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INSURANCE—VARIABLE ANNUITIES—APPLICATION OF INVESTMENT COMPANY ACT OF 1940—Anticipating the sale of variable annuity contracts as a part of its regular business, Prudential, a life insurance company, applied to the Securities and Exchange Commission for complete exemption from the requirements of the Investment Company Act of 1940.[1] Prudential claimed that it qualified for exemption as an insurance company[2] under the definition of "insurance company" in the Investment Company Act ("a 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").[3] In the alternative, Prudential requested exemption from specific provisions of the Investment Company Act[4] relating primarily to investor control and redeemability requirements. On the principal application, asking complete

1 54 Stat. 789, as amended, 15 U.S.C. §§ 80a-1 to -52 (1958).

2 Section 3(c)(3) of the Investment Company Act specifically exempts from the coverage of the act's provisions any "insurance company" as defined in § 2(a)(17). 54 Stat. 798, 793 (1940), 15 U.S.C. §§ 80a-3(c)(3), -2(a)(17) (1958).

3 54 Stat. 793 (1940), 15 U.S.C. § 80a-2(a)(17) (1958).

4 Section 6(c) provides that the SEC may grant exemptions, conditionally or unconditionally, from the provisions of the act "if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of the act. 54 Stat. 802 (1940), 15 U.S.C. § 80a-6(c) (1958). See Great American Life Underwriters, Inc., Investment Co. Act Release No. 3070, July 15, 1960.

exemption, *held*, denied. If an insurance company sells equity interests to the public and creates an investment fund, the insurance company's exemption from federal regulation does not carry over to the investment fund, which is treated as a separate entity. Moreover, the Supreme Court decision which initially brought the variable annuity under federal securities regulation as a "security" classified the annuity contract itself,[5] apart from any consideration of the type of company issuing it.[6] *Prudential Ins. Co. of America*, SEC Investment Co. Act Release No. 3620, Jan. 22, 1963.

The variable annuity was developed a decade ago in response to the need for a retirement plan which would guarantee payments until death, as did an ordinary annuity, yet provide for appreciation of the principal to counter inflation, as would a share of common stock.[7] The logical solution was to combine the insurance function of distributing mortality risk over a large number of persons with the security's ability to appreciate

[5] See SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); *cf.* the definition of an investment contract set forth in SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946).

[6] In response to Prudential's alternative applications for exemption from specific Investment Company Act provisions, the Commission made the following orders:

(a) Exemption from § 16(a), which requires election of directors by holders of the securities, was denied. Variable annuity holders, having funds at risk, must have power to determine management policies affecting the investment fund. The requirement of investor control was a prime concern of the Investment Company Act. See *Hearings on S. 3580 Before a Subcommittee of the Senate Committee on Banking and Currency*, 76th Cong., 3d Sess. 253 (1940) [hereinafter cited as *Hearings*].

(b) Exemption from §§ 22(e) and 27(c)(1), which require that all investment company securities be redeemable within seven days of presentation by the holder, was denied as to the "pay-in" period (the time in which the annuitant is accumulating "units" in the fund) and granted as to the "pay-out," or annuity, period. The redemption requirement in no way impairs or alters the variable annuity program during the accumulation period since the issuer then operates exactly like an ordinary investment company; however, the "pay-out" period involves a schedule of mortality assumptions by the insurer which would be useless if unilateral withdrawal of unliquidated units were permitted. See Variable Annuity Life Ins. Co. of America, Investment Company Act Release No. 2974, Feb. 25, 1960, pp. 20-21. Haussermann, *The Security in Variable Annuities*, 1956 INS. L.J. 382, 384.

(c) Exemption was also sought from § 22(d), which prohibits sale of securities at other than the public offering price, the insurer's plan being to charge a defaulting variable annuity holder who later cures the default with the higher of current offering price and the price at the time of default. In denying this exemption, the Commission reasoned that under Prudential's plan the penalty could well exceed (in a declining market) the 9% maximum prescribed in § 27(a)(1), or be "unconscionable or grossly excessive" in violation of § 22(b). Viewed as an administrative charge, it could exceed the "reasonable amount" standard of § 27(a)(5).

(d) Exemption from the semi-annual report requirement of § 30(d) was also denied. The disclosure requirement is essential for intelligent exercise by the variable annuity holder of his right to elect directors and to sell or redeem his securities. See *Hearings* 302-03, 329. See also Haussermann, *supra* at 390.

