹ the court stated that "a State regulates the business of insurance within the meaning of 1012(b) when a State statute generally prescribes or permits or authorizes certain conduct on the part of the insurance companies," without specifically covering the full substance of federal antitrust laws. Other cases require more specific coverage of state laws before excluding federal regulation. In *United States v. Chicago Title & Trust Company*,²⁵² the defendants were charged with stock acquisitions that lessened competition among insurance companies. The applicable state insurance laws did not regulate such stock acquisitions. The defendants argued that state regulation of insurance rates which assured the public reasonable rates achieved the same purposes as § 7 of the Clayton Act, and was sufficient "regulation" to oust federal antitrust laws under the proviso of § 2(b). The court rejected the argument and held that the provision of state law must be "precisely comparable" to federal law. "The Federal Government has decided competition is healthy economics and that intent is not necessarily satisfied be-

249 The constitutional minimum contact requirements have been changing to allow states to exercise personal jurisdiction. See, e.g., *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957); *Parmalee v. Iowa State Traveling Men's Assn.*, 206 F.2d 518, cert. denied, 346 U.S. 877 (1952). For a case where the minimum contact requirement was not satisfied see *State Board of Ins. v. Todd Shipyards*, 370 U.S. 451 (1962). The limitation on regulation of out-of-state insurers was recognized in the legislative history of the McCarran Act. HOUSE REP. No. 143, 79th Cong., 1st Sess. (1945). For a comprehensive treatment of the subject, see *Hanson & Obenberger, Mail Order Insurers: A Case Study in the Ability of the States to Regulate the Insurance Business*, 50 MARQUETTE L. REV. 175 (1966); *Dean, The Foreign Unauthorized Insurer: A State Regulatory Gap*, 32 INS. COUNSEL J. 432, 438-40 (1965). See also *Unauthorized Insurers Process Act*, 1951 N.A.I.C. Proceedings 66-68, adopted in most states and held constitutional in Florida. *Parmalee v. Iowa State Traveling Men's Assn.*, 206 F.2d 518, cert. denied, 346 U.S. 877 (1952).

250 *F.T.C. v. Travelers Health Assn.*, 362 U.S. 293, 297-99, 302 (1960), on remand, 298 F.2d 820 (8th Cir. 1962). See also, *Annot.*, 21 L. ED. 2d 962 (1969); *Johnson v. Universal Underwriters, Inc.*, 283 F.2d 316 (7th Cir. 1960). Note, *supra* note 242, at 1088; Note, *Regulation of Insurance Advertising Practices: A Jurisdictional Inquiry* 67 YALE L. J. 452 (1958).

251 175 F. Supp. 857, 860 (N.D. Cal. 1959). To the same effect see *Ohio AFL-CIO v. The Ins. Rating Board*, 451 F.2d 1178, 1182 (6th Cir. 1971); *Holy Springs Funeral Home, Inc. v. United Funeral Service, Inc.*, 303 F. Supp. 128, 135 (N.D. Miss. 1969); *Transnational Ins. Co. v. Rosenlund*, 261 F. Supp. 12, 26 (D. Ore. 1966); see also, *Professional and Business Men's Life Ins. Co. v. Bankers Life Co.*, 163 F. Supp. 274, 278-80 (D. Mont. 1958) (state statute prohibiting monopolies in general, but not referring to insurance was sufficient to exclude federal antitrust laws). See *Atwell, The McCarran-Ferguson Act—A Deceptive Panacea?* 5 FORUM 339, 341 (1970).

252 242 F. Supp. 56 (N.D. Ill. 1965). See also *Atlantic & Pacific Ins. Co. v. Combined Ins. Co.*, 312 F.2d 513 (10th Cir. 1962).

cause one of its ends is achieved by another means.²⁵³ On the same ground the court held that it was irrelevant that state commissioners had power to censure insurance companies, including foreign companies.²⁵⁴ Thus, state regulation of one factor in the federal regulatory scheme did not preclude the application of the federal statute.

The 1940 Act provides that purchasers of redeemable shares of investment companies may not be charged excessive fees,²⁵⁵ and imposes on the self-regulating broker-dealers association and the SEC the primary responsibility of defining standards and enforcing the Act.²⁵⁶ The Act also restricts the sales commission and front-end load on periodic payment plan certificates.²⁵⁷

Had state insurance laws regulated variable life insurance rates, the McCarran Act would have applied because rate regulation is the business of insurance,²⁵⁸ and variable life insurance policies contain a true life insurance arrangement.²⁵⁹ Life insurance rates or premiums depend on five factors: mortality rate, method of computing reserves, nonforfeiture values, net investment earnings, and expenses of executive, clerical, professional and sales services,²⁶⁰ of which the last is the largest single expense.²⁶¹

Since the main concern of state regulation is that insurance companies will charge sufficient amounts as premiums that go into reserves,²⁶² mortality tables²⁶³ and reserve computation are established by law and apply equally to

253 242 F. Supp. at 71.

254 *Id.*

255 § 22(b)(1); 15 U.S.C. § 80a-22(b)(1) (1970).

256 *Id.* The section was amended in 1970. It authorizes a securities association like the National Association of Securities Dealers to adopt rules regulating the distribution of redeemable securities "in order that the price at which such security is offered or sold to the public shall not include an excessive sales load, but shall allow for reasonable compensation. . . ." Within 18 months of the enactment of the amendments or after the association will have adopted rules the Commission is authorized also to adopt similar rules. § 22(b)(2); 15 U.S.C. § 80a-22(b)(2) (1970), or to alter the rules of the association, § 22(b)(3); 15 U.S.C. § 80a-22(b)(3) (1970). Until 1970 the only Rule was § 26 of the N.A.S.D.'s Rules of Fair Practices. The Commission has not interfered with § 26 of the N.A.S.D.'s Rules of Fair Practices except by enacting Rule 22c-1, 17 C.F.R. § 270.22c-1 (1971). See 4 L. LOSS, SECURITIES REGULATION 2429 (Supp. 1969).

257 § 27; 15 U.S.C. § 80a-27 (1970).

258 "The rate of commission paid to agents is a vital factor in the ratemaking structure." California League of Independent Ins. Producers v. Aetna Cas. & Sur. Co., 175 F. Supp. 857, 860 (N.D. Cal. 1959). And rate making (in automobile insurance) is insurance business. See SEC v. National Sec. Inc., 393 U.S. 453, 460 (1969).

259 It is interesting to examine the different treatment of life insurance rates and other rate regulation in the industry. Presently state laws regulate commissions on sales of fire and casualty insurance by requiring state approval of rates. Before the Civil War these companies competed unchecked. Stelzer, *The Insurance Industry and the Antitrust Laws: A Decade of Experience*, 1955 Ins. L.J. 137, 141-2 (hereinafter cited as Stelzer). There developed a pattern of fraudulent policy designs, misleading descriptions of the policies, and more insolvencies. This state of affairs led to the appointment of the Armstrong Commission in New York. The hearings before the Commission prompted many states to abolish their anticompetition laws regarding fire and casualty insurance, and permit cooperative rate making. Life insurance too suffered from unbridled competition in the 1890's. But it developed its protective mechanisms without rate regulation. *Id.* See also HUEBNER & BLACK, *supra* note 40, at 743. (on regulation of rates).

260 Stelzer, *supra* note 259, at 141-42. See also Butler, *Activities of Agents Under the McCarran Act*, 15 LAW & CONTEMP. PROB. 568, 572 (1950). See HUEBNER & BLACK, *supra* note 40, at 379. J. MACLEAN, *LIFE INSURANCE*, ch. 6 (9th ed. 1962).

261 Stelzer, *supra* note 259, at 149.

262 Kulp, *The Rate-Making Process in Property and Casualty Insurance—Goals, Techniques, and Limits*, 15 LAW & CONTEMP. PROB. 493 (1950).

263 Stelzer, *supra* note 259, at 143.

all life insurance companies.²⁶⁴ As to the investment item, all states set a minimum standard with respect to the type of investments that insurance companies may make. As to the commissions item, three states, one of which is New York, limit the amount that insurance companies may pay for marketing their policies.²⁶⁵ The purpose of these laws was to end the practice of the 1920's when insurance companies paid extravagant commissions and bonuses which led to their demise.²⁶⁶ The limitations on sales commissions in state laws are far less stringent than those of the 1940 Act.²⁶⁷ It is not the paramount concern of state laws to protect purchasers from paying excessive commissions.²⁶⁸ There is no such prohibition in any state law. It has been argued that free competition is an effective substitute to commissions control.²⁶⁹ Yet state laws do not seem to have competition high on the list of their priorities. Private "understandings" with respect to sales commissions that existed before the *South-Eastern Underwriters* decision may still exist.²⁷⁰ Furthermore, the areas of competition between insurance companies are blurred because the companies are selling three different types of life insurance.²⁷¹ Perhaps the strongest reason for questioning the efficacy of competition on sales commissions is that sales commissions in life insurance are fairly stable and arguably high.

Existing state insurance legislation is not "regulation" within the McCarran Act. As to states that neither require, prohibit, authorize nor explicitly permit specific rates on life insurance policies, it could be argued that they nonetheless regulate this subject because the states have a legitimate interest in protecting insurance companies from competition of the investment industry. Since the successful marketing of insurance and mutual fund shares depends on incentives to salesmen, the freedom given by insurance laws regarding sales commissions ensures to insurance companies a competitive advantage. This freedom is intentional; the silence of state laws is a "speaking silence." To this argument the

264 J. MAGEE, *GENERAL INSURANCE* 116 (6th ed. 1961).

265 N.Y. INS. LAWS § 213 (McKinney Supp. 1971).

266 See *Metropolitan Life Ins. Co. v. Durkin*, 301 N.Y. 376, 93 N.E. 2d 897, 899, 903-04 (1950). The purpose of the section "was to put an end to excessive and ex post facto rewards. . . ." *Id.* at 899. It has been suggested that all states should regulate commissions so as to prevent encroachment on payments due to cover losses and curb discrimination. Orfield, *Improving State Regulation of Insurance*, 32 MINN. L. REV. 219, 247 (1948).

267 In the Hearings it transpired that usually all first year's premiums are used to pay marketing expenses of which approximately 65 per cent are paid to the salesmen and underwriters. *SEC Hearings*, *supra* note 5, at SEC Exhibit K.

268 As to the history of rate regulation in the fire insurance industry, see Kimball & Boyce, *supra* note 244, at 545, 567. See also Note, *Insurance and the Anti-Trust Laws—A Problem in Synthesis*, 61 HARV. L. REV. 246, 271 (1948) in which the authors prophetically state that the rating system is not designed to tend to keep down commissions. See also Donovan, *Regulation of Insurance Under the McCarran Act*, 15 LAW & CONTEMP. PROB. 473, 485 (1950).

269 HUEBNER & BLACK, *supra* note 40, at 743.

270 Stelzer, *supra* note 259, at 150, states that these combinations may still exist but are less forceful.

271 The areas of competition are blurred by the three predominant types of life insurance selling: the stock companies that use low-premium plans, with profits going to the stockholders; mutual companies that sell at higher premiums, but quote estimated dividends which the policyholders may expect to receive; mutual companies that sell at low premiums as in stock companies. MAGEE, *supra* note 264, at 143.

answer is that the McCarran Act protects *laws* "enacted by any State." Silence is therefore not speaking.²⁷²

It may also be argued that state agencies' policy is to permit insurance companies to charge as much commissions as the market will bear so long as their financial solidity is not threatened. Two insurance commissioners testified at the SEC Hearings that they would be alarmed at lowering the ceiling on marketing expenses below the New York maximum, and that they would favor eliminating the New York limitation altogether.²⁷³ To this argument the answer is that policies of state commissioners are not protected by the McCarran Act unless they are expressed or authorized by the state legislature.

It may also be argued that since state laws regulate the issuance of variable life insurance they implicitly regulate the sales commissions by permitting companies to charge what the market will bear. To this argument the answer is that regulation, even for the purpose of the first paragraph of § 2(b) of the McCarran Act, must be express. Otherwise any mention by state law of insurance business limits the application of federal law.

As to New York,²⁷⁴ Illinois,²⁷⁵ and Wisconsin²⁷⁶ statutes that limit sales expenses, legislation with a view to protecting the financial integrity of insurance companies is regulation of the business of insurance. Federal law limiting the commissions that purchasers may pay to salesmen, in order to protect investors, must therefore pass the impairment test. It is difficult to see how the 1940 Act impairs these three statutes. The less a company spends, the fuller are its coffers. Further, these statutes are not designed to encourage the sale of insurance policies. If these three statutes were interpreted as giving license to insurance companies to pay sales commissions up to the limits stated, the statutes in this sense would not qualify as "regulation" under the McCarran Act. § 2(b) was not passed to immunize insurance companies from additional regulation.²⁷⁷ Congress did not intend to protect state laws that simply permit insurance companies to do as they please. The 1940 Act regarding commissions should apply unless it can be shown that the application would detrimentally affect the financial integrity, stability and development of insurance companies. These allegations require substantial proof which has not been produced to date. Even if this were shown, state laws would prevail only in the three states where these statutes govern.²⁷⁸

272 Emphasis added. See 33 ABA ANTITRUST L. J. 33, 34 (1967). See also *In re Aviation Ins. Indus.*, 183 F. Supp. 374 (S.D.N.Y. 1960).

273 SEC Hearings, *supra* note 5.

274 N.Y. INS. LAW § 213 (McKinney Supp. 1971).

275 ILL. ANN. STAT. ch. 73, § 736.2 (1965). First-year sales expenses can be as high as 100 per cent of the premium. SEC Hearings, *supra* note 5, at SEC Exhibit K.

276 WISC. STAT. ANN. § 206.29 (Supp. 1972). These limitations "are so liberal that it is doubtful if it ever has had any effect." SEC Hearings, *supra* note 5, at 333.

