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INSURANCE COMPANY INVOLVEMENT IN THE MARKETING OF EQUITY PRODUCTS

PAUL R. HUARD*

INTRODUCTION

It is by now an accepted fact that life insurance companies—on a rather large scale—have taken the "almighty leap" into the distribution of equity-based products.[1] Initially, perhaps, the movement was reluctant; traditionally, career life insurance agents had been instilled with distinctly unkind attitudes regarding the wisdom of investing in common stocks or other equity vehicles such as mutual funds. However, a glance at statistical data from the post-war decades shows that insurers came to have good reason to reassess that position. During the period from World War II to the late 1960's, the insurance industry's share of the American savings dollar fell by about two-thirds, even though assets held by insurers had increased substantially when measured in absolute terms.[2] On the other hand, interest in equity investments grew steadily; during roughly the same period, the assets held by the mutual fund industry increased more than a hundred-fold, and the number of mutual fund shareholders increased more than fifteen times.[3] A marked change in consumer preferences was underway, apparently motivated by a desire for protection against inflationary increases in the cost of living.

The current movement into equity distribution represents the life insurance industry's response to this change. Insurers have discovered that offering only their traditional products, which provide solely for fixed-dollar returns, places them at a disadvantage in competing for the consumer's investment dollar. Moreover, state insurance laws require that the assets held by insurers to back such traditional products be invested in nonequity securities.[4] Accordingly, many insurers

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1 Sheehan, Life Insurance's Almighty Leap Into Equities, 78 Fortune 142 (Oct., 1968).

2 Routier, The Mutual Fund Approach to Equity Products, 1968 Proceedings of the Legal Section, American Life Convention 13; Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. pt. 2, at 510 (1971) [hereinafter cited as SEC Institutional Investor Study].

3 The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Lawyer 732, 737 (1969).

4 Sheehan, supra note 1, at 146.

have concluded that they must offer equity-based products if they are to get a bigger share of the public savings dollar.[5] While such products vary over a broad spectrum, and a few companies have dabbled with some of the less common varieties such as real estate investment trusts and interests in oil and gas drilling ventures,[6] insurers have concentrated primarily on mutual funds and variable annuities. A potential third major product, variable life insurance, is currently being developed for sale.

This article examines the insurance industry's involvement with these three equity products. The article will assess each product in turn, describing its major features, outlining the applicable federal regulatory scheme, and discussing insurers' present and prospective activities with regard to sales of that product.

Finally, it will describe the position of the industry regarding regulation of variable life insurance. Although at this time sales of this product are only prospective, all segments of the industry are eagerly awaiting the outcome of the current Securities and Exchange Commission (SEC) hearings regarding the propriety of federal regulation of this product.

I. Mutual Funds

A. *Introduction*

A mutual fund is technically defined as an open-end management investment company.[7] As such, it invests in corporate stocks and sells to the public securities representing a pro rata share of its investments.[8] Typically, those investments are concentrated in a diversified

[5] See SEC Institutional Investor Study, supra note 2, at 508-11.

[6] Id. at 511.

[7] The Investment Company Act of 1940 defines an investment company, for the purposes of the Act, 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;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(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 (exclusive of Government securities and cash items) on an unconsolidated basis.

Id. § 3(a), 15 U.S.C. § 80a-3(a) (1970).

[8] Approximately 93.0 percent of the total net assets of mutual funds consisted of corporate securities, according to a study undertaken in 1958. Common stocks constituted 76% of net assets. Wharton School of Finance and Commerce, A Study of Mutual Funds, Prepared for the Securities and Exchange Commission, H.R. Rep. No. 2274, 87th Cong., 2d Sess. at 128 & 119 (1962).

common stock portfolio. As an open-end investment company, the fund is obligated to redeem the shares it issues upon demand,[9] in contrast to a closed-end investment company which is under no such duty.[10]

Thus an investor in a mutual fund obtains professional management of a portfolio of investment securities in which he has a proportionate interest. This management will have certain specific objectives, such as preservation of capital, long-term growth, or production of current income. Since objectives vary among different funds, an investor may choose one with investment policies and goals suited to his own particular purposes. The mutual fund shareholder also obtains a diversification of his investment risk, for the assets of the fund generally will be invested in as many as fifty or more different issues of securities.[11] Moreover, such diversification is available to the investor at a much lower capital outlay than would be necessary if he were to enter the stock market directly and attempt to spread his purchases among an equivalent number of securities. It appears safe to assume that such singular advantages will continue to attract increasingly large numbers of investors.[12]

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9 Investment Company Act of 1940 § 5(a)(1), 15 U.S.C. § 80a-5(a)(1) (1970).

Before redeeming outstanding shares, the company must compute the net asset value per share, calculated as follows. The total net asset value of the fund is determined on the basis of the current market prices of the fund's holdings. This figure is then divided by the total number of fund shares outstanding, yielding a per share redemption value. Rule 22c-1, promulgated under the Investment Company Act, requires that the net asset value of fund shares be computed not less often than daily or of the time trading closes on the New York Stock Exchange. 17 C.F.R. 270.22c-1(b) (1971). Current net asset value quotations for almost all funds of significant size appear in many daily newspapers.

10 Section 5(a)(2) of the Investment Company Act defines closed-end companies broadly as "any management company other than an open-end company." 15 U.S.C. § 80a-5(a)(2) (1970). Section 5(b) of this Act further classifies management companies as diversified and nondiversified, according to diversification in asset holdings of the company. 15 U.S.C. § 80a-5(b) (1970).

11 Under the Investment Company Act, a diversified company must invest at least 75% of the value of its assets in cash, government securities, securities of other investment companies or other securities "limited in respect of any one issuer to an amount not greater in value than 5 per centum of the value of the total assets of such management company and to not more than 10 per centum of the outstanding voting securities of such issuer." Section 5(b)(1), 15 U.S.C. § 80a-5(b)(1) (1970).

12 A nationwide survey by National Analysts, Inc., conducted for the Investment Company Institute, found that the most extensively appreciated advantage of mutual funds was diversification. Other recognized advantages were the shareholder's obligation to contribute regular payments, the superior performance of fund shares as compared to bank savings, fund management investment skills, capital gains tax advantages, and the protection offered against inflation. Wiesenberger Services, Inc., Mutual Affairs, vol. 11 no. 5 at 4 (May, 1971) [hereinafter cited as Mutual Affairs]. See also A Study of Mutual Funds, supra note 8 at 3-6. "[T]his diversification of risk and widespread acceptance of the associated indirect investment in common stock tends to lower the cost of equity capital and stimulate riskier undertakings, with a higher average rate of return than would probably otherwise be realized for a given total investment." Id. at 3.

