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Regulation of Business - Securities Act of 1933 - SEC Loses Fight to Regulate Variable Annuity

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REGULATION OF BUSINESS—SECURITIES ACT OF 1933—SEC LOSES FIGHT TO REGULATE VARIABLE ANNUITY—The defendant, Variable Annuity Life Insurance Company, regulated as a life insurance company by the District of Columbia, issued a contract[1] which it termed an annuity, but which differed from a conventional annuity in certain important respects. Ordinary annuity premiums are invested in debt securities while the premiums paid on the variable annuity are invested in common stocks. Further, instead of benefit payments in fixed dollar amounts, the variable annuity's benefits fluctuate since the value of the fund from which they are paid is affected by changing stock prices and dividend policies.[2] The SEC, claiming these provisions brought the contract within the definition of a security in the Securities Act of 1933[3] and the company, within the definition of an investment company in the Investment Company Act of 1940,[4]

[1] The defendant issued five different policies, two individual and three group. For an example of a variable annuity contract see the appendix to the principal case at 529.

[2] For a more comprehensive description of the securities aspects, see Long, "The Variable Annuity: A Common Stock Investment Scheme," 1956 INS. L. J. 393.

[3] 48 Stat. 74 (1933), 15 U.S.C. (1952) §77b. "The term 'security' means any . . . certificate of interest or participation in any profit-sharing agreement, . . . investment contract. . . ."

[4] 54 Stat. 789 (1940), 15 U.S.C. (1952) §80a-3. "'[I]nvestment company' means any issuer which—(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities. . . ."

sought to enjoin the issuance of policies until the defendant complied with the provisions of the acts. *Held,* complaint dismissed. Because of the novelty of the agreement the court is unable to classify it either as a security or an annuity.[5] Congress must decide whether there is to be federal regulation of the securities aspect of this contract. *SEC v. Variable Annuity Life Insurance Company,* (D.C. D.C. 1957) 155 F. Supp. 521.

Until the decision in *United States v. Southeastern Underwriters Association*[6] the Supreme Court had held that insurance was not commerce within the meaning of the commerce clause.[7] Although that decision opened the way to federal action in the insurance area, Congress immediately took steps to nullify its effect by passing the McCarran-Ferguson Act of 1946[8] which, as interpreted by the courts,[9] forbids any federal regulation of insurance except by statutes enumerated therein; where the state has not taken steps to regulate; or where Congress passes a statute expressly relating to insurance. Since the facts of the principal case do not permit federal regulation under the exceptions contained in the act, had the court found the contract to be one of insurance, congressional legislation would be necessary prior to any SEC action. If, however, the unusual provisions of the contract had caused the court to regard it strictly as a security, the agreement would be subject to federal regulation even though the issuer called the contract an "annuity."[10] The question whether the contract should be treated as a security or an annuity still demands judicial determination despite the court's reluctance to decide the controversy.[11] In attempting to classify the agreement, advocates for either treatment can point to definite characteristics supporting their respective views. Balanced against the security-like provisions are the use of mortality and annuity tables which insure that an individual will not outlive his benefit fund, and the withholding of any benefits until the start of the

5 The court also stated that the wording and history of the McCarran-Ferguson Act, 59 Stat. 33 (1945), as amended, 61 Stat. 448 (1947), 15 U.S.C. (1952) §1011, precluded regulation in light of the insurance aspects of the contract. Whether the novelty of the contract or the McCarran-Ferguson Act or both formed the basis for the court's decision is uncertain. The ambiguous opinion has also been analyzed as holding that the contract was a security, but that it was also an annuity and exempt under the McCarran-Ferguson Act. 71 HARV. L. REV. 562 (1957).

6 322 U.S. 533 (1944).

7 Paul v. Virginia, 8 Wall. (75 U.S.) 168 (1869); Hooper v. California, 155 U.S. 648 (1895); New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495 (1913).

8 59 Stat. 33 (1945), as amended, 61 Stat. 448 (1947), 15 U.S.C. (1952) §1011.

9 See Prudential Ins. Co. v. Benjamin, 328 U.S. 408 at 429 (1946); American Hospital and Life Assn. v. FTC, (5th Cir. 1957) 243 F. (2d) 719; National Casualty Co. v. FTC, (6th Cir. 1957) 245 F. (2d) 883.