277 Royal Standard Ins. Co. v. McNamara, 344 F.2d 240 (8th Cir. 1965). The McCarran Act did not create any statutory right for insurance companies. Therefore, they could not challenge the power of the Secretary of Defense to issue directives for uniform requirements as to automobile liability for personnel on military reservations. *In re Aviation Ins. Industry*, 183 F. Supp. 374 (S.D.N.Y. 1960) (where 45 states did not regulate aviation rates, federal antitrust laws apply. *Id.* at 379).

278 *E.g.*, F.T.C. v. Travelers Health Ass'n., 362 U.S. 293 (1960) (states cannot regulate insurance business extraterritorially); F.T.C. v. Nat. Cas. Co., 357 U.S. 560 (1958); United States v. Chi. Title & Trust Co., 242 F. Supp. 56, 60 (N.D. Ill. 1965).

Another area which state insurance laws do not regulate is that relating to fees paid to insurance companies for investment advice. The 1940 Act imposes a fiduciary duty on investment advisers with respect to these fees. The duty can perhaps be translated into a prohibition on unreasonable fees.²⁷⁹ The Act also limits the expenses charged by trustees of unit investment trusts.²⁸⁰ There are no parallel provisions in state laws,²⁸¹ except to the effect that the assets in separate accounts are owned by the insurance company, and that the company shall not be nor hold itself to be a trustee with respect to these assets.²⁸²

Investment advice in connection with variable life insurance is not the business of insurance.²⁸³ Even if it were, state regulation quoted above does not relate to investment advisory services, but to the assets in the account. Most state judicial decisions hold that, subject to statutory and contractual provisions, the relationship between the policyholders and the insurance company is that of creditor and debtor, and that an insurance company is not a trustee or fiduciary of the policyholder.²⁸⁴ The holdings deal with the status of the assets of the insurance company, when policyholders brought suits for accounting.²⁸⁵ They should not govern services rendered by the insurance company which create a fiduciary relationship. Therefore, it would seem that the provisions of the 1940 Act regulating investment advisory fees should apply.

5. "NO ACT OF CONGRESS SHALL BE CONSTRUED TO *invalidate, impair and supersede.*"

Most of the 1940 Act covers subjects specifically regulated by state laws. The federal act would apply unless it invalidated, impaired or superseded state law. Literally, to "impair" means to weaken, to make worse, to lessen power, diminish, or otherwise affect in an injurious manner;²⁸⁶ "invalid" means having no binding force or legal effect, lacking in authority or obligation,²⁸⁷ made weak or useless; "to supersede" means to make void, and to take the place of.²⁸⁸ The meaning of these terms in the McCarran Act has seldom been litigated.

It is submitted that if the application of federal law does not weaken the impact of state law and is compatible with state law policy, and if federal law limits the freedom of action of insurance companies but not the freedom of state agencies to protect policyholders, then under the main paragraph of § 2(b), federal law should apply concurrently with state law. The rules governing con-

279 See Frankel, *supra* note 19, at 364-70.

280 § 26(a)(2); 15 U.S.C. § 80a-26(a)(2) (1970).

281 Some state laws permit insurance companies to engage in the business of investment advice, but say no more. See, e.g., N.Y. INS. LAW § 46-a (McKinney Supp. 1971).

282 MODEL VARIABLE CONTRACT LAW Sec. 1(c). See also Frankel, *supra* note 19, at 242, 330.

283 See p. 1056 *supra*.

284 See Frankel, *supra* note 19, at 327-30. Note that the 1940 Act does not require that ownership of assets vests in the account or contractholders.

285 *Id.* at 328.

286 See BLACK'S LAW DICTIONARY 885 (4th Ed. 1957); WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1131 (1961).

287 See WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY 1188 (1961).

288 *Id.* at 2295.

flict between state and federal laws could be used to test whether federal law impairs, invalidates or supersedes state insurance laws. It should be borne in mind, however, that the McCarran Act protection of state laws is limited to regulation and taxation of insurance business as discussed before.

In *Securities and Exchange Commission v. Variable Annuity Life Insurance Company*²⁸⁹ Mr. Justice Douglas stated for the majority that the 1940 Act does "at least to a degree 'supersede' state insurance regulation, since the Federal Acts prescribe their own peculiar requirements."²⁹⁰ The Justice cited §§ 10, 14, 15, 17, 18, 19 and 21 of the 1940 Act as examples of such supersession. However, the statement did not go beyond this remark and was clearly dictum.

Ten years later the Supreme Court in *Securities and Exchange Commission v. National Securities, Inc.*²⁹¹ examined and determined the scope of supersession under the McCarran Act in connection with the application of the 1934 Act to insurance. In that case a state insurance agency approved a merger between two insurance companies, but the petitioner argued that the consent of the shareholders was obtained in violation of the SEC proxy rules. The Court held that the state authority's approval was regulation of insurance business within the McCarran Act. Nevertheless, the Court preserved the federal remedy. Limiting the decision to the facts of the case, the Court held that the attack on the merger and federal impairment of state law were indirect.

First, the Court reasoned, federal remedy regarding an act regulated by state insurance laws does not ipso facto invalidate state law.²⁹² Second, the complaint was directed not at the approval by the state insurance agency but at the manner in which shareholders' approval of the merger was obtained. Third, the protection of state law was preserved. The merger remained subject to the state commissioner's approval. Fourth, the state commissioner did not order the merger, but rather permitted it. An additional requirement that might result in prohibiting what he had authorized is not an impairment of his regulatory powers.²⁹³ "The paramount federal interest in protecting shareholders is in this situation perfectly compatible with the paramount state interest in protecting policyholders."²⁹⁴

Guided by these principles, some of the 1940 Act's provisions do not impair, invalidate or supersede state insurance laws. For example, the 1940 Act requires initial disclosure of information concerning the investment company²⁹⁵ and its

289 359 U.S. 65 (1959).

290 *Id.* at 67 n. 2.

291 393 U.S. 453 (1969).

292 *Id.* at 463.

293 In their brief the respondents argued that state law would be invalidated if a merger authorized by the commissioner of insurance were set aside: "Let us leave the matter with a rhetorical question for the SEC: How would it be possible more completely to impair or supersede the Director's power than to set aside a merger he allowed? If the SEC did wish to impair or supersede A.R.S. § 20-731, what else could it do?" Respondents' brief at 33, 34, *SEC v. National Sec. Inc.*, 393 U.S. 453 (1969). The Supreme Court laconically answered that any supersession or invalidation would be "indirect." *Id.* at 463.

294 393 U.S. at 463.

295 §§ 7, 8; 15 U.S.C. §§ 80a-7, 8 (1970).

operations,²⁹⁶ and periodic reporting to the Commission and to the policyholders.²⁹⁷ Insurance laws also require extensive reporting to insurance agencies²⁹⁸ and, to a lesser extent, to the policyholders.²⁹⁹

Additional federal disclosure requirements do not impair state law. In *SEC v. United Benefit Life Insurance Company*³⁰⁰ the Supreme Court held that the Securities Act of 1933 applied to variable annuities issued by a life insurance company because these contracts were securities. Implicit in the decision is the conclusion that the additional reporting requirements of the 1933 Act do not impair state insurance laws. With respect to the application of the 1940 Act, the Court did not reach this, or any conclusion, but remanded to the lower court to examine to what extent the Investment Company Act might impair state insurance laws regulating the business of insurance.³⁰¹ The Court emphasized that the Act's requirements went much further than "mere disclosure." A further inquiry into possible impairment was therefore necessary.

The 1940 Act also imposes the 1933 Act registration provisions with respect to the sale of mutual fund shares.³⁰² State insurance laws are inadequate to provide investors with information necessary to make an intelligent evaluation of policies. The Supreme Court reached this conclusion regarding variable

296 Form N-1R, 17 C.F.R. § 270.30a-1 (1972).

297 § 30; 15 U.S.C. § 80a-30 (1970).

298 ALA. CODE tit. 28, § 1 (Supp. 1969); ALASKA STAT. § 21.09.200 (1966); ARIZ. REV. STAT. ANN. § 20-223 (1956); ARK. STAT. ANN. § 66-2220 (1966); CAL. INS. CODE § 900 (Supp. 1971); COLO. REV. STAT. ANN. § 72-1-13, 72-1-34 (1963); CONN. GEN. STAT. ANN. § 38-24 (1969); DEL. CODE ANN. tit. 18, § 526 (1971); D.C. CODE ENCYCL. ANN. § 35-103 (1968); FLA. STAT. ANN. § 624.0223 (1960); GA. CODE ANN. § 56-315 (1971); HAWAII REV. STAT. § 431-106 (1968); IDAHO CODE ANN. § 41-355 (1961); ILL. ANN. STAT. ch. 73, §§ 743, 748, 751 (Smith-Hurd Supp. 1972); IND. ANN. STAT. § 39-5021 (1965); IOWA CODE ANN. § 508.11 (1949); KAN. STAT. ANN. § 40-225 (Supp. 1972); KY. REV. STAT. ANN. § 304.3-240 (1971); LA. REV. STAT. ANN. § 1451 (1959); ME. REV. STAT. ANN. tit. 24-A, § 423 (1971); MD. ANN. CODE art. 48A, § 58 (1972); MASS. GEN. LAWS ANN. ch. 175, § 25 (1958); MICH. STAT. ANN. § 24:1438 (1972); MINN. STAT. ANN. § 60A.13 (1968); MISS. CODE ANN. § 5726 (1957); MO. ANN. STAT. § 375.891 (1968); MONT. REV. CODE ANN. § 40-2820 (1961); NEB. REV. STAT. § 44-332 (1968); NEV. REV. STAT. tit. 57, § 680A.270 (1972); N.H. REV. STAT. ANN. § 402:37 (1968); N.J. STAT. ANN. § 17B:19-1 (Supp. 1971); N.M. STAT. ANN. § 58-5-18 (1962); N.Y. INS. LAW § 217 (McKinney 1966); N.C. GEN. STAT. § 58-21 (1965); N.D. CENT. CODE § 26-07-05 (1970); OHIO REV. CODE ANN. § 3907.19 (Page 1971); OKLA. STAT. ANN. tit. 36, § 311 (1958); ORE. REV. STAT. § 731.574 (1971); PA. STAT. ANN. tit. 40, § 443 (1954); R.I. GEN. LAWS ANN. § 27-12-1 (1969); S.C. CODE ANN. § 37-293 (Supp. 1971); S.D. COMP. LAWS ANN. § 58-6-75 (1967); TENN. CODE ANN. § 56-301 (1968); TEX. INS. CODE art. 1.11 (1963); UTAH CODE ANN. § 31-5-21 (1966); VT. STAT. ANN. tit. 8, §§ 3561, 3562 (1971); VA. CODE ANN. § 38.1-159 (1970); WASH. REV. CODE ANN. § 48.05-250 (1961); W. VA. CODE § 33-4-14 (1966); WISC. STAT. ANN. § 601.42(1)(a) (1972); WYO. STAT. ANN. § 26.1-72, 26.1-73 (1967).

299 The MODEL VARIABLE CONTRACT REGULATION *supra* note 49 provides at Art VII § 1: Any company issuing variable contracts shall mail to the contract holder at least once in each contract year after the first . . . , a statement or statements reporting the investments held in the separate account. . . . 2. Any company issuing individual variable contracts shall mail to the contract holder at least once in each contract year after the first . . . , a statement reporting as of a date not more than four months previous to the date of mailing: (a) In the case of an annuity contract under which payments have not yet commenced, (i) the number of accumulation units credited to such contract and the dollar value of a unit, or (ii) the value of the contract holder's account, and (b) in the case of life insurance policy, the dollar amount of the death benefit.

300 387 U.S. 202 (1967).

301 *Id.* at 212.

302 § 24; 15 U.S.C. § 80a-24 (1970).

annuities.³⁰³ The same reasoning applies, with greater strength, to variable life insurance.³⁰⁴

Advertising is another area where federal regulation does not impair state laws and where investor protection is needed. Under the Investment Company Act, advertising material must be filed with the Commission within ten days of use.³⁰⁵ The Commission has set guidelines, which the National Association of Securities Dealers administers, to eliminate misleading advertising peculiar to the mutual fund industry such as projection of future earnings from past performance.³⁰⁶

Insurance statutes regulate advertising by prohibiting misleading statements.³⁰⁷ Only five states require filing of advertising material or have similar requirements.³⁰⁸ Some states prohibit projections of future earnings.³⁰⁹ Twenty

303 SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959).

304 Many insurance laws require that the variable contract describe the formula used to measure the variable element in the payments. See Appendix A, Example 1, *infra*, for a sample policy presumably in conformity with this requirement.

The disclosure in Example 1 of the Appendix does not comply with federal standards. It is true that prospectuses concerning variable annuity contracts are also not easy to understand. It is very difficult to clearly translate complicated mathematical formulas into words. Prospectuses on variable annuities contain helpful examples, and their style and contents are improving. As for variable life policies, only actuaries who are acquainted with the formulas can understand them and perhaps compare the various policies. There must be a better way.

305 § 24(b); 15 U.S.C. § 80a-24(b) (1970).

306 22 Fed. Reg. 8977 (1957).