B. *The Entry of Insurers into the Field of Mutual Funds: General Regulatory Considerations*

Regulation by the SEC necessarily accompanies entry into the mutual fund field. Any mutual fund, once formed, must be registered under the Investment Company Act of 1940,[13] and its shares must be registered under the Securities Act of 1933.[14] The entity which manages the fund must register as an investment adviser under the Investment Advisers Act of 1940.[15] The entity which will act as the distributor for fund shares, usually a subsidiary established for this purpose, must register as a broker-dealer pursuant to the requirements of the Securities Exchange Act of 1934.[16] Compliance with the 1934 Act also requires that sales personnel take qualifying examinations and that the activities of such personnel be adequately supervised.[17]

[13] 15 U.S.C. §§ 80a-1 et seq. (1970). The Investment Company Act imposes requirements regarding the composition of a fund's board of directors (§§ 9, 10, 16, 15 U.S.C. §§ 80a-9, 10, 16 (1970)), regulates purchases and sales between the fund and affiliated persons (§ 17, 15 U.S.C. § 80a-17 (1970)), governs investment advisory and underwriting contracts (§ 15, 15 U.S.C. § 80a-15 (1970)) and prohibits the fund from making changes in its basic policies or classifications without shareholder approval (§ 13, 15 U.S.C. § 80a-13 (1970)). Also, the 1940 Act imposes price maintenance rules on mutual fund shares to prevent price discrimination against investors. Section 22, 15 U.S.C. § 80a-22 (1970). For a detailed discussion of § 22(d) see Hodes, Recent Developments under Section 22(d) of the Investment Company Act, at p. 1061 supra.

In addition, the 1940 Act requires filing of all sales literature used in conjunction with the sale of fund shares with the SEC or the National Association of Securities Dealers (NASD). See notes 23-27 and accompanying text infra. A comprehensive discussion of the regulatory considerations relevant to an insurance company's engagement in mutual fund sales is contained in Kannel, Life Companies and the Mutual Fund Business: The Out-Heroding of Herod, Paper Presented to the Association of Life Insurance Counsel (Dec. 8, 1969), reprinted in 21 Association of Life Insurance Counsel Proceedings 165 (1969-1970).

[14] 15 U.S.C. §§ 77a et seq. (1970). Section 5(a) of this Act makes it unlawful to use the mails or any other facilities in interstate commerce to sell or transport any securities covered by the Act which are not registered. 15 U.S.C. § 77e(a) (1970). Section 7 of the 1933 Act outlines the information required in a registration statement. 15 U.S.C. § 77g (1970). However, Section 24(a) of the Investment Company Act provides for filing a registration statement pursuant to the 1940 Act in lieu of filing the statement outlined in Section 7 of the 1933 Act. 15 U.S.C. § 80a-24(a) (1970).

In addition to the initial registration of the fund's shares, the 1933 Act further requires that a prospectus precede or accompany all sales of registered shares, informing investors of all facts relevant to the security and its issuer. Section 5(b), 15 U.S.C. § 77e(b) (1970). The prospectus must conform to the requirements of Section 10, 15 U.S.C. § 77j (1970). See generally 1 L. Loss, Securities Regulations chs. 2, 3. (2d ed. 1961).

[15] 15 U.S.C. §§ 80b et seq. (1970). This requirement is a relatively recent development resulting from the Investment Company Amendments Act of 1970. Prior to December 14, 1971, advisers whose sole clients were investment companies were exempt from registration under § 203(b)(2) of the Adviser's Act. 15 U.S.C. § 80b-3(b)(2) (1970), as amended by Act of Dec. 14, 1970, Pub. L. No. 91-547, § 24(a), 84 Stat. 1413.

[16] 15 U.S.C. § 78a et seq. (1970). Registration requirements for broker-dealers is set out in § 15, 15 U.S.C. § 78o (1970). The 1934 Act also seeks to guarantee that dealers are financially responsible by mandating the maintenance of minimum capital requirements. Section 15(b), 15 U.S.C. § 78o(b) (1970).

[17] Section 15(b)(8), 15 U.S.C. § 78o(b)(8) (1970).

The most important effect of registration under the 1934 Act is the subjection of the registrant company, the broker-dealer, as well as its individual sales personnel, to the Act's multifold antifraud provisions.[18] The broker is subject to civil and criminal liability, and violations of the Act's provisions may result in temporary or permanent revocation of a dealer's registration.[19] Finally, as a practical matter, the distributing entity will usually become a member of the National Association of Securities Dealers, Inc. (NASD), and will be subject to that organization's rules regarding sales practices and qualification of personnel.[20]

The fund must also comply with the requirements of state securities laws,[21] which are usually limited to registration of the fund shares and of the distributing broker-dealer. State requirements may vary a great deal, however; 1933 Act registration is sufficient to qualify fund shares in some states, while in others a complete and detailed separate state registration is mandated. For the most part, insurance companies have not found the problem arising from involvement in mutual funds sales more difficult than those encountered by the rest of the futual fund industry.[22] The particular difficulties that they do encounter lie primarily in the areas of sales practices and joint trans-

See NASD Rules of Fair Practice, CCH, NASD Manual ¶ 2001 (1971). See also Middlebrook and Gingold, Mass Merchandising of Equity Products by Insurance Companies, 3 Conn. L. Rev. 44 (1970).

18 Sections 7, 9, 10, 14, 16, 18, 20, 29, 15 U.S.C. §§ 78g, i, j, n, p, r, t, cc (1970).

19 Section 15(b)(7); 15 U.S.C. § 78o-3(*l*) (1970).

20 It is possible under Section 15(b)(8) of the Exchange Act for a broker-dealer to elect direct regulation by the SEC or the NASD. 15 U.S.C. § 78o(b)(8). However, in the case of a broker-dealer who wishes to sell established mutual funds, this is an illusory choice. Section 25 of the NASD's Rules of Fair Practice prevents NASD members from dealing with nonmembers other than on the same basis as the general public, and most mutual fund principal underwriters are NASD members. CCH, NASD Manual (1971). As such they are prohibited from extending dealer concessions or discounts to nonmembers who may want to sell the funds they distribute, so that the maximum potential profit to the nonmember and its salesmen on such a transaction is exactly zero. This rule has been challenged by an insurance company and two of its subsidiaries which are non-NASD broker-dealers and the hearing examiner has held in his initial decision that Rule 25 should be abrogated in part. All parties, including the NASD, have appealed the decision and the matter is now pending final resolution by the Commission itself. SEC Administrative Proceeding File No. 3-2428.

21 Section 18 of the 1933 Act preserves the rights of states to regulate securities despite the federal right to regulate. 15 U.S.C. § 77r (1970).

For detailed analyses of the problems in the area of state securities laws, see Ostlund, State Blue Sky Laws: Problems for Variable Annuity Companies; Problems for Mutual Fund Companies—Correlated Sales Problems, 1968 Proceedings of the Legal Section, American Life Convention 230; Googins, Blue Sky Laws—Some Lingering Clouds, 3 Conn. L. Rev. 1 (1970); and Wilson, State Regulation of a Broker-Dealer Selling Variable Annuities or Mutual Funds, 1970 Proceedings of the Legal Section, American Life Convention 43.