(e) Exemptions were granted from § 17(f), regarding banking procedures, and § 27(a)(3), which prohibits disproportionate deduction of sales expenses from monthly payments. It was reasoned that the insurance company had adequate facilities for safekeeping of securities, and, regarding sales load deductions, that the commission sales arrangements used in the insurance industry (whereby the commission is deducted from initial payments) rendered uniform deductions impractical.

[7] The variable annuity began as an employee pension or profit-sharing plan. See Haussermann, *supra* note 6, at 390.

in value along with general price rises.[8] Such a combination is the variable annuity. During a specified number of years the annuitant's premiums are placed in an investment fund which consists of a widely diversified pool of common stocks. His interest is computed in terms of "units," each "unit" being a proportion of the fund; the value of each "unit" fluctuates with the rise and fall of the stock values in the fund. After the premiums are fully paid and the "pay-out" period begins, the insurer must liquidate units of the fund periodically in order to make payments to the annuitant. The payments are measured by the value of a fixed number of units; however, the value of a unit in the "pay-out" period also depends upon the investment experience of the fund. The actuarial function of the insurance company becomes significant in the "pay-out" period, for, unlike shares in a mutual fund, the variable annuity guarantees "unit" payments for the life of the holder, whether he reaches or exceeds his statistical life expectancy.[9] However, unlike the ordinary annuity policy, the variable annuity guarantees no fixed sum payment. Underlying the variable annuity plan is the assumption that a diversified pool of common stock will appreciate at the same rate as general price levels; however, in practice the variable annuity holder is assuming not only the risk that a recession will drive the value of the annuity below its price,[10] but also the risk that through mismanagement the fund will not respond to general price increases.[11] These are not ordinary insurance risks; they are identical, however, to the risks facing purchasers of shares in an investment company. Consequently, the variable annuity is both a security and an annuity; both the mortality risk of insurance and the investment risk of securities are quite significant.

The dual nature of the variable annuity has created substantial problems as to the proper scope of federal securities regulation and state insurance regulation. In *SEC v. Variable Annuity Life Ins. Co.*,[12] the Supreme

8 See Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 INS. L.J. 357, 359. In addition to the assumption that common stock values reflect general price level fluctuations, the variable annuity theory assumes that the speculative features of equity investment are removed by (1) investing in a widely diversified group of equities, and (2) investing in equities over a long period of time. *Id.* at 359-60.

9 For an excellent comparison of the variable annuity, standard annuity and mutual fund share which points up the importance of the mortality risk which the insurer assumes, *i.e.*, guarantees the annuitant he will not outlive his income, see Mearns, *The Commission, the Variable Annuity, and the Inconsiderate Sovereign*, 45 VA. L. REV. 831, 834-38 (1959).

10 The adverse fluctuation of variable annuity "units" in a recession is defended as follows: "[I]s not the annuitant better off if he loses one half of his principal and maintains his purchasing power than he is if he maintains his principal and loses one half of the purchasing power?" Johnson, *supra* note 8, at 360.

11 See Spellacy v. American Life Ins. Ass'n, 144 Conn. 346, 131 A.2d 834 (1957), where the court held that the variable annuity was not insurance, and pointed out that the annuitant assumed the risk of "poor judgment or lack of skill in the management of the investments," *i.e.*, the danger that the "unit" "may be depreciated by reason of factors not traceable to general economic conditions." *Id.* at 357-58, 131 A.2d at 840.

12 359 U.S. 65 (1959) [hereinafter cited as VALIC].

Court held that the investment risks of the variable annuity were of primary significance, and therefore it is a security subject to the Securities Act of 1933[13] and Variable Annuity Life Ins. Co. is an investment company subject to the Investment Company Act of 1940. The majority in *VALIC* used what can best be described as a "conceptual" approach: the premise being that the variable annuity was either a security or an annuity, and the conclusion being that it was basically a security.[14] On the other hand, the dissenters adopted an "institutional" approach, arguing that the variable annuity was a new concept in insurance, and therefore traditional principles of "state regulation and federal abstention," as embodied in the McCarran-Ferguson Act,[15] required that the states be given an opportunity to modify their insurance regulation to provide adequate protection for the public, rather than relying upon federal regulation.[16] Mr. Justice Brennan, in his concurring opinion, recognized the dual nature of the variable annuity, but concluded that the more significant problems it presented were those which federal securities regulation, rather than state insurance laws, were designed to solve.[17] Widespread criticism of the Court's analysis lends strength to a third possible approach—that the variable annuity is both insurance and a security, and therefore the Investment Company Act's coverage of investment company activities clearly contradicts its express exemption of insurance activities under section 3(c)(3) when applied to the variable annuity. Moreover, in the setting of variable annuities, the policy of federal intervention in the regulation of securities and investment companies seems to conflict with the policy directive of the McCarran-Ferguson Act that "no act of Congress will 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."[18] This third

13 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1958).