307 *No filing required unless noted. UTP=Unfair Trade Practices.* ALA. CODE tit. 28, § 18 (1958); ALASKA STAT. § 21.36.040 (1966) (UTP); ARIZ. REV. STAT. ANN. § 20-443 (Supp. 1971) (UTP); ARK. STAT. ANN. §§ 66-3004, 66-3005 (1966) (UTP); CAL. INS. CODE § 790.03 (b) (Supp. 1971); COLO. REV. STAT. ANN. § 72-14-4(3) (1963) (UTP); CONN. GEN. STAT. ANN. § 38-57 (Supp. 1973) (filing required); DEL. CODE ANN. tit. 18, § 2304 (1971) (UTP); D.C. CODE ENCYCL. ANN. § 35-410 (1968); FLA. STAT. ANN. § 626.953 (1972) (UTP); GA. CODE ANN. § 56-704 (1)(2) (1971) (UTP); HAWAII REV. STAT. § 431-643 (1)(2) (1968) (UTP); IDAHO CODE ANN. §§ 41-1303, 41-1304 (1961) (UTP); ILL. ANN. STAT. ch. 73, § 760 (1965); § 1030 (Supp. 1972) (UTP); IND. ANN. STAT. §§ 39-5019, 39-5020 (1965); § 39-5304 (Supp. 1972); IOWA CODE ANN. § 511.22, (1949); § 507B.4 (2) (Supp. 1972) (UTP); KAN. STAT. ANN. § 40-2404(2) (Supp. 1972) (UTP); KY. REV. STAT. ANN. §§ 304.12-020, 304.12-050 (1971); LA. REV. STAT. ANN. § 22:1214(2) (1959); ME. REV. STAT. ANN. tit. 24-A, § 2153 (1971); MD. ANN. CODE art. 48A, § 218 (1972); MASS. GEN. LAWS ANN. ch. 175, § 191 (1958); MICH. STAT. ANN. §§ 24:12007, 24:12055 (1972); MINN. STAT. ANN. § 60A.08 subd. 2 (1968); MISS. CODE ANN. § 5634 (1957); MO. ANN. STAT. § 375.936(4) (Supp. 1973) (UTP); MONT. REV. CODE ANN. §§ 40-3503, 40-3504 (1961) (UTP); NEV. REV. STAT. tit. 57, § 686A.040 (1972) (UTP); N.H. REV. STAT. ANN. § 417:4 III, 580:9 (Supp. 1972); N.J. STAT. ANN. § 2A:117-1 (1963), § 17B:30-3 (Supp. 1971); N.M. STAT. ANN. § 58-9-12(A)(2) (1962) (UTP); N.Y. INS. LAW § 97,126 (McKinney Supp. 1972); N.C. GEN. STAT. § 58-124 (1965); N.D. CENT. CODE § 26-30-04(2) (1970) (UTP); OHIO REV. CODE ANN. § 3901.21 (Page 1971) (UTP); OKLA. STAT. ANN. tit. 36, § 1204(2) (1958) (UTP); ORE. REV. STAT. § 743.021 (1971) (filing required); PA. STAT. ANN. tit. 40, § 1152(b) (Purdon's Supp. 1971); R.I. GEN. LAWS ANN. § 27-29-4(2) (1968); S.C. CODE ANN. § 37-144 (1962); § 37-1205 (Supp. 1971); S.D. COMP. LAWS ANN. § 58-33-5 (1967) (UTP); TENN. CODE ANN. § 56-1204 (2) (1968); TEX. INS. CODE art. 21.20 (1963); UTAH CODE ANN. § 31-27-7 (1966); VT. STAT. ANN. tit. 8, § 4724(2) (1971); VA. CODE ANN. § 38.1-52(2) (1970); WASH. REV. CODE ANN. §§ 48.30.040, 48.30.070 (1961); W. VA. CODE § 33-11-4 (1966); WISC. STAT. ANN. §§ 201.45(1), 207.04 (2) (Supp. 1972); WYO. STAT. ANN. §§ 26.1-245, 26.1-246 (1967).

308 CONN. GEN. STAT. ANN. § 38-57 (Supp. 1973); ORE. REV. STAT. § 743-021 (1971); WISC. STAT. ANN. §§ 201.45(1), 207.04(2) (Supp. 1972). Authority of Commissioner required in PA. STAT. ANN. tit. 40, § 1150(6) (Purdon's Supp. 1971). Inspection upon request, MASS. GEN. LAWS ANN. ch. 175, § 191 (1958).

309 MD. ANN. CODE art. 48A, § 218 (1972); MASS. GEN. LAWS ANN. ch. 175, § 191 (1958); S.C. CODE ANN. § 37-144 (1962).

states include advertising regulation in their Unfair Trade Practices Acts.³¹⁰

Concurrent regulation of advertising does not impair state law. The difference between the main paragraph of § 2(b) and the proviso cannot be more clearly demonstrated than in this instance. For the purpose of the proviso, it was held that state law regulates advertising so as to preempt the field and exclude the application of the Federal Trade Commission Act. But state law is not impaired so as to exclude, under the main paragraph, concurrent regulation of advertisement by the 1940 Act.

State and federal laws are concerned with the integrity of those who deal in other people's money. The 1940 Act disqualifies persons convicted of securities frauds from serving as officers, directors, and employees of investment companies.³¹¹ State insurance laws do not have a similar self-executory standard, but grant wide discretionary powers to state insurance authorities to achieve a

310 See note 307 *supra*.

311 § 9; 15 U.S.C. § 80a-9(1970).

Insurance commissioners are required to investigate proposed officers and directors of new insurance companies before granting a certificate of authority. They may not grant the certificate unless they found that the general character and experience of the incorporators, directors and officers are such to assure reasonable promise of a successful operation; that they are persons of known good character and that there is no reason to believe that they are affiliated with persons known to have been involved in improper manipulation of assets, accounts or re-insurance. ALASKA STAT. § 21.09.100 (1966); CAL. INS. CODE § 717 (Supp. 1971); ILL. ANN. STAT. ch. 73, § 767.4 (Smith-Hurd Supp. 1972); KY. REV. STAT. ANN. § 304.3-080 (1970); MASS. GEN. LAWS ANN. ch. 175, § 49 (1958); MICH. STAT. ANN. § 24:1250 (Supp. 1972); MO. ANN. STAT. § 375.163 (1968); MONT. REV. STAT. ANN. § 40-2810 (1961); PA. STAT. ANN. tit. 40, § 388 (Purdon's Supp. 1971); TENN. CODE ANN. § 56-203(6) (1968); VT. STAT. ANN. tit. 8, § 3305 (1971); WISC. STAT. ANN. § 201.03 (1957). A slightly different version provides that no certificate of authority will be granted if the managing officers are known to be of bad character, incompetent, untrustworthy so as to make the operation of the company hazardous to the issuer, policyholders and the public. FLA. STAT. ANN. § 624.404 (1972); IDAHO CODE ANN. § 41-308 (1961); ME. REV. STAT. ANN. tit. 24-A, § 407 (1971); MD. ANN. CODE art. 48A, § 51 (1972); MINN. STAT. ANN. § 60A.051.5 (Supp. 1973); N.J. STAT. ANN. § 17B:18-42 (Supp. 1971); ORE. REV. STAT. § 731.386 (1971); S.C. CODE ANN. § 37-106.1 (Supp. 1971); S.D. COMP. LAWS ANN. § 58-6-8 (1967); TEX. INS. CODE art. 1.14 (1963); UTAH CODE ANN. § 31-5-3.5 (1966); WYO. STAT. ANN. § 26.1-53 (1967). In California the commissioner may refuse to renew a certificate of authority if a holder of 10 per cent of the stock has been convicted of a mail fraud, securities or insurance statute violation. CAL. INS. CODE § 704.5 (Supp. 1971). The commissioner may also decline to renew a certificate of authority if a director or officer has committed a felony, one of the elements of which is a fraudulent act, in a transaction of money or property. *Id.* § 704.5. In Illinois the director of an insurance company who was found after a hearing to be incompetent, untrustworthy or of known bad character, and if the company does not comply within 30 days the certificate of authority will be suspended. ILL. ANN. STAT. ch. 73, § 767.4 (Smith-Hurd Supp. 1972). New York has a similar provision. N.Y. INS. LAWS § 511(n) (McKinney 1966). See also *id.* §§ 133-139 requiring certification as trustworthy of officers and employees negotiating or soliciting applications and orders of life insurance from the public. Washington disqualifies a bankrupt and a person guilty of misconduct from being a director in an insurance company. WASH. REV. CODE ANN. §§ 48.09.160; 48.30.120, 48.30.130 (1961). In addition, insurance laws that permit the establishment of an account usually require the insurance agency to examine the adequacy of management of the company that proposes to offer and sell variable contracts. The language of this provision is similar to that of the MODEL VARIABLE CONTRACT LAW § 3:

No company shall deliver or issue for delivery within this state variable contracts unless it is licensed or organized to do a life insurance or annuity business in this state, and the Commissioner is satisfied that its condition or method of operation in connection with the issuance of such contracts will not render its operation hazardous to the public, or its policyholders in this state. In this connection, the Commissioner shall consider among other things:

- (a) The history and financial condition of the company;
- (b) The character, responsibility and fitness of the officers and directors of the company; and

similar goal.³¹² It may be that as a matter of interpretation of the 1940 Act, these provisions are sufficient protection to investors so as to preclude the application of the Act to insurance companies. On the other hand, the 1940 Act does not impair insurance laws. It adds protection and furthers the same policies manifested in state laws. State insurance agencies are never given power to reinstate or choose management. Their power is either to remove or disapprove proposed management. This power is left untouched by the 1940 Act.

Another area which should be regulated concurrently is the valuation of assets in the account for the purpose of calculating the investment performance. State insurance statutes concerning valuation of reserves funding the company's conventional insurance liabilities use conservative methods of valuation that might permit even valuation below market.³¹³ This is appropriate when insurance benefits are not linked to asset values. As to separate accounts different

(c) The law and regulation under which the company is authorized in the state of domicile to issue variable contracts.

If the company is a subsidiary of an admitted life insurance company, or affiliated with such company through common management or ownership, it may be deemed by the *Commissioner* to have met the provisions of this section if either it or the parent or the affiliated company meets the requirements hereof.

312 QUALIFICATIONS OF DIRECTORS.

Version 1.

Director shall not approve company's organization or issue certificate of authority until he found: (a) that the company has submitted a sound plan of operation and (b) the general character and experience of the incorporators, directors, and proposed officers are such as to assure reasonable promise of a successful operation; . . . persons of known good character and no good reason to believe that they are affiliated to persons known to have been involved in improper manipulation of assets, accounts or reinsurance.

Version 2.

The Director of insurance may order removal of a new director of an insurance company who was found after hearing to be incompetent or untrustworthy, or of known bad character. If the company does not obey within 30 days—suspension of authority will result.

Version 3.

If the commissioner has reason to believe that an officer or director is untrustworthy or has abused his trust, or his continuation as a director is hazardous or injurious to the insurer, policyholders or public, the commissioner must hold a hearing and if he so finds, may order removal of a director or officer.

Version 4.

No grant of certificate of authority if managing officers know to be of bad character, incompetent, untrustworthy as to make operation hazardous to the insurer, policyholders and the public.

Qualification of Directors: ALASKA STAT. § 21.09.100 (1966) (Version 1); CAL. INS. CODE § 717 (Supp. 1971) (Version 1); FLA. STAT. ANN. § 624.404(3) (1972) (Version 4); IDAHO CODE ANN. § 41-308 (1961) (Version 4); ILL. ANN. STAT. ch. 73, § 767.4 (Smith-Hurd Supp. 1972) (Versions 1 & 2); KY. REV. STAT. ANN. § 304.3-080 (1971) (Version 1); ME. REV. STAT. ANN. tit. 24-A § 407 (1971) (Version 4); MD. ANN. CODE art. 48A, § 51 (1972) (Version 4); MASS. GEN. LAWS ANN. ch. 175, § 49 (1958) (Version 1); MICH. STAT. ANN. § 24:1250 (1972) (Versions 1 & 3); MINN. STAT. ANN. § 60A.051 Subd. 5 (Supp. 1973) (Version 4); MO. ANN. STAT. § 375.163 (1968) (Version 1); MONT. REV. CODE ANN. § 40-2810 (1961) (Version 1); N.J. STAT. ANN. § 17B:18-42 (Supp. 1971) (Version 4); N.Y. INS. LAW § 511n (McKinney 1966) (Commissioner's power to require removal of an officer); ORE. REV. STAT. § 731.386 (1971) (Version 4); PA. STAT. ANN. tit. 40 § 388 (Purdon's Supp. 1971) (Version 1); S.C. CODE ANN. § 37-106.1 (Supp. 1971) (Version 4); S.D. COMP. LAWS ANN. § 58-6-8 (1967) (Version 4); TENN. CODE ANN. § 56-203 (1968) (Version 1); TEX. INS. CODE art. 1.14 (1963) (Version 4); UTAH CODE ANN. § 31-5-3.5 (1966) (Version 4); VT. STAT. ANN. tit. 8 § 3305 (1971) (Version 1); WASH. REV. CODE ANN. §§ 48.09.160, 48.30.120, 48.30.130 (1961) (Disqualified if bankrupt—48.09.160, misconduct—48.30.120, Presumption of knowledge—48.30.130); WISC. STAT. ANN. § 201.03(5) (1957) (Version 1); WYO. STAT. ANN. § 26.1-53 (1967) (Version 4).

313 Some laws provide for valuation according to the methods established by the National Association of Insurance Commissioners. *E.g.*, OKLA. STAT. ANN. tit. 36, § 1512 (Supp. 1972); HAWAII REV. STAT. § 431-272 (1968). Others provide for the market value, and if

considerations apply. If valuations are not realistic, policyholders will not receive their due. At present, formulas used to determine investment performance vary with companies issuing the policies.³¹⁴ The investment factor is affected by the valuation of the assets in the account at the time of computation. Valuation is at market, or, if there is no market value, according to the terms of the policy.³¹⁵ In the three sample variable life policies produced by the insurance industry at the SEC Hearings, one policy provides for fair value according to accepted practices and applicable laws and regulation, whatever these might be.³¹⁶ Another policy does not mention valuation at all.³¹⁷ The third policy provides for "fair market value as determined in accordance with a method of valuation established in good faith by the company."³¹⁸ Two companies will value each

unascertainable, the book value, or the net worth at which the issuing company is audited, or the acquisition cost adjusted in accordance with generally accepted accounting principles, or any other method which the insurance commissioner will at his discretion permit. *See, e.g., CAL. INS. CODE* §§ 1250, 1251 (1955); *IDAHO CODE ANN.* § 41-614 (Supp. 1971); *MINN. STAT. ANN.* § 60A.12 (1968); *ALASKA STAT.* § 21.18.130 (1966); *ILL. ANN. STAT.* ch. 73, § 736.6(2) (1965).