22 See generally Kannel, supra note 13.

actions between the insurance company's mutual fund subsidiary and the insurer's general investment account.

Selling mutual fund shares offers a new challenge to insurers in that the disclosure requirements and advertising limitations of the securities laws apparently require the insurance companies to abandon the marketing and advertising techniques usually employed to sell traditional insurance products. For example, all offers for the sale of mutual fund shares must be accompanied by a prospectus[23] as defined in Section 10 of the Securities Act of 1933.[24] The prospectus, a disclosure document rather than a sales document, is strictly limited in content and scope. Advertisements that comply with Rule 134 of the 1933 Act are permitted, but the information which may be listed in the so-called tombstone advertisement is so precisely curtailed that its usefulness is doubtful.[25]

All other sales literature issued in connection with the sale of mutual fund shares must be filed with the SEC as well as the NASD, and must comply with the Statement of Policy (SOP), a strict set of guidelines governing advertising promulgated by the SEC.[26] Although this requirement is common to the entire mutual fund industry, insurance companies have found it difficult to adapt their advertising practices to the rather inflexible requirements of the SOP, because they are accustomed to use liberal promotional practices when selling their traditional insurance products. Data commonly used to promote the sale of life insurance, such as performance projections and product comparisons, are strictly prohibited in mutual fund sales literature.[27] Moreover, an insurance company's burden of compliance with these strict standards may be heavier than that borne by other entities in the fund industry, because the insurer must supervise a large number of sales agents. Representatives of the insurance industry met recently with the SEC staff to discuss possible changes in advertising standards, and the Commission is now considering amendments to SEC rules

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[23] Section 5(b) of the Securities Act of 1933, 15 U.S.C. § 77e(b) (1970).

[24] 15 U.S.C. § 77j (1970).

[25] 17 C.F.R. § 230.134 (1971). A proposed Amendment to this rule is under current consideration. See Romanski, The Role of Advertising in the Mutual Funds Industry, at p. 959 supra, for a detailed discussion of mutual fund advertising and an analysis of current developments in the area.

[26] Securities Act Release No. 3856, 22 Fed. Reg. 8977 (Nov. 5, 1957), amending Release No. 3530; 20 Fed. Reg. 791 (Jan. 31, 1955). The SOP covers virtually all literature relating to mutual funds, including reports to shareholders. Its restrictions are so specifically detailed that, as one writer has observed, "it has forced all mutual fund advertising into a narrow, stereotyped and unexciting pattern, which was undoubtedly the purpose of the entire exercise." Kannel, supra note 13, at 230.

[27] Rule 134, 17 C.F.R. § 230.134 (1971). Securities Act Release No. 4709 (July 14, 1964) 1 CCH Fed. Sec. L. Rep. ¶ 1461 (1971). See also Romanski, The Role of Advertising in the Mutual Funds Industry, pp. 959-63 supra.

governing advertising of mutual funds.[28] The industry is hopeful that revisions it considers necessary will be forthcoming.

Insurance companies have for some time questioned the provisions of Section 17 of the Investment Company Act as applied to transactions involving both an insurance company's general investment account and its affiliated mutual fund.[29] Section 17, an attempt to enjoin self-dealing, proscribes certain joint transactions between an investment company and its affiliates.[30] The Commission's interpretation of the section was promulgated in Rule 17d-1, and is widely regarded in the industry as further obscuring rather than clarifying the many questions that arise concerning the nature of the joint participations proscribed. Such questions cause widespread concern, since the insurance company risks violating Rule 17d-1 in any number of transactions involving stockholdings common to its general investment and mutual fund accounts.[31] The insurance industry is presently seeking an amendment to, or revision of, Rule 17d-1 which would remove its ambiguities and eliminate the current requirement that an individual ruling be obtained for every exemption to the rule's prohibition of joint transactions.[32]

C. *The Entry of Insurers into the Field of Mutual Funds: Specific Methods and Regulatory Considerations*

1. *The Company-Organized Mutual Fund Complex*

The formation of a self-organized mutual fund is the most straightforward method of entering the mutual fund business. It is by no means the easiest. Utilization of this approach creates federal and state regulatory problems that do not arise if the insurance company purchases, or enters into a selling agreement with, an existing fund.[33] Moreover, a company choosing this route faces particular corporate legal problems and nonlegal administrative difficulties.[34] Specific regulatory problems presented in the creation of a mutual fund complex include initial federal and state registration of a fund's securities,

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28 Routier, Federal Securities Regulation 1971 at 57, Paper Presented Before the American Life Convention (Oct. 26, 1971), to be reprinted in 1971 Proceedings of the American Life Convention, Legal Section [hereinafter cited as Routier; citations are to manuscript pages].

29 15 U.S.C. § 80a-17(d) (1970).

30 15 U.S.C. § 80a-17(d) (1970); 17 C.F.R. § 270.17d-1 (1971).

31 Rule 17d-1, 17 C.F.R. § 270.17d-1 (1971).

32 Investment Company Act Release No. 7035 (March 9, 1972).

33 See Thornsjo, Legal Problems and Processes in the Formation of a "Mutual Fund," 1967 Proceedings of the Legal Section, American Life Convention 61; Kannel, supra note 13, at 202-14.

34 See sources cited in note 33 supra.

a costly and lengthy process.[35] In addition, the fund is, of course, subject to the general regulations of the Investment Company Act,[36] the Securities Exchange Act[37] and the Investment Advisers Act.[38]

Nonlegal problems encountered in the creation of a mutual fund distinguish this method of entering the field from the alternative approaches available. Many practical business decisions must be made regarding the type of fund desired, selection of its portfolio, the number and price of the shares to be offered, sales charges to be imposed, and bookkeeping and auditing requirements. Distribution arrangements must be made with an underwriter before shares can be offered for sale. Also, acquisition of the necessary management skills may prove difficult and in any case will require expensive contracts with the management team chosen. It has been said that "the creation and launching of a new Fund complex is a major undertaking which obviously should not be taken on without a careful analysis of the costs of the venture and the prospects for success."[39]

Despite these difficulties, most large insurance firms have preferred to build their own mutual fund complex.[40] Self-organization of a fund permits greater profits in the long run, allows the insurer to mold the image and investment objectives of the fund, and guarantees identification of the insurance company with its fund.[41] Perhaps for these reasons, the difficulties inherent in the creation of a mutual fund complex do not appear to have deterred insurance companies from utilizing this route. By the first quarter of 1971, more than sixty insurers had organized a total of eighty mutual funds with total net assets of $823 million.[42] Although this figure represents only 3.5 percent of the total assets in insurance company owned or controlled mutual funds, the number of funds involved is roughly equivalent to the eighty-six funds purchased by insurers and considerably outnumbers the fifty-three funds affiliated with insurers.[43] Furthermore, the performance of company-organized funds has outstripped that of the other types of funds associated with insurers. Between the end of 1970 and March 1971, the aggregate assets of insurer-organized funds grew 16.9 percent.[44] Although this dramatic growth is due in part to their initially

35 See Schneider and Manko, Going Public—Practice, Procedure and Consequences, 15 Vill. L. Rev. 283, 298 (1970).

36 See note 13 supra.

37 See notes 16-19 and accompanying text, supra.

38 15 U.S.C. §§ 80b et seq. (1970).