14 Mr. Justice Douglas (who served as Chairman of the SEC, 1934-1936) emphasized in the majority opinion: "There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage." 359 U.S. at 73.

15 59 Stat. 33 (1945), 15 U.S.C. §§ 1011-12 (1958).

16 Mr. Justice Harlan, dissenting, stated that "the Court is agreed that we should not 'freeze' the concept of insurance as it then existed [1933-1940]. By the same token we should not proceed on the assumption that the thrust of state regulation is frozen. As the insurance business develops new concepts the States adjust and develop their controls." 359 U.S. at 101.

17 "Accordingly, while these contracts contain insurance features, they contain to a very substantial degree elements of investment contracts as administered by equity investment trusts. They contain these elements in a way different in kind from the way that insurance and annuity policies did when Congress wrote the exemptions for them in the 1933 Act and the 1940 Act. Since Congress was intending a broad coverage in both these remedial Acts and since these contracts present regulatory problems of the very sort that Congress was attempting to solve by them, I conclude that Congress did not intend to exclude contracts like these by reason of the 'insurance' exemptions." 359 U.S. at 91.

18 59 Stat. 34 (1945), 15 U.S.C. § 1012(b) (1958). Both the Securities Act and the

approach suggests that the Court should have made its decision, not on the basis of which category the variable annuity most resembled, but, rather, which form of regulation most suited this type of annuity-security scheme. Whether such an approach would have produced a different holding is questionable. Nevertheless, as the law exists today a variable annuity is a security, and a company primarily engaged in issuing variable annuities will be regulated as an investment company.

The primary importance of the principal case is that it raises the question of whether the *VALIC* rule was meant to apply to a company such as Prudential whose dominant business is the issuance of insurance.[19] *VALIC* involved a company engaged *primarily* in the sale of variable annuities; it was not an "insurance company" within the Investment Company Act definition[20] and thus could not invoke the section 3(c)(3) exemption from federal regulation, once the Court had decided that a variable annuity is a security. The question of whether this is a valid distinction for regulatory purposes is not answered by a simple conceptual analysis such as was employed in *VALIC*. Rather, it requires an analysis which the critics said *VALIC* avoided—an evaluation of state and concurrent state-federal regulation, both of which are applicable on technical grounds, and both of which, arguably, are applicable on policy grounds.[21] The SEC declared in the principal case that the adequacy of state regulation was irrelevant, and that the only consideration was the relationship between the variable annuity holder and the issuing company—a relation-

Investment Company Act were enacted before there was any thought of variable annuities, indeed, before Congress even realized its power to regulate insurance. See H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933). In 1944 the Supreme Court reversed the settled view that the insurance business did not involve interstate commerce. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944), overruling Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1869). Congress then passed the McCarran-Ferguson Act to assure the states that it did not intend to exercise this newly discovered power. Since the dual nature of the variable annuity brings it within the scope of both securities legislation and the insurance company exemption of § 3(c)(3), the question as to which one applies cannot be answered by reference to the laws themselves. Professor Mearns has stated that "the *VALIC* case should have been treated as a problem created by the acts of an inconsiderate sovereign. One of his commands could be obeyed, but not both. Pick one, deny the other, and your reasons for doing so must ultimately rest on values indicating that the particular command selected was the one which *ought* to be obeyed. Yet no one of the opinions makes it clear what values were relied upon." Mearns, *supra* note 9, at 845. See also 56 MICH. L. REV. 656 (1958).

19 See VALIC, 359 U.S. 65, 74 n.3 (1959). The Investment Company Act defines "investment company" in § 3(a)(1) as any issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities." 54 Stat. 797 (1940), 15 U.S.C. § 80a-3(a)(1) (1958). This definition would apply to Variable Annuity Life Ins. Co., but could not cover Prudential. It is arguable, then, that the Court did not contemplate extension of its holding to a company squarely under the "insurance company" definition of § 2(a)(17). 54 Stat. 793 (1940), 15 U.S.C. § 80a-2(a)(17) (1958). See generally 71 HARV. L. REV. 562, 563 (1958); 8 KAN. L. REV. 492, 495 (1960).