314 See APPENDIX A.

315 *Version 1.* Market value or as determined in the variable contract.

Version 2. Market value or as determined by Commissioner according to method of NAIC (insurance reserve valuation).

Version 3. Valuation of insurance reserves. Permitted to value at cost.

ALA. CODE tit. 28, § 4(5)(1)(d) (Supp. 1969) (Version 1); *ALASKA STAT.* § 21.42.-370(e) (Supp. 1972) (Version 1); *ARIZ. REV. STAT. ANN.* § 20-515 (Supp. 1972) (Version 1); *ARK. STAT. ANN.* § 66-3523(d) (Supp. 1971) (Version 1); *CAL. INS. CODE* § 10506(e) (1972) (general security valuation); *COLO. REV. STAT. ANN.* § 72-2-45(e) (Supp. 1971) (Version 1); *CONN. GEN. STAT. ANN.* § 38-1542 (1958) (general security valuation); *DEL. CODE ANN.* tit. 18, § 2933(a)(4) (1971) (Version 1); *D.C. INS. REGS.* No. 7 (1971); *FLA. INS. REGS. V.* § 625.151 (1960) (general security valuation); *GA. CODE ANN.* § 56-1038(d), § 56-1040(h) (1971) (Version 1); *HAWAII REV. STAT.* § 431-563(a)(3) (Supp. 1972) (Version 1); *IDAHO CODE ANN.* § 41-1936(4) (Supp. 1971) (Version 1); *ILL. ANN. STAT.* ch. 73 § 857.21(d) (Supp. 1972) (Version 1); *IND. INS. REG.* § VI (1971) (Version 1); *KAN. STAT. ANN.* § 40-436(d) (Supp. 1972) (Version 1); *KY. REV. STAT. ANN.* § 304.15-390(3) (1971) (Version 1); *LA. REV. STAT. ANN.* § 22:1500(G) (Supp. 1972) (Uniform non-discriminatory standards); *ME. REV. STAT. ANN.* tit. 24-A, § 2537(4) (1971) (Version 1); *MD. ANN. CODE* art. 48A, § 96A(j) (1972) (Version 1); *MASS. GEN. LAWS ANN.* ch. 175, § 132G (Supp. 1971) (Version 1); *MINN. STAT. ANN.* § 61A.14(7) (Supp. 1973) (Version 1); *MISS. CODE ANN.* § 5649-34 (Supp. 1971) (Version 1); *MO. ANN. STAT.* § 376.309(5) (Supp. 1973) (Version 1); *MONT. REV. CODE ANN.* § 40-3014 (1961) (Version 2); *NEB. REV. STAT.* § 44-310.02 (1968) (Valued at cost. Applicable to all assets.) *NEV. REV. STAT.* §§ 443(1)(d) (1968) (Market value, appraised value, prices determined by the Commissioner representing fair market value.); *N.H. REV. STAT. ANN.* § 408:32 (1968) (current market value); *N.J. STAT. ANN.* § 17B:28-10 (Supp. 1971) (market value); *N.M. STAT. ANN.* § 58-4-6.1(4) (Supp. 1971) (Version 1); *N.Y. INS. LAW* § 227.1(f) (McKinney Supp. 1971) (Version 1); *N.C. GEN. STAT.* § 58-79.2(i) (Supp. 1971) (Version 1); *N.D. CENT. CODE* § 26-11.1-01(4) (Supp. 1971) (Version 1); *OHIO REV. CODE ANN.* § 3907.15(B) (Page 1971) (Version 1); *OKLA. STAT. ANN.* tit. 36, § 6061(g) (Supp. 1972) (Version 1); *ORE. REV. STAT.* § 733.160(b) (1971) (Method of computation approved by the Commissioner. Applies to all insurance assets with regard to securities.); *PA. STAT. ANN.* tit. 40 § 506.2(h) (Supp. 1971) (Version 1); *R.I. GEN. LAWS ANN.* § 27-32-4 (1969) (Version 1); *S.C. CODE ANN.* § 37-333(c) (Supp. 1971) (Version 1); *S.D. COMP. LAWS ANN.* § 58-28-21 (Supp. 1972) (Version 1); *TENN. CODE ANN.* § 56-315 (1968) (Version 1); *TEX. INS. CODE* art. 3.72, § 9 (Supp. 1972) (Version 1); *UTAH CODE ANN.* § 31-13-32(4) (Supp. 1971) (Version 1); *VT. STAT. ANN.* § 3855(a)(4) (Supp. 1972) (Version 1); *VA. CODE ANN.* § 38.1-167 (1970) (general security valuation); *WASH. REV. CODE ANN.* § 48.18A.020(3) (Supp. 1972) (Version 1); *W. VA. INS. REGS.* 56 L-2 (VII) (1966) (market value) § 33-7-11 (1966); *WISC. STAT. ANN.* § 206.385(4) (Supp. 1972) (Version 1); *WYO. STAT. ANN.* § 26.1-367(d) (1967) (Version 1).

316 Policy of the Equitable Variable Life Ins. Co. See APPENDIX A, Example 1 at 5.

317 Policy of AETNA Variable Annuity Life Ins. Co. See APPENDIX A, Example 3.

318 Policy of New York Life Ins. Co. See APPENDIX A, Example 2 at 7.

day;³¹⁹ another, each month.³²⁰ The same portfolios may therefore show different assets values and different investment performances, and these in turn affect both the death benefits and cash surrender value. The policies vary with investment performance formula, with dates of valuation, and with methods of valuation.

Flexible valuation and calculating methods and the ease with which the investment factor may be manipulated are an invitation to undesirable practices. State laws do not provide adequate protection against potential abuse. The 1940 Act does. Open-end investment companies must price their securities for sale and redemption purposes on the basis of the current net asset value at the time of computation.³²¹ If no market value exists, valuation must be made by the board of directors in good faith.³²² The Commission prescribes methods of valuation from time to time,³²³ and whenever problems arise.³²⁴ Insurance companies may comply with both laws. Concurrent regulation is therefore possible in this area without impairment of state law.

Some of the provisions of the 1940 Act may impair state regulation. Such a provision is the 1940 Act requirement of a minimum net worth of \$100,000 before variable contracts can be offered by an account to the public.³²⁵

Minimum capital and surplus and maintenance of reserves are the cornerstone of state insurance regulation. State laws require as a condition to starting an insurance business, minimum capital and surplus which, with few exceptions,³²⁶ exceed \$100,000.³²⁷ This capital and surplus must be maintained throughout the lifetime of the company. These requirements apply in many

319 Policies of New York Life Ins. Co. and Equitable Variable Life Ins. Co., *supra* notes 316, 318.

320 Policy of AETNA Variable Annuity Life Ins. Co., General Definition 3 at 3.

321 § 22(c); 15 U.S.C. § 80a-22(c) (1970); 17 C.F.R. § 270.22c-1 (1972).

322 § 2(a)(39); 15 U.S.C. § 80a-2(a)(41) (1970).

323 SEC Investment Company Act Release No. 5847, Acc. Series Release No. 113 (Oct. 21, 1969).

324 *Id.* Problems arising from investments in letter stock.

325 In order to ensure that promoters of investment companies be financially responsible persons who have a stake in the enterprise. § 14(a); 15 U.S.C. § 80a-14(a) (1970). *Hearings on H.R. 10065 Before the Subcomm. of the House Comm. on Inter. & For. Commerce*, 76th Cong., 3d Sess. 117 (1940) (statement of David Shenker).

326 *States having provisions requiring less than \$100,000*: ARIZ. REV. STAT. ANN. § 20-711 (1956) (domestic mutual insurer, \$20,000 minimum surplus plus qualifications, or \$50,000 deposit in lieu of qualifications); ARK. STAT. ANN. § 66-4210 (1966) (domestic mutual insurer, \$50,000 minimum surplus plus qualifications, or \$100,000 deposit in lieu of qualifications); D. C. CODE ENCYCL. ANN. § 35-202 (1968) (corporation, joint stock company, or association, must have assets or capital stock fully paid up in cash, or both together, or not less than \$25,000 as capital or guarantee fund); IDAHO CODE ANN. § 41-2820 (1961) (domestic mutual insurer, \$50,000 minimum surplus plus qualifications, or \$100,000 deposit in lieu of qualifications); KY. REV. STAT. ANN. § 304.24-100 (1971) (domestic mutual insurer, \$50,000 minimum surplus plus qualifications, or \$150,000 deposit in lieu of qualifications); MISS. CODE ANN. § 5660 (5) (Supp. 1971) (life insurance on the industrial plan needs capital of not less than \$50,000 and a surplus of \$25,000); UTAH CODE ANN. § 31-9-8 (1966) (domestic mutual insurer, \$5,000 minimum surplus plus qualifications, or \$50,000 deposit as guaranty fund in lieu of qualifications); WASH. REV. CODE ANN. § 48.09.081 (1961), (domestic mutual insurer, \$25,000 minimum surplus plus qualifications, or \$50,000 deposit in lieu of qualifications).

All the states that require \$100,000 or more: ALA. CODE tit. 28, § 1 (Supp. 1969); ALASKA STAT. § 21.09.070 (1966); ARIZ. REV. STAT. ANN. § 20-210 (Supp. 1972); ARK. STAT. ANN. § 66-2207 (Supp. 1971); CAL. INS. CODE §§ 700.02, 700.03, 700.05, 4013, 10510 (Supp. 1971); COLO. REV. STAT. ANN. § 72-1-36(b) (1963); CONN. GEN. STAT. ANN. § 38-130a (1969); DEL. CODE ANN. tit. 18, § 511 (1971); D.C. CODE ENCYCL. ANN. § 35-508 (1968); FLA. STAT. ANN. §§ 624.407, 624.408 (1972); GA. CODE ANN. §§ 56-306, 56-307, 56-1510 (1971); HAWAII REV. STAT. §§ 431-87, 431-88 (1968); IDAHO CODE ANN. § 41-313 (Supp.

instances also to foreign companies doing business in the state. Enforcement of these provisions is rigorous. In most states insurance companies must obtain a certificate of authority before starting business,³²⁸ and must file with the insurance agency an annual report³²⁹ and may be examined, not less frequently than once every specified period (usually three years).³³⁰ Some insurance laws require com-

1971); ILL. ANN. STAT. ch. 73, § 625 (Supp. 1972); IND. ANN. STAT. § 39-3615 (Supp. 1972); IOWA CODE ANN. § 508.05 (Supp. 1973); KAN. STAT. ANN. §§ 40-401, 40-402 (Supp. 1972); KY. REV. STAT. ANN. § 304.3-120 (1971); LA. REV. STAT. ANN. §§ 22:71, 22:121 (Supp. 1972); ME. REV. STAT. ANN. tit. 24-A, § 410 (1972); MD. ANN. CODE art. 48A, §§ 47(3), 48(3)(a), 49(1) (1972); MASS. GEN. LAWS ANN. ch. 175, § 47, 48, 93E, 151, 153 (1958); MICH. STAT. ANN. §§ 24.1408, 24.1410 (1972); MINN. STAT. ANN. §§ 60A.07, 60A.10(2) (Supp. 1973); MISS. CODE ANN. §§ 5660(4), 5670.1(5) (Supp. 1972); MO. ANN. STAT. § 376.280 (1968); MONT. REV. CODE ANN. §§ 40-2807, 40-4708 (1961); NEB. REV. STAT. §§ 44-214, 44-219 (1968); NEV. REV. STAT. tit. 57, §§ 628.160, 628.170 (1972); N.H. REV. STAT. ANN. §§ 401:4, 405:2, 411:3 (Supp. 1971); N.J. STAT. ANN. §§ 17B:18-35, 17B:18-36 (Supp. 1971); N.M. STAT. ANN. § 58-18-24 (Supp. 1971); N.Y. INS. LAW § 191, (McKinney Supp. 1972); §§ 196(a), 42.5 (McKinney 1966); N.C. GEN. STAT. § 58-77 (Supp. 1971); N.D. CENT. CODE §§ 26-08-04, 26-09-1, 26-11-02, 26-14-23 (1970); OHIO REV. CODE ANN. §§ 3907.05, 3941.06 (Page 1971); OKLA. STAT. ANN. tit. 36, §§ 610, 2111 (Supp. 1971); § 611 (1958); ORE. REV. STAT. §§ 731.554(1), 731.554(4), 731.558 (1971); PA. STAT. ANN. tit. 40, §§ 386(a), 386(d), 621.3, 624.1 (Supp. 1971); R.I. GEN. LAWS ANN. § 27-2-5 (1969); S.C. CODE ANN. §§ 37-181, 37-182 (Supp. 1971); S.D. COMP. LAWS ANN. §§ 58-5-21, 58-5-22, 58-6-23 (1969); TENN. CODE ANN. §§ 56-214, 56-1602 (1968); TEX. INS. CODE art. 3.02(5), 3.22 (1963); UTAH CODE ANN. § 31-11-1 (Supp. 1967); VT. STAT. ANN. tit. 8, §§ 3304, 3309 (1971); VA. CODE ANN. §§ 38.1-73, 38.1-90, 38.1-91 (1970); WASH. REV. CODE ANN. § 48.05.340 (Supp. 1971); W. VA. CODE § 33-3-5a (Supp. 1971); WISC. STAT. ANN. §§ 201.03, 201.11(1) (Supp. 1972); WYO. STAT. ANN. § 26.1-59 (1967) § 26.1-671 (Supp. 1971).