39 Kannel, supra note 13, at 197.

40 SEC Institutional Investor Study, supra note 2, at 522.

41 Id. at 522-23.

42 Mutual Affairs, supra note 12, at 1. The relatively small overall size of these funds can be attributed primarily to the fact that most have come into existence since 1968. Id.

43 Id. at 1-4.

44 Id. at 1.

low base point, "[n]evertheless, in the light of their newness, the market atmosphere into which they were thrust and sales efforts which at best could be generally considered to be more exploratory than exceptional, the records of these funds need no apology."[45]

2. *The Acquired Mutual Fund Complex*

One of the quickest ways to get into the mutual fund business with a minimum of preparatory work and delay is to acquire a controlling interest in a fund management company and, in cases where the distribution entity is separate from the management company, in the underwriting organization as well. This approach eliminates initial registration difficulties and other problems attached to the creation of a new fund. Of course, if the company still desires to use its own sales force to sell fund shares—as it frequently will—it remains necessary to qualify the salesmen to sell securities.[46] Creation and registration of a broker-dealership may also be a necessity.[47] In addition, the 1934 Act's antifraud strictures, of course, apply.[48] These problems, however, are common to all methods of entry into the field.[49]

The difficulties peculiar to acquisition of a fund arise from the fact that the SEC consistently maintains the position that investment advisory contracts with a mutual fund are automatically terminated upon the sale of a controlling interest in the management company.[50] As a result, approval of new advisory contracts by the shareholders must be secured before the purchasing company can derive any benefit from the controlling interest it has acquired. Proxy solicitation is therefore required, and there always exists the possibility that the shareholders will fail to approve. In practice, however, this simply has not proven to be a problem.[51]

A far more serious difficulty attendant upon the acquisition of a fund has arisen from the recent decision of the Second Circuit in *Rosenfeld v. Black*.[52] In that case, the appellate court held that an investment adviser to a registered investment company may be held accountable, under common law equity principles of fiduciary obligation, for any profits it receives from securing or influencing the transfer of its management contract with such investment company to an-

[45] Id. at 2.
[46] See note 17 supra.
[47] See note 20 supra.
[48] See note 18 and accompanying text supra.
[49] See Kannel, supra note 13, at 181.
[50] Investment Company Act of 1940, § 15(a), 15 U.S.C. § 80a-15(a) (1970); Rule 15a-1, 17 C.F.R. § 270.15a-1 (1971).
[51] Kannel, supra note 13, at 225; Frankel, Variable Annuities, Variable Insurance and Separate Accounts, 51 B.U.L. Rev. 173, 355 (1971).
[52] 445 F.2d 1337 (2d Cir. 1971).

other. This decision would appear to conflict with a prior decision of the Ninth Circuit[53] which dismissed an SEC suit alleging substantially the same cause of action, although the SEC suit was based in part on Section 36(a) of the Investment Company Act of 1940.[54] That decision notwithstanding, *Rosenfeld* appears to have discouraged further transfers of management contracts. It also raises questions concerning the numerous transfers of mutual fund managements which have occurred in recent years, a substantial number of which have involved insurance companies as the acquiring parties.[55] Although *Rosenfeld v. Black* was a suit against the disposing parties, it has been reported that, among the number of similar suits which have been filed since the Second Circuit announced its decision, there is at least one in which an insurance company was named as a defendant.[56]

Important practical advantages arising from acquisition of a fund are the opportunities to buy a profitable, successful company and to acquire a skilled management team. However, these advantages must be weighed against the facts that few such companies are available, and that, if available, their price may be prohibitive. Despite these difficulties, however, statistics show that insurance companies have acquired a significant number of mutual fund management/underwriter organizations, primarily from 1968 through 1970.[57] By the end of March, 1971, a total of eighty-six mutual funds had become part of insurance company complexes in this manner, and the net assets of the funds in this category aggregated about $7.8 billion.[58] The substantially larger aggregate net asset value of these funds as compared to that of company-organized funds is due to the fact that many of the "acquired" funds were well-established and successful operations. It remains to be seen whether insurance company acquisitions of funds will con-

[53] SEC v. Insurance Securities, Inc., 146 F. Supp. 778 (N.D. Cal. 1956), aff'd, 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823 (1958). For a discussion of the SEC's unsuccessful efforts to challenge "trafficking" in the control of fund management companies, cf. The Mutual Fund Industry: A Legal Survey, supra note 3, at 956-67.

[54] Section 36, 54 Stat. 841 (1940), as amended 15 U.S.C. § 80a-35 (1970). This section authorizes injunctive suits directed at breaches of fiduciary duty toward a registered investment company. The *ISI* case involved Section 36 as it stood prior to its amendment by Section 20 of the Investment Company Amendments Act of 1970. Act of Dec. 14, 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1428. It is conceivable that the *ISI* case would be decided differently today under the expanded provisions of amended Section 36, which now provide that breaches of fiduciary duty may be alleged and proved with respect to "payments" received by an investment adviser from an investment company. 15 U.S.C. § 80a-35 (1970). This might be construed as being applicable to profits received by the adviser from the transfer of the advisory contract if such profits are deemed to belong to the investment company.

[55] Routier, supra note 28, at 26.

[56] Id.

[57] Wiesenberger Services, Inc., Investment Companies 1971 at 377.

[58] Wiesenberger Services, Inc., Mutual Affairs, vol. 11, no. 5 at 1 (May, 1971) [hereinafter cited as Mutual Affairs].

tinue in the seventies despite the potential liabilities inherent in this route.

3. *Association with an Existing Fund*

For those companies finding that creation or acquisition of a fund is too ambitious a program, there is a third alternative which is more economical than either in terms of expense involved and degree of regulation encountered. Simply stated, an insurer can always elect to sell someone else's mutual fund shares. The insurer must set up a broker-dealer operation, usually through a subsidiary of the insurance company, and register this broker-dealer with the SEC. The regulatory framework that he must cope with, however, will be limited principally to the Securities Exchange Act of 1934, the various state Blue Sky laws, and the various rules of the NASD.[59] The costs and problems of registering shares under the 1933 Act will not concern him.