20 See note 2 *supra*.

21 See Mearns, *supra* note 9, at 847; *cf.* 71 HARV. L. REV. 562 (1958).

ship which *VALIC* had held was an investment transaction. Prohibited by the section 3(c)(3) from classifying Prudential as an "investment company," the Commission reasoned that the variable annuity segment of Prudential's business was a separate entity—an investment company created by Prudential and subject to federal securities regulation as such. The SEC apparently created this fictional "entity" only to define the scope of federal regulation;[22] it indicated that enactment by the states of legislation to accommodate insurance regulation affecting variable annuities with the federal requirements would be appropriate.[23] In practice, there is hardly any separation between the insurance company and the investment fund since the "pay-in" or investment period, as well as the annuity period, must be managed in harmony with the actuarial function.[24] So too, the interdependence of the investment fund and general surplus, as planned by Prudential, would provide the annuitant some protection from malfeasance in the management of the investment fund as well as erroneous computation in the actuarial department.[25] Thus, not only does a literal reading of the Investment Company Act permit classification of Prudential, including its business in variable annuities, as an "insurance company," but, also unlike *VALIC*, the existence of a business devoted primarily to insurance provides investment protections which were noticeably lacking in a company such as Variable Annuity Life Ins. Co. Indeed, the absence of these protections explained why sale of variable annuities by Variable was prohibited in most states,[26] and further indicates why federal regulation was necessarily imposed by the Supreme Court.

22 The Commission differentiated the investment fund from the insurance company on the basis of the promises: "[I]nsurance promises are made solely by the insurance company and supported by its assets (not including the investment fund); investment participations are measured solely by the investment fund (separate from the insurance company's assets)." Principal case at 7. The difficulty in this separation is that under Prudential's plan any dividend surpluses (excess over amounts estimated to be needed for administrative expenses of the variable annuity operation) are available for other operations of the insurance company; also, any deficiencies in the variable annuity operation resulting from lower mortality than assumed will be covered by the insurance company's general surplus. This "pourover" of profits and losses does not appear similar, even in its "entity" form, to an investment company. See principal case at 3-4.

23 In response to Prudential's contention that Investment Company Act regulation would make it impossible for an insurance company to issue variable annuities, the Commission stated: "[I]t seems highly unlikely that any state, including New Jersey, would be reluctant to join with the largest insurance company in its jurisdiction to provide for a legitimate expansion of its business by amending its insurance code." Principal case at 7.

24 See Johnson, *supra* note 8, at 372.

25 See note 22 *supra*.

26 Almost all states have quantitative and qualitative standards for the investments which can be made by insurance companies in common stocks; see, *e.g.*, MINN. STAT. ANN. § 61.11(5) (Supp. 1961); PA. STAT. ANN. tit. 40, § 506.1(g)(2) (1954). See also VALIC, 359 U.S. 65, 94 (1959); PATTERSON, ESSENTIALS OF INSURANCE LAW 45-46 (2d ed. 1957). Variable Annuity Life Ins. Co., being composed almost entirely of common stock investments, could operate only as a seller of securities. Note, however, that Prudential could sell the variable annuities within these state laws since its common stock proportion would not exceed the maximum allowed. Apart from the variable annuity issuers, there