327 *Id.*

328 ALA. CODE tit. 28, § 49 (Supp. 1969); ALASKA STAT. § 29.09.130 (1966) (renewable); ARIZ. REV. STAT. ANN. §§ 20-215, 20-216 (1956); ARK. STAT. ANN. § 66-2212 (1966); CAL. INS. CODE § 700 (1955); COLO. REV. STAT. ANN. § 72-1-17 (1963) (renewable annually); CONN. GEN. STAT. ANN. § 38-20 (Supp. 1973); DEL. CODE ANN. tit. 18, §§ 515-518 (1971); D.C. CODE ENCYCLO. ANN. § 35-404 (1968); FLA. STAT. ANN. §§ 624.401, 624.416 (1972) (continued each year on payment of license tax); GA. CODE ANN. §§ 56-303, 56-315 (1971) (renewal must be filed); HAWAII REV. STAT. §§ 431-82, 431-94 (1968) (renewable); IDAHO CODE ANN. §§ 41-305, 41-324 (1961) (continues); ILL. ANN. STAT. ch. 73, §§ 636 (1965); § 663 (Supp. 1972); IND. ANN. STAT. § 39-3324 (Supp. 1972); IOWA CODE ANN. § 508.13 (1949) (expires annually); KAN. STAT. ANN. § 40-215 (1964); KY. REV. STAT. ANN. § 304.3-160 (1971); LA. REV. STAT. ANN. § 22:35 (1959); ME. REV. STAT. ANN. tit. 24-A, § 404 (1971); MD. ANN. CODE art. 48A, §§ 52-54 (1972); MASS. GEN. LAWS ANN. ch. 175, § 32 (1958); MICH. STAT. ANN. § 24.1432 (1972) (remains in force); MINN. STAT. ANN. § 60A.051 (1968); MISS. CODE ANN. § 5627 (1957); MO. ANN. STAT. § 375.236 (1968); MONT. REV. CODE ANN. § 40-2812 (1961); NEB. REV. STAT. 44-303 (1968); NEV. REV. STAT. tit. 57, §§ 680A.160, 680.180 (1972); N.H. REV. STAT. ANN. § 402:10 (1968); N.J. STAT. ANN. § 17B:18-42 (Supp. 1971); N.M. STAT. ANN. § 58-9-1 (1962); N.Y. INS. LAW § 40 (McKinney 1966); N.C. GEN. STAT. § 58-71 (1965); N.D. CENT. CODE § 26-01-06 (1970); OHIO REV. CODE ANN. § 3905.09 (Page 1971); OKLA. STAT. ANN. tit. 36, § 606 (1958); ORE. REV. STAT. § 731.402 (1971); PA. STAT. ANN. tit. 40, § 405 (Purdon's Supp. 1971); R.I. GEN. LAWS ANN. § 27-4-21 (1969); S. C. CODE ANN. § 37-102 (1962) (renewable); S.D. COMP. LAWS ANN. § 58-6-1, 58-6-2 (1967); TENN. CODE ANN. § 56-202 (1968); TEX. INS. CODE art. 114 (1963); UTAH CODE ANN. § 31-5-2 (1966); VT. STAT. ANN. tit. 8, § 3368 (1971); VA. CODE ANN. § 38.1-85 (1970); WASH. REV. CODE ANN. § 48.05.030 (1961); W. VA. CODE § 33-3-1 (1966); WISC. STAT. ANN. § 201.045 (1) (Supp. 1972); WYO. STAT. ANN. § 26.1-50 (1967).

329 See note 298 *supra*.

330 ALA. CODE tit. 28, § 50 (1958); ALASKA STAT. § 21.06.120 (1966); COLO. REV. STAT. ANN. § 72-1-10 (1963); CONN. GEN. STAT. ANN. § 38-7 (1969) (5 years); DEL. CODE ANN. tit. 18, § 322 (1971) (5 years); D.C. CODE ENCYCLO. ANN. §§ 35-202 (year), 35-418 (3 years) (1968); FLA. STAT. ANN. § 624.318 (1972); GA. CODE ANN. § 56-208 (1971); HAWAII REV. STAT. § 431-54 (1968) (3 years); IDAHO CODE ANN. § 41-219 (1961) (3 years); ILL. ANN. STAT. ch. 73, § 744 (Supp. 1972); IND. ANN. STAT. §§ 39-3312, 13 (1965) (3 years); IOWA CODE ANN. § 507.2 (1949) (3 years); KAN. STAT. ANN. § 40-222 (1964) (3 years); KY. REV. STAT. ANN. § 304.2-210 (1971) (4 years); LA. REV. STAT. ANN. § 22:1302 (Supp.

panies to qualify specially for the sale of variable contracts.³³¹ The financial conditions of these companies are again examined. Insurance companies must reserve assets to cover future liabilities. This is an additional protection, comparable to the 1940 Act provisions regarding face amount certificate companies.³³² State laws require that reserves on variable contracts be placed and maintained in separate accounts³³³ on which variable contractholders might have priority over other creditors of the insurance company. All the assets of the sponsoring insurance company are also subject to the claims of variable contractholders. Since the Investment Company Act provides a minimum standard, it does not exclude the application of more stringent state laws that further the policies of the Act.³³⁴

It is submitted that as a matter of interpretation of the 1940 Act an account should be deemed to comply with the federal Act even if it contains less than \$100,000 so long as the insurance company maintains a net worth of that amount. It is unlikely that reserves will go below \$100,000, especially if the values of the insurance company's guarantee of fixed death benefits are taken into account. Yet in such circumstances, or, more importantly, in the few states that permit the establishment of an insurance company with less than \$100,000 in paid-in capital or surplus, the question of federal impairment must be squarely faced.

There are serious arguments for the position that the federal Act must yield. The assets in separate accounts constitute reserves³³⁵ the determination of which is the business of insurance. Reserves and premiums change according to the age and health of policyholders and the mortality experience of the group.

1972) (3 years); ME. REV. STAT. ANN. tit. 24-A, § 221 (1971) (5 years); MD. ANN. CODE art. 48A, § 30 (1972) (4 years); MASS. GEN. LAWS ANN. ch. 175, § 4 (1958) (3 years); MICH. STAT. ANN. § 24.1222 (1972); MINN. STAT. ANN. § 60A.031 (Supp. 1973) (within 6 months after first certification and after 3rd successive year—at least every 3 years); MISS. CODE ANN. § 5628 (Supp. 1972) (3 years); §§ 5659.5, 5659.7 (Supp. 1972); MO. ANN. STAT. §§ 374.190, 375.164.2 (1968); MONT. REV. CODE ANN. § 40-2713 (1961) (3 years); NEB. REV. STAT. § 44-107 (1968) (3 years); NEV. REV. STAT. tit. 57, § 679B.230 (1972) (3 years); N.H. REV. STAT. ANN. § 400:16 (1968); N.J. STAT. ANN. § 17B:21-3 (Supp. 1971) (5 years); N.M. STAT. ANN. § 58-5-13 (1962); N.Y. INS. LAW § 28 (McKinney Supp. 1972) (5 years); N.C. GEN. STAT. § 58-16 (1965) (3 years); N.D. CENT. CODE § 26-01-07 (1970) (at least biennially); OHIO REV. CODE ANN. § 3901.07 (Page Supp. 1972) (3 years); OKLA. STAT. ANN. tit. 36, §§ 306, 309 (1958) (3 years); ORE. REV. STAT. § 731.300 (1971) (3 years); PA. STAT. ANN. tit. 40, §§ 51 (1 year first 5 years then every 4 years) 52 (for holding cos.), 405 (new stock before cert.) (Supp. 1971); R.I. GEN. LAWS ANN. §§ 27-1-9 (for purpose of ascertaining the value or condition of any stock before deposit), 27-13-1 (1969); S.C. CODE ANN. § 37-281 (1967) (3 years); S.D. COMP. LAWS ANN. § 58-3-1, 58-3-2 (1967) (3 years); TENN. CODE ANN. §§ 56-113 (cert.), 56-120 (3 years), 56-121 (when requested), 56-122 (foreign) (1968); TEX. INS. CODE art. 1.15 (Supp. 1972); UTAH CODE ANN. § 31-3-1 (1966) (3 years); VT. STAT. ANN. tit. 8, §§ 3563, 3564 (Supp. 1972) (3 years); VA. CODE ANN. § 38.1-174 (1970) (3 years); WASH. REV. CODE ANN. § 48.03.010 (1961) (5 years); W. VA. CODE § 33-2-9 (Supp. 1971) (3 years); WISC. STAT. ANN. § 200.03 (Supp. 1972); WYO. STAT. ANN. § 26.1-32 (1967) (3 years).

331 See MODEL VARIABLE CONTRACTS REG. *supra* note 49, at Art III.

332 Investment Company Act of 1940 § 28; 15 U.S.C. § 80a-28 (1970).

333 Frankel, *supra* note 19, at 318 n.452.

334 This conclusion is contrary to *Investors Diversified Services v. Diggles*, discussed *supra* at note 137.

335 See Frankel, *supra* note 19, at 237-46. For a distinction between insurance and investment, see *id.* at 196-99.

A fixed minimum inherently conflicts with the changing standards and upsets the insurance scheme.³³⁶ On the other hand, following the *National Securities, Inc.* decision³³⁷ one might argue for federal regulation, even though impairment or supersession may be direct, since state regulation sets only a minimum standard which is not impaired by a higher minimum requirement.³³⁸

Safe custody of assets is another area of potential conflict. The 1940 Act provides for safe custody of company's securities³³⁹ and bonding of officers having access to the assets.³⁴⁰ The trustee of a unit investment trust must be qualified.³⁴¹ The proceeds of the sale of periodic payment plan certificates must be deposited with a qualified trustee under essentially the same conditions.³⁴²

Insurance statutes do not have similar provisions,³⁴³ but they do regulate the safekeeping of assets. State agencies exercise strict control over insurance companies by virtue of their statutory authority. As a matter of federal law, the 1940 Act provisions should not apply because it is doubtful whether added protection to investors is needed. If such protection is needed, the 1940 Act might impair state regulation.³⁴⁴ By requiring assets to be kept with qualified banks, the federal Act impairs state laws that require the assets of insurance companies to be in their vaults, or limits the discretion of state authorities.

Investments is another problem area in which concurrent state and federal law may conflict. The 1940 Act restricts or prohibits certain investment companies from engaging in some undesirable financial activities. State insurance laws provide a comprehensive regulatory scheme for investments of insurance companies' reserves for the main purpose of preserving and ensuring the financial integrity of the companies.

With respect to separate accounts, state laws regulating investments vary. Twenty-two states free investments in separate accounts from all the traditional

336 Federal impairment of state law is greater in variable life insurance than in variable annuities accounts because the latter are, in effect, mutual funds during the pay-in period. Net premiums equal assets. Frankel, *supra* note 19, at 197. In variable life insurance, the assets in the account are the reserves from its inception.

337 393 U.S. 453 (1969).

338 Unless the purpose of state law is to encourage a particular form of insurance organization by permitting a lower minimum capital, it is difficult to see the logic of limiting the application of a more stringent federal law when the policy of both laws is compatible.

339 § 17(f); 15 U.S.C. § 80a-17(f) (1970); 17 C.F.R. § 270.17f-1 (1972); 17 C.F.R. § 270.17f-2 (1972). See Frankel, *supra* note 19, at 318-20.

340 § 17(g); 15 U.S.C. § 80a-17(g) (1970). Frankel, *supra* note 19, at 321.

341 26(a); 15 U.S.C. § 80a-26(a) (1970).

342 § 27(c)(2); 15 U.S.C. § 80a-27(c)(2) (1970).

343 Some states provide for bonding of officers, e.g., ALASKA STAT. § 21.69.360 (1966); FLA. STAT. ANN. § 628.241 (1972); ILL. ANN. STAT. ch. 73, § 204.6 (1965); IND. ANN. STAT. § 39-3714 (1965); KAN. STAT. ANN. § 40-207 (1964); MICH. STAT. ANN. § 24:15246 (1972); MINN. STAT. ANN. § 60A.07 subd. 11 (1968); MONT. REV. CODE ANN. § 40-4722 (1961).

344 The Commission exempted accounts from its Rules 17f-1 and 17f-2 to enable state insurance agencies to examine the assets of the account. Exemption was also granted from the requirement for a trust indenture, which requirement conflicts squarely with state law. Frankel, *supra* note 19, at 319-21. On the other hand, there is no conflict of purpose between federal and state laws. Experience of concurrent regulation of separate accounts funding variable annuities has been good. With respect to safety of assets, separate accounts funding variable annuities are not different from accounts funding variable life insurance.

restrictions.³⁴⁵ The rest of the states have a variety of limitations which defy generalization.³⁴⁶

A comparison of the 1940 Act with state laws is difficult because they vary in substance and in purpose. The following rules are proposed in order to determine the applicability of federal law according to whether or not state laws adequately protect investors, and according to whether the 1940 Act impairs state law.

When state law prohibits an investment that federal law either does not prohibit or restricts only conditionally, the 1940 Act should be interpreted as preserving state law.³⁴⁷ The 1940 Act restricts registered diversified investment companies in their underwriting activities, to limit their risk.³⁴⁸ The Act limits investments in broker-dealer firms and in insurance companies³⁴⁹ in order to protect investment companies from financing, without controlling, underwriting and insurance businesses, and in the case of insurance companies to prevent their control by investment companies because they may have conflicting purposes.