While this approach has obvious practical advantages, its limitations must be noted. Should there be actionable or criminal misstatements or material omissions of fact in the fund's prospectus, the insurance company broker-dealer and its salesmen may be held liable for such misstatements or omissions under the federal securities laws.[60] Perhaps the greatest disadvantage of this method is the fact that no profit can be realized from the management aspect of a mutual fund operation. Rather, only the selling agents will realize profits from the sale of an outside fund's shares, although the availability of this equity product in an agent's offerings may help bolster sales of traditional insurance products.[61]

Notwithstanding its limitations, the practice of selling shares of an outside mutual fund is widespread in the insurance industry. As of March 1, 1970, over 160 life insurance companies were members of the National Association of Security Dealers, either directly or through subsidiary broker-dealers.[62] Of these, 130 insurers were selling shares of unrelated funds and only thirty were marketing shares of their own fund.[63] Whatever the method of entry chosen, insurers now appear inextricably committed to involvement with mutual funds.

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[59] See pp. 1198-1201 supra.

[60] See note 18 and accompanying text supra.

[61] The Institutional Investor Study found that of the many factors motivating insurers to enter the mutual fund field, the most important considerations were that "mutual funds [provide] 1) a means of developing a financial package more salable than traditional products in an inflationary environment, 2) a means of increasing agents' income, and 3) a means of increasing sales of individual insurance policies." Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. pt.2, at 529 (1971) [hereinafter cited as SEC Institutional Investor Study].

[62] Id. at 523.

[63] Id.

By March, 1971, 219 mutual funds holding approximately $24 billion, or forty-four percent of the total net assets of the mutual fund industry, were in some way linked to insurance companies.[64] At the same time, more than 160 insurers were actually involved in selling their own mutual fund shares or shares of an unrelated fund.[65] Yet it would seem that the actual volume of mutual fund shares sold by insurance agents is still far below their expected potential,[66] due to the relative novelty of equity products as a part of the insurance sales line.

Insurance companies are excited about this sales potential. There is reason for their optimism. Full-time insurance agents outnumber full-time mutual fund salesmen by more than six to one, a figure which indicates that insurers have marketing forces available which can easily be activated upon proper training and registration. In addition, insurance policyholders, all prospective sales contacts, outnumber mutual fund shareholders by 130 million to 5 million.[67] The implications of these statistics in terms of the insurance industry's potential for reaching a sizeable segment of the investing public are clear. They further evidence the fact that the combination of insurance and mutual funds is here to stay.

II. Variable Annuities

A. *Introduction*

The second major equity product currently marketed by life insurance companies is the variable annuity. An annuity, in simple terms, is a contract under which the insurance company, in return for the consideration paid by the purchaser, agrees, upon maturity of the contract, to make periodic cash payments to the purchaser for the remainder of his life. Under a traditional annuity, the amount of each payment is actuarially calculated when the annuity is purchased, a calculation based upon the annuitant's remaining life expectancy after the date on which payments begin, and, once determined, the amount remains fixed for the duration of the contract. The purchaser of an annuity seeks to insure that, regardless of how long he may live, he will have a guaranteed source of income; however, because annuity payments are fixed, he is not protected against decreases in the purchasing power of his income arising from inflation. The variable an-

[64] Mutual Affairs, supra note 58, at 1. About $15 billion of this figure is held by 53 funds in which the insurance company is a single element in a large fund or corporate complex. Id. at 4.

[65] SEC Institutional Investor Study, supra note 61, at 523.

[66] Id. at 536.

[67] The Mutual Fund Industry, A Legal Survey, 44 Notre Dame Lawyer 732, 874 (1969).

nuity contract was developed to furnish protection against cost-of-living increases. It functions in essentially the same manner as a straight annuity, with one critical distinction: the purchase price of the variable annuity is used to fund a separate account with equity securities, and the periodic payments due the annuitant will vary to reflect the investment performance of this account.[68]

The contract usually has two separate phases. The first is a "pay-in" period during which the contract holder makes installment payments which, after deductions for sales and administrative charges, are applied to the purchase of accumulation units in the separate account.[69] Subsequently, at a date selected by the contract holder—usually retirement—the current value of the units accumulated during the "pay-in" phase is applied to the purchase of an annuity, which may be fixed, variable or a combination of both.[70] The "pay-out" phase then begins and, to the extent the annuity payments elected are variable, they will be adjusted in accordance with the investment performance of the separate account.[71] Thus the variable annuity has the

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[68] Because of the variety of plans possible, the distinction between fixed and variable annuities is not always clear. See G. Johnson and D. Grubbs, Variable Annuities 41 (2d ed. 1970).

Until recently the term "separate account" was not statutorily defined under the federal securities laws. Section 4 of the Investment Company Amendments Act of 1970 added § 2(a)(37) to the Investment Company Act which defines the term as follows:

> (37) "Separate account" means 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.

15 U.S.C. § 80a-2(a)(37) (1970). For a detailed explanation of the separate account concept see Frankel, supra note 51, at 247.

[69] Since the value of these units fluctuates to reflect the investment performance of the separate account, at any given time, its value may be determined in precisely the same manner as the net asset value of a mutual fund share is calculated. See note 9 supra.

[70] It is possible to omit the "pay-in" or accumulation phase by purchasing a variable annuity under which payments to the annuitant begin immediately. In the past, traditional fixed-benefit annuities were sold principally in such single-payment form. Today, however, variable annuities are sold mostly on an installment basis.

[71] The value of each periodic payment under a variable annuity is determined by the then current value of a number of annuity units. Annuity units are similar to accumulation units and are valued in the same manner. For example, if under a particular contract monthly annuity payments are based on the value of 15 annuity units, the monthly payment will be $60.00 if the value of an annuity unit is $4.00. If in the following month the value of an annuity unit has increased to $4.10, the payment in that month will be $61.50. This is a slight oversimplification, since it does not take into account adjustments made for the assumed interest rate which is built into the contract. If in the above example the assumed interest rate were set at the typical figure of 3½%, monthly payments would remain constant at $60.00 if the investment performance of the separate account was exactly 3½% and would vary only if such performance exceeded or fell below this assumed annual increment. The assumed interest rate is one of the factors

capacity to furnish annuitants protection against cost-of-living increases.

B. *SEC Regulation of Variable Annuities*

In the landmark case of *SEC v. Variable Annuity Life Insurance Co. of America*, the United States Supreme Court held that variable annuities were securities requiring registration under the Securities Act of 1933 and that VALIC, as issuer, was an investment company subject to the Investment Company Act of 1940.[72] The Court rejected VALIC's argument that the 1933 Act exemption for annuity contracts applied to variable annuities.[73] Although the Court recognized the obvious similarities between the traditional annuity and the variable annuity, it noted a crucial distinction between the two: "[A]bsent some guarantee of fixed income, the variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a *pro rata* share of what the portfolio of equity interest reflects—which may be a lot, a little, or nothing."[74] Because of this absence of risk-taking on the insurer's part, the variable annuity could not be equated with a straight annuity for purposes of the exemption provided by the 1933 Act.[75] The Court further found that VALIC was an investment company within the meaning of the Investment Company Act, and that it did not qualify for the insurance company exemption under the Act since its principal business activity was the writing of variable annuity contracts rather than insurance contracts.[76]

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which, together with the remaining life expectancy of the annuitant and the value of accumulation units purchased during the "pay-in" period, goes into the actuarial calculations which in each case determine the number of annuity units on which periodic payments will be based.