10 See SEC v. Howey Co., 328 U.S. 293 (1946).

11 The contract must be insurance before the McCarran-Ferguson Act governs. Because of Congress' seeming distaste for federal entry into the regulation of insurance company products [See generally S. Hearing before Subcommittee of Committee on Judiciary on S. 1362, 78th Cong., 1st-2d sess., pp. 1 to 22], the regulation, if needed, will probably have to arise from court interpretation of existing legislation.

annuity payment period, clearly insurance provisions.[12] The fact that its characteristics lend themselves to either classification indicates that the real basis of the decision must be on ground of policy, namely, the desirability of federal regulation in this area.[13] This in turn depends on whether issued contracts should be subject to the full disclosure standards which are the salient feature of federal securities regulation.[14] The requirement that all representations be candid assumes even greater importance for variable annuities than for ordinary securities when it is realized that the variable annuity will ordinarily serve as a retirement refuge. Some have contended that state agencies can more effectively accomplish all that the SEC can do.[15] While it may be conceded that the company itself can be competently regulated by state insurance boards, the fact that states also regulate securities has not proved that federal securities regulation is superfluous, since the federal government took steps to regulate securities only after state Blue Sky laws had proved inadequate.[16] Therefore, it would seem that a system of concurrent jurisdiction would be the most desirable solution in this area. Regulation by the SEC looks primarily to full disclosure of the terms of the security, and making this information available to the public should help protect it from possible misrepresentations by companies less responsible than defendant and deter the formation of such companies because of the possibilities of federal penalties.[17] This would seem to complement, not interfere with, the usual state regulation of mortality tables, interest rates, waiver of premiums and other traditional areas of insurance regulation.[18] Such a result would have the dual purpose

[12] There are also provisions suspending premium payments in case of disability of the policyholder. On his death his entire interest in the contract is terminated. But see Booth v. Ammerman, 4 Bradf. (N.Y.) 129 (1856), for a classic definition of an annuity: ". . . a stated sum per annum . . . not income or profits." For a more extensive discussion of the contract, see Morrissey, "Dispute Over the Variable Annuity," 35 HARV. BUS. REV. 75 (1957); Day, "Variable Annuity Is Not a 'Security,'" 32 NOTRE DAME LAWYER 642 at 645 (1957); Johnson, "The Variable Annuity, What It Is and Why It Is Needed," 1956 INS. L. J. 357.

[13] Two aspects of the security versus insurance problem are important in any consideration of variable annuities, but could be solved by federal legislation without the regulation of the contracts as securities: (1) Any tax advantages which the contracts have over their opposite numbers in the Mutual Fund area should be eliminated by a change in the tax laws. (2) Large scale institutional buying of common stocks by insurance companies may call for a revision of our securities market structure. See Morrissey, "Dispute Over the Variable Annuity," 35 HARV. BUS. REV. 75 at 81 (1957).

[14] See SEC v. Universal Service Assn., (7th Cir. 1939) 106 F. (2d) 232 at 237, cert. den. 308 U.S. 622 (1940).

[15] See the arguments in 43 VA. L. REV. 699 at 710 (1957); Day, "A Variable Annuity Is Not a 'Security,'" 32 NOTRE DAME LAWYER 642 at 680 (1957).

[16] See LOSS, SECURITIES REGULATION 56 et seq. (1951). See also p. 19 for a survey which indicates that state statutes are of doubtful effectiveness today.

[17] 48 Stat. 82, 87 (1933), 15 U.S.C. (1952) §§77k, 77*l*, 77x.

[18] See, e.g., Ill. Rev. Stat. (1957) c. 73, §838. A similar double regulation system exists in those states having Blue Sky Laws today. See LOSS, SECURITIES REGULATION 47 (1951).

of satisfying public need for disclosure of facts about the security aspects of the contract, enabling the purchaser to evaluate better the possibilities of fluctuating income, while giving the insurance companies no real fears of extensive federal interference with managerial decisions in their business. If the courts are unwilling to reach such a result, legislation would seem appropriate[19] in order that purchasers of this admittedly valuable addition to private retirement plans will be adequately protected in their acquisition.

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[19] But see note 11 supra.