State insurance laws that altogether prohibit underwriting activities by

345 ALA. CODE tit. 28, § 4(5)(b) (Supp. 1969); ALASKA STAT. § 21.42.370 (Supp. 1972); COLO. REV. STAT. ANN. § 72-2-15(c) (1964); CONN. GEN. STAT. ANN. § 38-33(a) (Supp. 1973); DEL. CODE ANN. tit. 18, § 2933 (1970); HAWAII REV. STAT. § 431-563(a)(2) (Supp. 1972); IDAHO CODE ANN. § 41-734(1) (Supp. 1971); ILL. ANN. STAT. ch. 73, § 857.21 (Smith-Hurd Supp. 1972); KAN. STAT. ANN. § 40-436(b) (Supp. 1972); KY. REV. STAT. ANN. § 304.7-240 (1971); ME. REV. STAT. ANN. tit. 24-A, § 1128 (1971); MICH. STAT. ANN. § 24.1925 (1972); MINN. STAT. ANN. § 61A.13 sub. 3 (1968); N.M. STAT. ANN. § 58-4-6.1(2) (Supp. 1971); N.D. CENT. CODE § 26-11.1-01.2(a) (Supp. 1971); R.I. GEN. LAWS ANN. § 27-32-2 (1969); TENN. CODE ANN. § 56-313 (1968); TEX. INS. CODE art. 3.39 § (a) (Supp. 1972); UTAH CODE ANN. § 31-13-31(2) (Supp. 1967); VT. STAT. ANN. § 3855(a)(2)(A) (Supp. 1972); WIS. STAT. ANN. § 206.385(2) (Supp. 1972); WYO. STAT. ANN. §§ 26.1-367, 26.1-136 (1967); *See also* MODEL VARIABLE CONTRACT LAW § 1(b):

Except as may be provided with respect to reserves for guaranteed benefit and funds referred to in Section 1(c), (i) amounts allocated to any separate account and accumulations thereof may be invested and reinvested without regard to any requirements or limitations prescribed by the laws of this state governing the investments of life insurance companies and (ii) the investments in such separate account or accounts shall not be taken into account in applying the investment limitations otherwise applicable to the investments of the company.

The exception in 1(c) relates to fixed dollar amounts which the insurance company undertakes to pay, but seems not to include death benefits guaranteed in a variable life insurance policy. 346 *See for example:* ARK. STAT. ANN. § 66-2633 (1966) (variable annuities only); GA. CODE ANN. § 56-1040c (1970) (variable annuities only); MISS. CODE ANN. § 5649-32 (Supp. 1972); OHIO REV. CODE ANN. § 3907.15 (Page 1971); WASH. REV. CODE ANN. § 48.18A.020(2) (Supp. 1972); IOWA CODE ANN. § 508.32 (1949) Regs. 3.4(508)3.4(1); MONT. REV. CODE ANN. § 42-3105 (1961). *See also,* ARIZ. REV. STAT. ANN. § 20-536.01(A) (Supp. 1972); MD. ANN. CODE art. 48A, § 362 (1972); CAL. INS. CODE § 10506(A) (Supp. 1971); FLA. STAT. ANN. § 627.804 (1972) (variable annuities only); IND. ANN. STAT. § 39-4202 (1965); LA. REV. STAT. ANN. § 22:1500(c) (Supp. 1972) (variable annuities only); N.C. GEN. STAT. § 58-79.2 (Supp. 1971) (variable annuities only); OKLA. STAT. ANN. tit. 36, § 6061 (Supp. 1972) (variable annuities only); D.C. CODE ENCYCL. ANN., §§ 35-541, 535 (1968); Mo. ANN. STAT. § 376.309(4) (Supp. 1973); MASS. GEN. LAWS ch. 175, § 132 H (Supp. 1971); NEB. REV. STAT. § 44-310:06 (1967); N.H. STAT. ANN. § 408:32 (1968); NEV. REV. STAT. tit. 57, § 688A.390 (1972); N.J. STAT. ANN. § 17B:28-9 (Supp. 1971); PA. STAT. ANN. tit. 40, § 506.2(c) (Supp. 1971) (variable annuities only); S.D. COMP. LAWS ANN. § 58-28-15 (Supp. 1972); VA. CODE ANN. § 38.1-183.1 (1970); W. VA. INS. REGS. 56L-2 (1966) (variable annuities only); ORE. REV. STAT. § 733.180-4 (1971); S.C. CODE ANN. § 37-333 (Supp. 1971) (variable annuities only).

347 *See* pp. 1041-43 *supra*.

348 § 12(c); 15 U.S.C. § 80a-12(c) (1970).

349 §§ 12(d)(2), 12(d)(3), 12(g); 15 U.S.C. §§ 80a-12(d)(2), 12(d)(3), 12(g) (1970).

separate accounts,³⁵⁰ or that limit investments in any one company,³⁵¹ apply as a matter of interpretation of the federal Act.³⁵² The purpose of these laws—to limit investment risk—is compatible with the policies of the 1940 Act. Investment companies can comply with both laws, even though their options are limited by state laws.

Federal law should continue to apply in the area of investments even when state laws contain very similar provisions. More often than not the two regulatory systems have different purposes, which might result in different enforcement and leave investors unprotected. For example, federal law limits investments of one investment company in another.³⁵³ Many state laws limit, generally, investment of assets of separate accounts in one company.³⁵⁴ The purpose of the 1940 Act was to prevent duplicate charging of investment advisory fees, and to prevent minority control through pyramiding.³⁵⁵ The purpose of insurance laws is to minimize investment risk through diversification.³⁵⁶ Therefore, both laws should apply.

Federal law impairs state law if it requires, or otherwise counteracts by express permission what state law prohibits, but not necessarily the converse. State laws prohibiting underwriting activities and limiting investments are impaired by a more permissive 1940 Act provision because it nullifies state law protection of policyholders.

When federal law restricts an activity which state law expressly permits, state law is not protected because it does not qualify as "regulation" under the McCarran Act. State laws that expressly release insurance companies in their operation of accounts from investment restrictions that apply to conventional insurance are not regulating insurance. Federal law should apply also because the need for investor-protection in these states is great. All safety restrictions on investments have been lifted and policyholders bear the risk.

Similar rules should apply to the 1940 Act's regulation of transactions that might result in conflict of interest between an investment company and its external managers. Twenty states prohibit some transactions along the lines of the 1940 Act. But not fully so.³⁵⁷ State insurance laws also prohibit directors

350 D.C. CODE ENCYCL. ANN. § 35-541, 535 (1968); FLA. STAT. ANN. §§ 627.804, 625.325 (Supp. 1972); MONT. REV. CODE ANN. § 42-3101 (1961); N.Y. INS. LAWS § 78.2 (McKinney 1966); S.D. COMP. LAWS ANN. § 58-28-15 (1967).

351 For example, D.C. CODE ENCYCL. ANN. § 35-541 (1968).

352 See pp. 1041-43 *supra*.

353 § 12(d)(1); 15 U.S.C. § 80a-12(d)(1) (1970).

354 See statutes cited note 346 *supra*.

355 SEC REPT. ON THE STUDY OF INVESTMENT TRUSTS AND INVESTMENT COMPANIES, Pt. III, H.R. Doc. 279, 76th Cong. 1st Sess. cc. 1-6 (1960). Note, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAWYER 732, 787-88 (1969); See also *In re Equity Corp. & Development Corp.*, 40 S.E.C. 124 (1960).

356 There is no limitation on one account owning all the shares of several investment companies in New York, even though the law limits investment in other companies to not more than 5 per cent of their voting power, and to 10 per cent of the insurance company's assets. N.Y. INS. LAW § 46-a (McKinney Supp. 1971).

357 THE MODEL VARIABLE CONTRACT LAW sec. 1(f) provides:

(f) No sale, exchange or other transfer of assets may be made by a company between any of its separate accounts or between any other investments account and one or more of its separate accounts unless in case of a transfer into a separate account, such transfer is made solely to establish the account or to support the operation of the contracts with respect to the separate account to which the transfer is made and unless

and officers of insurance companies from being financially interested in the transactions of the insurance company.³⁵⁸ The two regulatory systems are compatible. Inasmuch as the 1940 Act limits transactions for the protection of investors, but does not permit transactions that are disallowed by state law, the 1940 Act does not impair state law.

Perhaps the most difficult application of the McCarran Act concerns the question of control over investment activities in the account. Even though the predominant business of separate accounts is investment, the results of this

such transfer, whether into or from a separate account, is made (i) by a transfer of cash, or (ii) by a transfer of securities having a readily determinable market value, provided that such transfer of securities is approved by the Commissioner. The Commissioner may approve other transfers among such accounts if, in his opinion, such transfers would not be inequitable.

It would seem that the term "transfer" does not include sale or exchange, and means transfer without value. Such transfer occurs when the company pays into the account sums in order to establish the account, and when the company receives from the account profits from the insurance business, the differences between mortality tables and mortality experience. Thus, there is no prohibition on borrowing and on joint venture between the insurance company and accounts or between accounts *inter se*.

Sixteen states follow the pattern of the Model Law: ARIZ. REV. STAT. ANN. § 20-536.01 (Supp. 1972); DEL. CODE ANN. tit. 18, § 2933(a) (1970); GA. CODE ANN. § 56-1040(f) (1971); HAWAII REV. STAT. § 431-563(a) (5) (Supp. 1972); IDAHO CODE ANN. § 41-1936(6) (Supp. 1971); ILL. ANN. STAT. ch. 73, § 857.21(f) (Supp. 1972); ME. REV. STAT. ANN. tit. 24-A, § 2537.8 (1971); MICH. STAT. ANN. § 24.1925(4) (Supp. 1972); MINN. STAT. ANN. § 61A.14 subd. 8 (Supp. 1973); N.J. STAT. ANN. § 17B:28-9(c) (Supp. 1971) (slightly different version); N.C. GEN. STAT. § 58-79.2(n) (Supp. 1971); N.D. CENT. CODE § 26-11.1-01(6) (Supp. 1971); OHIO REV. CODE ANN. § 3907.15 (Page 1971); S.D. COMP. LAWS ANN. § 58-28-20 (Supp. 1972); VT. STAT. ANN. tit. 8, § 3855(6) (Supp. 1972); WASH. REV. CODE ANN. § 48.18A.020(5) (Supp. 1972). Massachusetts prohibits transfer of investments by sale, exchange, or substitution between investment accounts and general account except by permission of the Insurance Commissioner. MASS. GEN. LAWS ANN. ch. 175, § 132G (Supp. 1971). The same pattern is followed in New York, N.Y. INS. LAWS § 227.1(g) (McKinney Supp. 1972); New Mexico, N.M. STAT. ANN. § 58-4-6.1(6) (Supp. 1971); South Carolina, S.C. CODE ANN. § 37-333(d) (Supp. 1971); and Missouri, MO. ANN. STAT. § 376.309.4 (Supp. 1973) ("no investment in the separate account or in the general investment account . . . shall be transferred by sale, exchange, substitution or otherwise from one account to another.") New York also prohibits the investment of assets in affiliates and subsidiaries of the insurance company. N.Y. INS. LAW § 227.1(b) (6) (McKinney Supp. 1972). It is not clear whether the result of this provision is what it seems under § 46-a of the N.Y. INS. LAW. The definition of a subsidiary and an affiliate is based solely on 51 per cent stock ownership. New York therefore does not prohibit investments in corporations in which the insurance company own 49 per cent. The definition of an affiliated person in the 1940 Act is much wider. *See* § 2(a)(3); 15 U.S.G. § 80a-2(a)(3) (1970). New Hampshire requires that "investments and liabilities of the variable annuity account shall at all times be clearly identifiable and distinguishable from the other investments and liabilities of the corporation. No investments of the variable annuity account shall be pledged or transferred as a collateral for a loan." N.H. REV. STAT. ANN. § 408:31 (1968). Texas provides that "no investment shall be transferred between separate accounts or between separate and other accounts, unless the state Board of Insurance shall authorize such transfer in circumstances where such transfer would not be inequitable." TEX. INS. CODE art. 3.39 III(f)(2) (Supp. 1972). Mississippi prohibits investments in "securities of the insurance company or any other company in which the insurance company, its officers, or any member of the board of directors hold more than 1½ of one per cent . . . of the securities of the company or together own more than 5 per cent . . . of the securities of the company." MISS. CODE ANN. § 5649-39 (Supp. 1971). West Virginia prohibits "investments which create a conflict of interest between officers and directors of the insurance company and the corporation whose stock is purchased." W. VA. REG. 56L-2 § VI.6 (1966). Wisconsin gives the state insurance authority the power to regulate transfers between separate accounts. WISC. STAT. ANN. § 206.385(7) (Supp. 1972); N.Y. INS. LAW § 227.1(f) (McKinney Supp. 1972); N.C. GEN. STAT. § 58-79.2(m) (Supp. 1971); and ORE. REV. STAT. § 733.180 (3) (1971) prohibit unfair discrimination among accounts.

³⁵⁸ *See* note 234 *supra*.

investment affect the insurance business of the company since it "guarantees" a minimum of death benefits under the policies.

It can be argued that the guarantee of death benefits is not insurance because a guarantee of a security (and the variable insurance policy is a security), is itself a security in federal law.³⁵⁹ In general, the word guarantee may mean either a warranty³⁶⁰ or a contingent obligation,³⁶¹ depending on the context. In the Securities Act of 1933 the term "guarantee" means a contingent obligation only.³⁶² The definition of a guarantee in the 1933 Act presupposes the existence of another security issued by another issuer, and the legislative history indicates that the duties of the issuer of the guarantee under the 1933 Act are limited to the guarantee and do not extend to the other security.³⁶³ In variable insurance, the company is the primary obligor; its undertaking is not conditioned on someone's default. The investment performance affects the insurance obligations of the insurance company to pay a "guaranteed" amount of death benefits just as the investment performance of the general or other accounts affects conventional insurance obligations. Therefore, the question of who controls investments in the account involves the business of insurance. State law regulating control of these investments is within the McCarran Act.