[72] 359 U.S. 65 (1959), rev'g 257 F.2d 201 (D.C. Cir. 1958). See Frankel, supra note 51, at 195-219 for a complete analysis of the *VALIC* case.

[73] 359 U.S. at 72. Section 3(a)(8) of the 1933 Act exempts from its provisions "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia." 15 U.S.C. § 77c(a)(8) (1970).

[74] 359 U.S. at 71.

[75] Securities Act of 1933 § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1970). In an attempt to conform to the judicial guidelines laid down in *VALIC*, United Benefit Life Insurance Co. created a variable annuity contract which would satisfy the requirements for exemption from the Securities Act expressed by the *VALIC* Court. In SEC v. United Benefit Life Insurance Co. the hybrid annuity was held by the Supreme Court to be nonexempt and subject to the 1933 Act, the Court relying on the insurance-investment distinction enunciated in *VALIC*. 387 U.S. 202 (1967).

[76] 359 U.S. at 71. 15 U.S.C. § 80a-3(c)(3) (1970). The 1940 Act explicitly provides that insurance companies are not investment companies for purposes of that Act.

The McCarran-Ferguson Act provides that "[n]o 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." § 2(b), 15 U.S.C. § 1012 (1970).

There remained for a time the question of the status under the Investment Company Act of an insurer who wrote variable annuities but who, unlike VALIC, was primarily engaged in traditional insurance activities and therefore appeared to be within the standard for exemption set by Section 3(c)(3) of the Act.[77] This issue was resolved by the SEC in a 1963 decision, *Prudential Insurance Company of America v. SEC*, holding that, while the insurance company was not itself an investment company, the pool of equity securities funded by the annuity contract was an investment company subject to registration as such under the Investment Company Act.[78] The Commission reasoned that when an insurance company "creates a fund exclusively for investment, and sells equity interests in the fortunes of the fund, the exemption [of Section 3(c)(3) of the Act] does not carry over to the fund."[79] The Commission concluded that Prudential's sale of variable annuity contracts would create a fund, "the Investment Fund account," which would "invest, reinvest or trade in securities," thereby subjecting these activities to the requirements of the Investment Company Act.[80] Thus *Prudential* led to the practice of registering insurance company separate accounts used to fund variable annuities as investment companies, and to the dual regulation of such accounts, and the contracts funded therein, by the SEC and state insurance authorities who regard variable annuities as insurance products.[81]

The end result of the *VALIC* and *Prudential* decisions was to place variable annuities under the same basic regulatory scheme that is applicable to mutual funds.[82] From such placing an "uncomfortable

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[77] See note 73 supra.

[78] Prudential Insurance Co. of America v. SEC, 41 S.E.C. 335 (1963), aff'd, 326 F.2d 383 (3d Cir.) cert. denied, 377 U.S. 953 (1964).

[79] 41 S.E.C. at 340-41.

[80] Id. at 348.

> Although one legacy of the *Prudential* decision is a tendency to regard the variable annuity separate account as "just another mutual fund", there are basically important structural and operational differences between the two that should not be forgotten. A variable annuity contract is just that—a contract between the annuitant and the insurer sponsoring the separate account. In contrast, the mutual fund shareholder is an equity owner of the fund which in turn contracts with the investment manager. There is no contractual relationship between the shareholder and the investment manager.

Finnegan and Garner, The Separate Account as an Investment Company: Structural Problems of the "Ectoplasmic Theory", 3 Conn. L. Rev. 106, 116 (1970).

[81] State insurance regulation, like state securities regulation, varies from jurisdiction to jurisdiction. Insurers have had a long time to accustom themselves to state regulation, however, and difficulties with respect to the regulation of variable annuities occur primarily at the federal level. See note 21 supra.

[82] The operation of a variable annuity business involves the same four basic statutes that must be complied with in the mutual fund business. See notes 13-19 and accompanying text supra. The restrictions on sales literature noted earlier with regard to mutual funds

combination"[83] arose: numerous practical difficulties were encountered in adapting the requirements of the Investment Company Act to the insurance aspects of the variable annuity.[84] As one scholar has said of the problems arising from this regulatory scheme, "[t]he application of the 1940 Act to a business based on an insurance scheme also raised conceptual difficulties. The operation and structure of an insurance account is not compatible with the model to which the Investment Company Act applies. Measures of investment performance and reserves cannot fit into the molds of shares and corporate-like capital structures."[85]

The impact of *VALIC* and *Prudential* has been significantly modified, however. A series of ad hoc exemptions from regulation by the federal securities laws has been made available for certain types of annuity contracts. This development began with a series of exemptive rules issued by the SEC with regard to certain classes of equity-funded group contracts,[86] and recently culminated in the codification

also exist with respect to variable annuities, since the Statement of Policy applies to all types of investment companies. See notes 24-27 and accompanying text supra. However, in the latter case the problem is of greater magnitude, since it can be argued with some justification that it is difficult for the consumer properly to evaluate different variable annuity contracts having differing assumed interest rates because the SOP prohibits the use of comparative projections showing the effects of such differing rates.

[83] Jones, The Variable Annuity and the 1940 Act—An Uncomfortable Combination, 3 Conn. L. Rev. 144 (1970).

[84] An illustrative example is the problem of redeemability during the "pay-out" period of a variable annuity contract. Because of the SEC's classification of variable annuities as periodic payment plans, the issuer would be required to redeem such annuities by virtue of § 27(c)(1) of the Act and § 22(e) would prohibit the issuer from suspending this right of redemption. 15 U.S.C. §§ 80a-22(e), 27(c)(1) (1970). However, the actuarial calculations used in determining annuity payments assume that all annuitants will remain in the group, so that permitting redemption during the pay-out period would undermine the actuarial basis of the contracts. As a result, each insurance company registering a variable annuity separate account had to request exemption from this requirement.

Another example is the still unresolved issue of whether total charges (sales and administrative) under a variable annuity contract can exceed the limitations on sales charges alone imposed under § 27 of the Act. 15 U.S.C. § 80a-27 (1970). If sales and administrative charges are stated separately to avoid this problem, it is still possible the staff of the SEC will attempt to impose a total limit by questioning the reasonableness of the administrative portion of the charges, thus involving itself in the administrative affairs of the life insurance company. For addtional examples, see Jones, supra note 83, at 163-75.