Not only do the policy reasons underlying the *VALIC* decision appear to be inapplicable to Prudential's circumstances, but the imposition of investment company regulation upon the issuer of the variable annuity effectively removes several of the "insurance" characteristics of this type of contract. Specifically, the redemption requirements of section 22(e) of the Investment Company Act and the public offering price standard of section 22(d) (exemptions from which were denied in Prudential's alternative application) preclude Prudential's proposals for a thirty-six month redemption period, which would discourage speculation,[27] and prohibit a policy provision which would encourage timely payment of premiums by charging the defaulting annuitant a slight penalty. In return for this dilution of the variable annuity as an insurance plan, federal regulation offers investor control of the investment fund "entity" through voting rights, a board of directors substantially independent from the insurance company, and more detailed information to the variable annuitant regarding the condition of the fund. The need for investor control and independence of directors would seem to be offset by a need, unique in the insurance industry, for coordination of the investment and actuarial functions. The protection intended by independence of directors could be achieved more expediently under the New Jersey laws which provide for appointment of six directors by the Supreme Court of New Jersey.[28] Under New Jersey law, the reliance of the variable annuity fund upon the actuarial skill, as well as the assets, of the insurance company would not be obstructed. It might also be argued that the typical annuitant, primarily interested in an adequate retirement plan (as opposed to the more speculative interests of the investment company stockholder), would gain little advantage from the more elaborate federal disclosure provisions.[29] It appears, then, that under federal regulation the variable annuity is substantially changed from a retirement plan to what more closely resembles a medium for speculation. If the premise may be indulged that the *VALIC* decision left a rational opening for continued exclusive state regulation of variable annuities when sold by a company "primarily engaged" in the insurance business, it appears that the regulation available under New Jersey law would afford a more reasonable system of regulation than would the Investment Company Act. Moreover, the combined impact of federal securities regulation and state in-

appears to be a trend among insurance companies toward increased common stock trading. See VANCE, INSURANCE § 5, at 43 (3d ed. 1951).

27 See Haussermann, *supra* note 6, at 386. See also Comment, 42 MINN. L. REV. 1115, 1133 (1959), in regard to the N.A.I.C. proposal that speculation in variable annuities be prevented by prohibiting lump sum withdrawal of the cash value of the annuitant's "units." New Jersey law requires the thirty-six month payment period. N.J. REV. STAT. § 17:35A-5(d) (Supp. 1963).

28 See N.J. REV. STAT. §§ 17:34-3.12 to .22 (Supp. 1963). Other provisions enacted specifically to regulate the sale of variable annuities are codified in N.J. REV. STAT. §§ 17:35A-1 to -13 (Supp. 1963).

29 See Comment, *supra* note 27, at 1128; *but cf.* Haussermann, *supra* note 6, at 390.

surance (and security) regulation may well discourage the sale by insurance companies of the potentially beneficial variable annuity.

However, the apparent adequacy of New Jersey regulation of a company such as Prudential, and the burdening effects of concurrent state-federal regulation, do not dispose of the argument for the protections of the Investment Company Act. Underlying the reasoning of both *VALIC* and the principal case must have been the recognition of a need for a basic set of uniform requirements for variable annuity issuers throughout the nation—a need which could only be answered by the federal government. Regardless of what might be adequate supervision in New Jersey, other states, administering different insurance and securities laws, might fall far below the minimum protections provided by federal regulation. So too, the creation of new variable annuity companies, or assumption of the scheme by existing companies, could develop problems and dangers for the annuitant faster than state legislatures would be able to enact protective measures. The true balancing involved, then, was not between exclusive regulation under New Jersey laws and the added confusion under concurrent regulation. Rather, it would appear that the Commission weighed the value of uniform, nationwide investor protection against the inherently inconsistent nature of state regulation, and found the former policy ultimately less confusing and more beneficial. The *VALIC* decision, as written, did not command such an extension as the principal case reached; however, both decisions seem to reflect a careful evaluation of state insurance regulation and a choice of concurrent state-federal regulation. Recalling the catastrophic beginnings of the unregulated investment company industry, the caution, despite the confusion, appears justified.

In light of the holding in the principal case, it would appear that future sales by insurance companies of variable annuities will necessarily be conducted through a subsidiary possessing a high degree of independence, as required by section 10 of the Investment Company Act.[80] Another possibility is that the insurance industry will drop the variable annuity entirely and leave its development to the "investment companies" such as Variable, whose prospectus was cleared by the SEC in 1960.[81] A third possibility would be to modify the variable annuity contract to provide a certain minimum guaranteed return. A partial assumption of investment risk by the insurer should bring the variable annuity back into the insurance category.[82]

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80 54 Stat. 806 (1940), 15 U.S.C. § 80a-10 (1958).

81 See Variable Life Ins. Co. of America, Investment Company Act Release No. 2975, Sept. 6, 1960. In contrast to Prudential, which was required to be registered under the Investment Company Act only to the extent of the investment fund, Variable was completely brought under the act, then given exemptions for its life and disability insurance contracts. See 1 LOSS, SECURITIES REGULATION 501 (2d ed. 1961).

82 See VALIC, 359 U.S. 65, 71 (1959).