The 1940 Act limits the discretion of investment advisers to determine investment policies by requiring a detailed statement of these policies in the registration statement of the company, and prohibiting changes in certain investment policies without majority shareholder approval.³⁶⁴ In addition, the Act regulates the form and part of the substance of advisory and underwriting contracts. Advisory contracts must specify fees and prohibit their transfer by the adviser. The contracts must be terminable on sixty days' notice without penalty, and must be discontinued unless approved annually by the unaffiliated directors.³⁶⁵ The board of the account is elected exclusively by the contract-holders³⁶⁶ and at least 40 per cent of the directors must be unaffiliated with the insurance company or its affiliates.³⁶⁷

State insurance laws usually provide that the board of directors of the insurance company will make investment decisions.³⁶⁸ Some states prohibit insurance companies from entering into management contracts, and some permit

³⁵⁹ Investment Company Act of 1940, § 2(a)(35); 15 U.S.C. § 80a-2(a)(36) (1970). "Security" means any "note, stock, treasury stock, bond, debenture, . . . guarantee of, . . . any of the foregoing."

³⁶⁰ *Roberts v. Reynolds*, 212 Cal. App. 2d 818, 28 Cal. Rptr. 261, 266 (1963); *Northern Imp. Co. v. Pembina Broadcasting Co.*, 153 N.W.2d 97, 103 (N.D. 1967); *Morgan Supply Co. v. Yarbrough*, 87 Ga. 521, 74 S.E.2d 500, 501 (1953); *Parker Pen Co. v. FTC*, 159 F.2d 509, 511 (7th Cir. 1946).

³⁶¹ *McCallum v. Campbell—Simpson Motor Co.*, 82 Idaho 160, 349 P.2d 986, 987, 989 (1960).

³⁶² *Cf. Methodist Hospital v. Saylor*, 15 Cal. App. 3d 862, 93 Cal. Rptr. 516 (1971).

³⁶³ 1 L. LOSS, *SECURITIES REGULATION* 455, 466 (2d ed. 1961).

³⁶⁴ §§ 8(b), 13; 15 U.S.C. §§ 80a-8(b), 13 (1970). In addition, the basic security of a unit investment trust cannot be changed without the Commission's permission § 26(b); 15 U.S.C. § 80a-26(b) (1970). The harm which variable policyholders might suffer from change of investments is just as great as that of shareholders of mutual funds. No comparable protection is afforded by insurance statutes so long as the underlying security is easily valued.

³⁶⁵ § 15; 15 U.S.C. § 80a-15 (1970).

³⁶⁶ § 16; 15 U.S.C. § 80a-16 (1970).

³⁶⁷ § 10(a); 15 U.S.C. § 80a-10(a) (1970).

³⁶⁸ *E.g.*, N.Y. INS. LAWS § 78(1) (McKinney 1966).

them only subject to approval by state insurance agencies (if the fees and length of the contract are reasonable) or subject to their approval of the fee.³⁶⁹ These provisions do not apply to a management arrangement between the insurance company and the separate account or the aggregate of contractholders (policyholders).

There are no state laws along the lines of the federal Act and no indication that state law considers the insurance company's role different from its role in conventional insurance. Yet the company's role has changed drastically. Instead of investing at its own risk and calculating its investment advisory services at cost, the policyholders bear part of the investment risk, and are charged fees calculated as a percentage of the assets. This charge places the insurance company in potential conflict of interest with the policyholder. In addition, a guarantee of a minimum fixed death benefit may affect investment decisions, and not necessarily in accord with contractholders' interest. Therefore, as a matter of interpretation of the 1940 Act, control of contractholders over investment policies should be preserved.

In practice contractholders elect a slate proposed by the insurance company and the unaffiliated directors are nonetheless friendly directors. The declared investment policies leave the investment adviser a great measure of freedom in his choice of investments. The board of directors in fact supervises investment directors only superficially. The insurance company will lose this freedom in the unlikely event of contractholders' revolt, if contractholders refuse to ratify the investment advisory contract or when the insurance company is disqualified from acting as an investment adviser. However, the Act's provisions granting contractholders a measure of control over investment policies raise serious questions of impairment of state laws regulating the business of insurance. If the insurance company needs full control and freedom over investment decisions in order to guarantee minimum fixed death benefits, then impairment by the federal Act is substantial.

The variable life policy poses for the company competing investment goals. The guarantee of minimum death benefits dictates a conservative investment policy with the resultant low income. The advisory fees are an incentive to increase sales. The way to increase sales is to show appreciation of capital, income, or both. The 1940 Act will impair state laws if it is shown that these competing goals cannot be achieved within the constraints of an investment policy under the Act, and that a prescribed investment policy impairs the ability of the company to honor its insurance obligations. The onus is on the insurance industry and state authorities.

369 *E.g.*, ALASKA STAT. § 21.69.380 (1966); ARIZ. REV. STAT. ANN. § 20-727 (1956); CAL. INS. CODE § 4030 (Supp. 1971); DEL. CODE ANN. tit. 18, § 4921 (1970); FLA. STAT. ANN. § 628.251 (1972); GA. CODE ANN. § 56-1532 (1971); IDAHO CODE ANN. §§ 41-2838, 2835 (Supp. 1971); ILL. ANN. STAT. ch. 73, § 767.4 (Supp. 1972); ME. REV. STAT. ANN. tit. 24-A § 3411 (1971); MD. ANN. CODE art. 48A, § 268A (1972); MINN. STAT. ANN. § 60A.076 (1968); MISS. CODE ANN. § 5657.3 (Supp. 1972); MO. ANN. STAT. § 375.164 (1968); MONT. REV. CODE ANN. § 40-4724 (1961); NEV. REV. STAT. tit. 57, § 693A.110 (1972); OKLA. STAT. ANN. tit. 36, § 2127 (1958); ORE. REV. STAT. § 732.220 (1971); PA. STAT. ANN. tit. 40, §§ 290, 291 (Supp. 1971); S.D. COMP. LAWS ANN. § 58-5-85, 87 (1967); UTAH CODE ANN. § 31-7-7 (1966); VA. CODE ANN. § 38.1-29.1 (1970); W.VA. CODE § 33-5-21 (1966); WYO. STAT. ANN. § 26.1-491 (1967).

A direct impairment of state insurance agencies' powers may occur in connection with changes in the investment policy that may not be made without the approval of shareholders. If the shareholders refuse to approve, or if the SEC refuses to grant an exemption, what is the effect of state insurance commissioners' permission to change investment policies in order to protect policyholders?

The SEC's and state authorities' considerations may be different because insurance authorities will be concerned with the guarantee, and the SEC will be concerned with investment. It seems that under the present law, the statutory power of insurance authorities to change investments to protect policyholders from insolvency of the insurance company cannot be impaired by the SEC or the policyholders, provided that the reason for the change is to prevent insolvency. If the reason is only to prevent losses to the insurance companies, the change may be attacked on the ground that it is not regulating the business of insurance but protecting it from competition. Admittedly, the line is hard to draw.

A similar analysis can be made with regard to the provisions of the 1940 Act that permit policyholders to terminate the advisory and underwriting contracts.³⁷⁰ Again, this power is very rarely used. Nonetheless, the provisions permit a complete abrogation of the power of the board of directors of the insurance company. It is difficult to see how an insurance company can guarantee investment performance over which it has no control.³⁷¹ Theoretically, an independent investment adviser would then speculate, safe in the knowledge that the insurance company will always pay the minimum face amount of death benefits. The power to terminate investment advisory contracts therefore impairs state laws vesting investment decision in the board of the insurance company. But if the power is not granted, policyholders will be left with insufficient protection. Their only remedy is to lapse the policy. The remedy is inadequate. The lapse of a policy might entail loss of prepaid commissions. It might result in the complete loss of insurance, if the policyholder has become uninsurable, or it might result in higher premiums simply because the insured grew older. The solution to this dilemma must come by legislation.

Policyholders' right to elect the account managers³⁷² also rarely affects the power of the investment adviser over the account's activities, but this right raises difficult theoretical problems. Policyholders and the insurance company should share the management of an account because both have a stake in the investment performance. Under the 1940 Act, only policyholders can vote for directors, but at the same time 60 per cent of the board's members may be affiliated with the company. Besides, the insurance company retains responsibility for the day to day investments through the advisory contract. The policyholders' exclusive right to elect the management of the account may impair state law if they acquire effective control of the account's management. The question is whether the right balance in making investment decisions is thus achieved.

³⁷⁰ § 15; 15 U.S.C. § 80a-15 (1970).

³⁷¹ On the impact of termination on the insurance promises, see Frankel, *supra* note 19, at 355-59.

³⁷² See *In re Prudential Ins. Co.*, 41 S.E.C. 335, 350, 352 (1963).

There is no need to cover here all the provisions of the 1940 Act. They fall under one or more of the categories that have been examined. The inescapable conclusion is that hybrid insurance and securities products require special regulation.

V. Conclusion

There are basic differences in techniques and philosophies between state insurance regulation and federal securities regulation. Insurance regulation is paternalistic and secretive. State agencies determine what is good for the consumer and the public and enforcement of the law rests primarily with them. The consumer is not given incentives to represent, and is sometimes prohibited from representing, his fellow consumers as a class.

The main purpose of insurance regulation is to insure integrity of the financial condition of insurance companies. Most other considerations, such as equity as between the company and the policyholders and among policyholders inter se, are subservient to this purpose.³⁷³ This purpose is most effectively achieved by direct state supervision of insurance operations without policyholders' intervention.

One of the unique characteristics of insurance is that it does one thing for the individual policyholder and another for the insurance company. For the policyholder insurance transfers risk of loss for a minimal fixed amount, for the insurance company insurance is a business of assuming risk through pooling and distribution, a special technique that individuals cannot perform for themselves unless they can become self-insurers. Insurers consider these techniques to be their property. The policyholders expect from the insurance company results rather than service. They have no interest in, and no control over, the manner in which the results are reached. Further, insurance techniques are complicated and cannot be evaluated except by skilled actuaries. Under these circumstances surveillance by government authorities behind closed doors may be appropriate.

On the other hand, securities regulation places the evaluation and investment decision squarely on the consumer and attempts to secure for him adequate information. The 1940 Act goes further to ensure for the consumer a stronger bargaining position in his dealings with the investment adviser. The power of the SEC is not primary, and the tendency of the courts is to encourage the bar and the consumer to privately enforce the law. Unlike buyers of insurance, investors in mutual funds are essentially contracting for investment advisory services and the advantages of diversified investments. Their interest in controlling the investment process is paramount.

The philosophy of securities regulation is justified mainly on the ground that

³⁷³ For a thought provoking work on insurance regulations, see Kimball, *The Purpose of Insurance Regulation: A Preliminary Inquiry in the Theory of Insurance Law*, 45 MINN. L. REV. 471 (1961). See also KIMBALL & DENENBERG, *INSURANCE, GOVERNMENT AND SOCIAL POLICY: STUDIES IN INSURANCE REGULATION* (1969).

other alternatives are not acceptable. The alternatives would be to leave managements of companies accountable to no one but their conscience and God, or to permit government agencies to evaluate and control investments. Both solutions are repugnant to the American tradition. Power must be checked, and government should not interfere with business decisions. Securities regulation has, therefore, mainly a prophylactic effect.

Responsible insurance counsel are questioning the utility of a prospectus, complain about the unnecessary expenses and burdensome paper work, and point out that class actions are an incentive to champerty. The securities lawyer has heard these arguments before. To him the issues are not debatable anymore. But in the variable life insurance context some of the arguments may have a new vitality. Purchasers may not be sufficiently sophisticated to understand the complexities of the policies, and it is difficult to prepare a legible prospectus for them. Yet the objections to government control of investments and freedom of managements from accountability are just as valid in the area of variable insurance as they are in the securities area.

The 1940 Act involves additional considerations. Variable insurance products cannot be treated as investments for the purposes of securities regulation without qualification. Variable policies involve at least as much concern with financial integrity as conventional policies. The policies are in their infancy. They may entail unknown losses. Conventional policyholders are entitled to protection. Variable life insurance policyholders also have an interest, as policyholders and as holders of investment guarantee, in the financial integrity of the company. Thus, the regulation of the investment component in the policies should not interfere or weaken the regulation of insurance.

The regulation of insurance is much more complex than the regulation of mutual funds because it involves many and sometimes competing interests. Ordinary policyholders and variable policyholders have been mentioned. To these we must add the shareholders in stock companies, and the public that has an interest in the efficient service of insurance companies. The balance among these parties is not easy to achieve.

Thus, the automatic application of the 1940 Act is also not the solution. This new type of policy should be governed by a new kind of regulation. While preserving the features of conventional regulation it should add new dimensions to match the synthesis between insurance and investment which the policy strives to achieve.

The crucial question before the Commission was who should be primarily responsible for legislating and enforcing the new regulation. The staff of the Commission recommended that the Commission should regulate variable policies under the 1940 Act with adjustments to be worked out between the staff and the industry. The Commission chose another route. It granted exemption from the 1940 Act to separate accounts funding variable insurance because it recognized the difficulties in applying the Act to insurance and respected the expertise of the states in direct regulation of insurance. However, the Commission recognized the inadequacy of state regulation. It therefore asserted its jurisdiction over the accounts and issued to the states the following invitation:

In adopting these exemptive rules, the Commission contemplates that the states will develop a comprehensive regulatory structure to provide the protections that would otherwise be available under these Acts. Accordingly, if after a reasonable period of time the Commission observes the development of variable life insurance products for which exemption from the Investment Company Act or the Investment Advisers Act is not appropriate, or that state insurance laws are not adequate to protect the public, it will consider modification or revocation of the exemptions. In this regard, we would expect that state regulation will be developed that will be substantially equivalent in material respects to those relevant sections of the . . . Acts.³⁷⁴

The Commission's decision is remindful of the solution which Congress chose with respect to federal antitrust regulation of insurance in the McCarran Act. There Congress gave states a three-year moratorium during which to prepare adequate substitutes for the federal legislation. After that period, federal law would have applied in states that did not preempt the field. A similar provision appears in the 1964 Amendments to the 1934 Act.³⁷⁵ States have the opportunity to preempt the area of proxy solicitation, reporting, and insider trading concerning insurance companies. But unlike the McCarran Act, no moratorium is provided. The 1934 Act governs so long as states do not preempt the field.