[85] Frankel, supra note 51, at 246.

[86] Exemptions which routinely had been granted upon individual application were codified in Investment Company Act Rules 14a-2, 15a-3, 16a-1, 22e-1, 27a-1, 27a-2, 27a-3, 27c-1, and 32a-2, 17 C.F.R. §§ 270.14a-2, 15a-3, 16a-1, 22e-1, 27a-1, 27a-2, 27a-3, 27c-1, 32a-2 (1971). See Investment Company Act Release No. 5738 (July 10, 1969) and 6559 (June 10, 1971). An additional group of exemptive rules for variable annuity separate accounts registered under the Act was proposed in 1970 but was recently withdrawn. See Investment Company Act Release Nos. 6039 (Apr. 30, 1970) and 6949 (Jan. 19, 1972). The existence of these rules and proposals tends to confirm the proposition that the Investment Company Act is not well-suited to variable annuity regulation.

A discussion of the history of these rules appears in Middlebrook and Gingold, Mass Merchandising of Equity Products by Insurance Companies, 3 Conn. L. Rev. 44 (1970).

of various exemptions in the Investment Company Amendments Act of 1970.[87]

A group contract allows the insurer to cover a number of individuals, who are unrelated to each other, by utilization of a single source of payment, such as an employer, a trust, or an association. Traditionally, the term "group annuity" identified an agreement by the insurer to receive payments from the group or their employer and to credit these payments to a fund that would be sufficient "to provide a fixed amount of dollars on a periodic basis to a group of identifiable employees."[88] The most common form of group contract is the pension plan. The Commission had for some years offered exemptions from the securities laws to certain defined tax qualified group contracts which resembled already exempt stock bonus, pension and profit-sharing plans.[89] The critical determinant in justifying these exemptions, one authority writes, "has been the realization that employers charged with providing retirement benefits for employees have a degree of sophistication and investment experience which does not require the same range of protection under the federal securities acts as has been extended to individuals or others purchasing equity-funded insurance products."[90]

Many of these exemptions were codified in the Investment Company Amendments Act of 1970.[91] In this Act, Congress passed legis-

[87] Pub. L. No. 91-547, 84 Stat. 1414 (1970), amending Investment Company Act of 1940, § 3(c)(13), 15 U.S.C. § 80a-3(c)(13) (1970), renumbered to § 3(c)(11), 15 U.S.C. § 80a-3(c)(11). See Routier, Federal Securities Regulation 1971, at 33, for a concise summary of the 1970 Amendments. Paper Presented Before the American Life Convention (Oct. 26, 1971), to be reprinted in the 1971 Proceedings of the American Life Convention, Legal Section [hereinafter cited as Routier; citations are to manuscript pages].

[88] Middlebrook and Gingold, supra note 86, at 51-52.

[89] See note 86 supra.

[90] Middlebrook and Gingold, supra note 86, at 50.

[91] The following diversity of regulatory patterns exists today with respect to variable annuity contracts:

(a) pursuant to § 3(c)(11) of the Investment Company Act an insurance company separate account is excluded from the definition of an investment company if its assets are derived solely from contributions under pension or profit-sharing plans qualified under §§ 401 or 404(a)(2) of the Internal Revenue Code (or from advances made by the insurance company in connection with the operation of such account). 15 U.S.C. 80a-3(c)(11) (1970). This category encompasses both corporate plans and the so-called "Keogh" or "H.R. 10" self-employed retirement plans. Separate accounts funding only such plans are completely outside the regulatory scope of the Investment Company Act. However, if the separate account is used as the funding medium for any other type of variable annuity contract, this exclusion is inapplicable;

(b) pursuant to § 3(a)(2) of the Securities Act, as amended, and §§ 3(a)(12) and 12(g)(2)(H) of the Securities Exchange Act, as amended, corporate pension or profit-sharing plans qualified under §§ 401 or 404(a)(2) of the Internal Revenue Code are defined as "exempt securities" for the purposes of such Acts. 15 U.S.C. § 77c(a)(2) (1970); 15 U.S.C. § 78c(a)(12), *l*(g)(2)

lation designed to place insurance companies competing for the group pension and profit-sharing plan business on an equal plane with banks, whose administration of such plans is not subject to federal securities laws.[92] The obvious rationale for this result is that if banks have been granted statutory exemptions for their administration of pension plans, it is not unreasonable to give insurance companies, which provide similar services and would deal with the same sophisticated and experienced employers, a similar exemption.

C. *The Outlook for the Future*

At the end of 1970, reserves held in individual variable annuity contracts amounted to more than $150 million, while reserves on group variable annuity plans totalled $1.7 billion, indicating the predominant popularity of the latter plans.[93] The predominance of group variable annuities can be expected to continue in the future, for several reasons. In the first place, insurers realize substantial savings from handling annuity coverage on a group basis rather than on an individual basis. Similarly, mass merchandising of annuities allows insurance sales personnel to earn commissions competitive with those available from the sale of traditional insurance products, in contrast to individual sales of annuities on which commission rates are restricted.[94]

Another major factor contributing to the predominance of group annuity plans over individual annuities is the federal securities law regulatory pattern. The exemption of group annuities from the sweep of the federal laws has removed the dual burden of federal and state regulation and has undoubtedly made sales of group plans more palatable than individual sales to insurance companies. Moreover,

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(H) (1970). Variable annuity contracts of this type are therefore not subject to any of the registration or reporting requirements of these Acts, although, as is true of any "exempt security" they remain subject to the general antifraud provisions thereof. These exemptions do not apply to the Keogh or H.R. 10 retirement plans, whether sold on an individual or group basis, producing the somewhat anomalous result that variable annuities under such plans are treated as registered securities although the separate account in which they are funded is not subject to registration as an investment company;

(c) all remaining types of variable annuity contracts remain subject to all the federal securities statutes. This includes all individual and group contracts not having tax-qualified or tax-deferred features, as well as tax-sheltered annuities qualified under § 403(b) of the Internal Revenue Code. Of these, however, only the group § 403(b) plans are of much significance in terms of sales volume.

[92] See SEC Institutional Investor Study, supra note 61, ch. 8, for a detailed discussion of the Investment Company Amendments Act of 1970.

[93] Institute of Life Insurance, Tally of Life Insurance Statistics 2 (Jan. 1972).