In exempting variable life insurance separate accounts, the Commission went further than both the McCarran Act and the 1934 Act. The exemption is for an indefinite period, a "reasonable time." There is no deadline, as in the case of the McCarran Act, and there is no investor protection in the interim period as is guaranteed in the 1934 Act. This part of the decision raises questions as to the scope of the SEC's discretion to exempt from the 1940 Act. It is arguable that difficulties in adjusting the Act to insurance, and hopes that the states will provide adequate protection to investors in the future, are not sufficient to justify an exemption.

To sum up, the SEC agreed with the investment industry that variable policies are securities, that the separate accounts are nonexempt investment companies, that the SEC has jurisdiction over them, and that state regulation is not presently a substitute to federal protection. The SEC agreed with the insurance industry that it is appropriate to exempt the accounts from the 1940 Act, at least for a while, to give the states an opportunity to provide an alternative to federal protection. The process of resolving the issue has just begun.

³⁷⁴ Letter of Chairman William J. Casey to Robert J. Routier and Paul S. Mason, January 31, 1973.

³⁷⁵ 15 U.S.C. § 781(g)(2)(G) (Supp. 1971).

APPENDIX A

Example 1

SEPARATE ACCOUNT I

Separate Account I is a separate investment account maintained by Equitable VLI. Assets will be allocated to Separate Account I to support the operation of this contract and certain other contracts. Assets may also be allocated to Separate Account I for other purposes.

It is contemplated that investments in Separate Account I will, at most times, consist primarily of common stocks and other equity-type investments. However, Equitable VLI may, in its discretion, invest the assets of Separate Account I in any investments permitted by applicable law. Equitable VLI may rely conclusively on the opinion of counsel (including attorneys in its employ) as to what investments it is permitted by law to make.

SEPARATE ACCOUNT INDEX

The Separate Account Index for the valuation period which included the first day in which there were assets in Separate Account I was 100. The Separate Account Index for each subsequent valuation period is the Separate Account Index for the immediately preceding valuation period multiplied by the Net Investment Factor for such subsequent valuation period. The Separate Account Index for a valuation period applies to each day in that period.

VALUATION PERIOD. Each business day together with any non-business day or consecutive non-business days immediately preceding such business day will constitute a valuation period. A business day is any day on which both the Equitable VLI Home Office and the New York Stock Exchange are open for business and trading, respectively.

NET INVESTMENT FACTOR. The Net Investment Factor for a valuation period is (a) divided by (b), minus (c), where

- (a) is (1) the value of the assets in Separate Account I at the close of business of the preceding valuation period, plus (2) the investment income and the capital gains, realized or unrealized, credited to the assets of Separate Account I in the valuation period for which the Net Investment Factor is being determined, minus (3) the capital losses, realized or unrealized, charged against such assets in such valuation period, minus (4) any amount charged against Separate Account I in such valuation period for taxes or for amounts set aside by Equitable VLI as a reserve for taxes attributable to the maintenance or operation of Separate Account I;
- (b) is the value of the assets in Separate Account I at the close of business of the preceding valuation period;

- (c) is a charge not exceeding .00002063 for each day in the valuation period (corresponding to .75% per year; this charge is for investment management, mortality and expense risks and other contingencies).

The value of the assets in Separate Account I shall be taken at their fair market value or, where there is no readily available market, their fair value determined in accordance with accepted accounting practices and applicable laws and regulations.

ACTUAL AND BASE NET RATES OF RETURN

ACTUAL NET RATE OF RETURN. The Actual Net Rate of Return for a policy year is equal to the change in the Separate Account Index from the first day of the policy year to the first day of the next policy year, divided by the Separate Account Index for the first day of the policy year. The Actual Net Rate of Return is negative if the Separate Account Index decreases. The Actual Net Rate of Return for a period less than a year is determined on a corresponding basis.

BASE NET RATE OF RETURN. The Base Net Rate of Return for this policy is .03 (3%) per year. (For a period less than a year, it is a pro rata part of the annual rate.) Assuming premiums are duly paid and there is no surrender of benefits under this policy, the benefits and cash values of this policy have been determined so that if the Actual Net Rate of Return for each policy year equals the Base Net Rate of Return, the Death Benefit in each policy year will equal the face amount and the cash value at the end of each policy year will equal the tabular cash value.

DEATH BENEFIT

Provided premiums are duly paid and there is no surrender of any benefits under this policy, the Death Benefit shall equal the face amount plus the Variable Adjustment Amount for the policy year in which death occurs, except that if the Variable Adjustment Amount is negative, a minimum Death Benefit equal to the face amount shall apply. If a partial surrender is made, the Death Benefit and the minimum Death Benefit are reduced as provided in the Partial Surrender provision on page ten. Upon default in the payment of a premium, the Death Benefit shall be as provided in the Grace and Insurance Non-Forfeiture Options provisions.

VARIABLE ADJUSTMENT AMOUNT

On each policy anniversary to which premiums have been duly paid, Equitable VLI will determine the Variable Adjustment Amount for the policy year beginning on that anniversary, to take into account the investment experience of Separate Account I for the preceding policy year. The Variable Adjustment Amount is zero during the first policy year, and thereafter it may be positive or negative. It remains at a constant amount during a policy year as long as pre-

miums are duly paid unless during such year there is a partial surrender of benefits.

If the Actual Net Rate of Return for the preceding policy year is different from the Base Net Rate of Return, the Variable Adjustment Amount will change on a policy anniversary. The change will be an increase or a decrease depending on whether the Actual Net Rate of Return is greater or less than the Base Net Rate of Return, and the amount of the change shall equal the product of (a) and (b), divided by (c), where

- (a) is the difference between the Actual and Base Net Rates of Return;
- (b) is the sum of the tabular cash value on the previous policy anniversary and the non-forfeiture factor, increased or decreased by the net single premium on the previous policy anniversary for the Variable Adjustment Amount in effect just prior to the current policy anniversary; and
- (c) is the net single premium on the current policy anniversary for \$1.00 of Variable Adjustment Amount.

The tabular cash value and non-forfeiture factor are determined from the table on page three. The net single premium for the Variable Adjustment Amount is determined from the table on page six. If the Variable Adjustment Amount is negative, the net single premium for it is negative.

The Equitable Life Insurance Co., Variable Whole Life Policy at 5.

Example 2

PREMIUM AND INVESTMENT ADJUSTMENT FACTORS

The premium and investment adjustment factors are used in determining the daily variations in the variable benefits under the policy.

Premium Adjustment Factor

The premium adjustment factor for any day is equal to (A) divided by (B), where

(A) is the sum of

- (i) the mean of the reserve at the end of the policy year during which such day occurs and the reserve at the end of the preceding policy year, with each such reserve being for the face amount on the day which immediately precedes the day for which the factor is being calculated, and
- (ii) the daily net premium element for the Initial Face Amount

and

(B) is the sum of

- (iii) the same mean of reserves described in (A) (i) above, and

- (iv) the daily net premium element for the face amount on such immediately preceding day.

The daily net premium element on any day for a specified face amount is equal to the applicable daily net premium element, per \$1,000 of face amount, shown in the Table of Cash and Non-Forfeiture Values and Daily Net Premium Elements, multiplied by the number of \$1,000's in the specified face amount.

Investment Adjustment Factor

The investment adjustment factor for any day is determined as of the end of that day by dividing (a) by (b), reducing the result by (c), and multiplying the reduced result by (d), where

- (a) is: (i) the value of the assets of the Separate Account as of the end of the immediately preceding day less any tax reserves held in the Separate Account as of the end of that day; *plus* (ii) capital gains, realized and unrealized, and investment income credited to the Separate Account since the immediately preceding day; *minus* (iii) capital losses, realized and unrealized, charged against the Separate Account since the immediately preceding day; *minus or plus*, respectively, (iv) any increase or decrease since the immediately preceding day in any tax reserves held in the Separate Account, with appropriate adjustment for any such taxes actually paid;
- (b) is: the value of the assets of the Separate Account as of the end of such immediately preceding day less any tax reserves held in the Separate Account as of the end of that day;
- (c) is: .0000274, which is a deduction, at the rate of .01 per annum, for investment management charges and for risks assumed by the Company;

and

- (d) is: .99991902, which is a factor to recognize the interest rate of 3% compounded annually used in computing net premiums and reserves.

The term "tax reserves", as used above, means any amounts held for taxes and reserves for taxes incurred by the Separate Account.

Although the variable benefits under the policy will be affected by the deduction stated above, they will not otherwise be reduced because of adverse experience with respect to the mortality and expense risks assumed by the Company.

Separate Account. The Separate Account is a separate investment account established and maintained by the New York Life Insurance Company under the laws of the State of New York. Although the assets of the Separate Account are the exclusive property of the Company, that portion of such assets which represents reserves and other contract liabilities with respect to such Separate Account will not be chargeable with liabilities arising out of any other business of the Company.

The assets of the Separate Account will be valued at fair market value as determined in accordance with a method of valuation established in good faith by the Company. Brokerage fees, transfer taxes and other expenses directly resulting from the purchase or sale of a security will be included as part of the purchase price of the security or will be deducted from the sales price.

The Company reserves the right to transfer assets of the Separate Account, in excess of the reserves and other contract liabilities with respect to such Separate Account, to another separate account or to the Company's General Account.

New York Life Insurance Co., Variable whole life policy at 6.

Example 3

7. Net Investment Rate and Net Investment Factor

(a) The net investment rate for any period for the General Account is guaranteed, and is equal to an effective interest rate of $3\frac{1}{2}\%$ compounded annually.

(b) The net investment rate for any valuation period for the Separate Account for Variable Settlement Options is equal to the gross investment rate for that Account for the valuation period less a margin deduction of .0000395 for each day of the valuation period. The gross investment rate is equal to (i) the investment income and capital gains and losses, both realized and unrealized, on the assets of the Separate Account for Variable Settlement Options less a deduction for any applicable taxes arising from such income and realized and unrealized capital gains, divided by (ii) the amount of such assets at the beginning of the valuation period. Such gross investment rate may be either positive or negative.

(c) The net investment factor for each Account is the sum of 1.0000000 plus the net investment rate for the Account.

8. Annuity Unit Value

(a) The value of a General Account annuity unit is fixed at \$10.

(b) The value of a Separate Account for Variable Settlement Options annuity unit was fixed at \$10 for the valuation period ending May 17, 1966. The value of such annuity unit for any valuation period thereafter is determined by multiplying the value of the annuity unit for the preceding valuation period by the product of (i) .9999058 for each day of the valuation period and (ii) the net investment factor of the Separate Account for Variable Settlement Options for the tenth valuation period preceding the period for which the value is being calculated.

9. Annuity Tables

Under Modes 4 and 5 below the amount of each installment will depend upon the sex of the payee and the payee's adjusted age at the time the first installment is due (in the case of Mode 5 the sex of the co-payee

and the co-payee's adjusted age as well). Adjusted ages are determined in accordance with the following:

<i>Calendar Year of Birth</i>	<i>Adjusted Age</i>
Before 1916	Actual Age
1916 - 1935	Actual Age minus 1 year
1936 - 1955	Actual Age minus 2 years
1956 - 1975	Actual Age minus 3 years
1976 and thereafter	Actual Age minus 4 years

Actual Age, as used in the table above, shall mean age nearest birthday at the time the first installment is due.

The Tables on the following pages show the dollar amount of the first monthly installment for each \$1,000 applied whether applied to provide fixed installments (General Account) or variable installments (Separate Account for Variable Settlement Options). Monthly installments after the first from the General Account shall be equal to the first monthly installment. Monthly installments after the first from the Separate Account for Variable Settlement Options are not predetermined and may change from month to month. The method of calculating the dollar amount of all installments is described elsewhere in the Modes of Settlement provisions.

The Table for Mode 3 is based on a net investment rate equal to an effective interest rate of $3\frac{1}{2}\%$ compounded annually. Tables for Modes 4 and 5 are based on the Progressive Annuity Table assuming births in the year 1900 and a net investment rate of $3\frac{1}{2}\%$ compounded annually.

10. *Interest Payments*

MODE 1. The proceeds may be left on deposit with AETNA in its General Account and interest will be paid annually, semi-annually, quarterly, or monthly, as selected, equal to the net investment rate for the period multiplied by the amount remaining on deposit. Election of this Mode constitutes election of a fixed investment rate. The time during which interest shall be paid shall not exceed the lifetime of one payee except with AETNA's consent.

11. *Installments of Fixed Amount*

MODE 2. The payment in advance of monthly installments of any fixed amount specified in the election, provided the amount payable each month is not less than \$5 for each \$1,000 of the sum payable under this Mode. If the remaining balance at any time is less than the amount of one installment, such balance will be paid and will be the final payment

under the option. To determine the remaining balance in either Account at the end of any valuation period such balance at the end of the previous period is decreased by the amount of any installment paid during the period and the result multiplied by the net investment factor for the period. The time during which monthly installments shall be paid shall not exceed the lifetime of one payee except with AETNA's consent. Aetna Variable Annuity Life Insurance Co., at 9.