[94] See Middlebrook and Gingold, supra note 86; SEC Institutional Investor Study, supra note 61, at 536-38.

group contracts have proven popular vehicles for tax qualified retirement and pension plans, which offer substantial tax benefits to annuitants. In fact, much of the group variable annuity market has been concentrated in tax-qualified plans because of their attractiveness as retirement planning vehicles, and it is reasonable to assume that this concentration will continue.[95]

Historically, individual annuity sales have been of minor importance in comparison to overall insurance sales, and the introduction of the variable annuity has done little to alter this pattern. Many of the very factors contributing to the popularity of group variable annuities indicate the reasons why individual annuities have not enjoyed success. In particular, the burden of SEC regulation, with its limitations on advertising and commission rates, has inhibited sales of individual variable annuities.[96] In the early years of its development, the variable annuity was not considered an important equity product by the majority of the insurance industry. A 1959 poll revealed that four out of five insurance companies were opposed to the sale of individual annuities, and opposition to group contracts was nearly as strong.[97] Now this opposition has largely subsided, and the future of the variable annuity, at least in the area of group tax-sheltered plans, should prove to be of continuing significance to insurers in their attempt to capture more of America's savings dollar.

III. Variable Life Insurance

A. *Introduction*

While mutual funds and variable annuities have been valuable additions to life insurance product lines, enabling agents to offer policyholders a more complete and balanced financial planning program, they have never been viewed by the insurance industry as a substitute or replacement for life insurance itself. Rather, mutual funds and variable annuities have been recognized as primarily investment-oriented vehicles, and hence as unsuitable for fulfilling the basic purpose of life insurance—the provision of protection to the insured's beneficiaries in the form of policy benefits payable on the death of the insured. A life insurance policy, under which the insuring company must pay the full face amount upon death even though the insured may have made only one relatively small premium payment,[98] is still the only viable means of providing such protection. However, the fact

[95] Id. at 541.

[96] Id. at 536.

[97] Journal of Commerce 1 (June 17, 1959).

[98] In comparison, an investor in mutual fund shares or variable annuities would only realize a return of his equity upon death.

that policy benefits are stated in fixed-dollar amounts has come to be regarded by many persons as an unsatisfactory characteristic of an otherwise desirable product. The disadvantages of fixed benefits are particularly marked where the insured is long-lived, since the erosion in purchasing power of any given fixed-dollar amount over a number of decades is likely to be dramatic. In their quest to mitigate this effect, insurance companies are actively engaged in the development of a new product called variable life insurance.

It must be noted at this point that the term "variable life insurance" currently has no generally accepted meaning. In some cases the term may be used to describe policies that are little more than variations of the old scheme of decreasing term insurance plus equity investments.[99] Essentially, these are "buy term and invest the difference" programs sold in a single wrapper; they will not be discussed further in this article. In other cases, the variability of policy benefits is linked to some external index, for instance a cost-of-living or consumer price index.[100] A rise in the index to a certain level will trigger an incremental increase in policy benefits. Hence, when this type of policy is in effect, benefit increases do not depend upon favorable investment experience on the part of the issuing life insurance company. Even should the value of the company's investments in fact decline during a given period, the company is contractually obligated to increase benefits by the amount stated under the policy if, during the same period, the index rises to a certain level. This feature cuts both ways, however, since favorable investment experience by the company does not act to increase policy benefits, which rise only as the index rises. Policies of this nature are often referred to as "index" policies, and these also will not be included in the balance of this discussion.

The remaining types of variable life insurance, unlike the index policies just described, are truly equity-based in that policy benefits vary in accordance with the investment performance of an equity

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[99] See Beck, Variable Life Insurance: A Perspective on Current Issues and Developments, in Proceedings of the National Conference on Variable Life Insurance 2, 3 (March 1971). Insurance of this type is currently being marketed in Great Britain. Id.

[100] See SEC Institutional Investor Study, supra note 61, at 539. A relatively negligible number of these policies have been sold in the United States to date. Id. Although it had been assumed that index policies were not within the aegis of federal securities legislation, a recent insurance company request for an SEC staff opinion recognizing this exemptiton has put in doubt the validity of this assumption. The variable policy in question was tied to the New York Stock Exchange index and provided that the variable portion of the contract would not fall below the original cash surrender value. While the SEC response indicated that there was a lack of information on which a decision could be announced, it also indicated that, in general, if policy benefits vary in relation to a pool of equity securities, a security exists requiring registration under the 1933 Act and registration of the issuer under the 1940 Act. Routier, supra note 87, at 17.

account maintained to fund such policies.[101] American insurers have become principally interested in this category of policy.[102] For the purpose of further discussion, then, the term "variable life insurance" will be applied only to policies whose death benefits vary to reflect the investment experience of the separate account through which they are funded.[103]

While on the surface this definition may appear to be somewhat simplistic, it nevertheless includes the key elements which distinguish the variable life insurance policies now being developed in this country both from their fixed-benefit counterparts and from other so-called variable policies:

(1) *Variable benefits.*—This is the obvious distinction between fixed-benefit policies and variable policies of any kind.
(2) *Fluctuation in accordance with investment performance.*—Unlike index policies, increases in policy benefits are contingent upon investment performance rather than upon a change in the cost of living or some other external yardstick.
(3) *Use of a separate account.*—Fixed-benefit policies are not funded in separate accounts. Index policies may or may not be.[104] Under the definition of variable life insurance used here, net premium payments are applied entirely to a single separate account.

Although the definition does not so specify, it is also generally assumed that the assets of a separate account maintained to fund variable life insurance policies will be invested primarily in equities rather than in the more conservative debt investments, such as high-grade bonds and mortgages; state laws require that most assets held with respect to fixed benefit policies be invested.

[101] See generally Beck, note 99 supra. See also Variable Life Insurance—A Product of the Seventies, in 1970 Proceedings of the ABA Section of Insurance, Negligence and Compensation Law at 266, for an interesting panel discussion on variable life insurance [hereinafter cited as Variable Life Insurance, 1970 ABA Proceedings]. Variable life insurance policies of this type are currently being marketed in Canada and Holland. Id. at 268.

[102] There is some limited interest in index or formula type variable policies. See note 100 supra. See also, Bragg, Life Insurance with Guaranteed Purchasing Power, in Proceedings of the National Conference on Variable Life Insurance 47 (March 1971) [hereinafter cited as Bragg]; Institutional Investor Study, supra note 61, at 538-40.

[103] This separate account would consist of a segregated pool of investment assets and would have essentially the same characteristics as a separate account maintained to fund variable annuity contracts. See note 68 supra.

[104] In variable policies along the British model, noted above, only part of the premium payment is allocated to an equity investment pool; the remainder is applied to the purchase of decreasing term insurance.

There does not appear to be any serious doubt that variable life insurance policies of this nature can be developed successfully, although, as with any new product, initial growing pains are bound to be felt, and concrete problems must be discovered and worked out. Actuaries appear to agree that existing actuarial techniques used in the fixed-benefit policy area to determine premiums, reserves and other associated calculations can be modified and employed to design comparable policies providing variable benefits linked to the performance of an equity-based separate account.[105] Further, through specific changes in statutes or regulations, at least twelve states have authorized the sale of variable life insurance, and such sale also appears to be permissible under the existing laws of a dozen or so additional states.[106] Amendment of existing statutes or regulations would be required to permit the sale of variable life insurance in the remaining states, but past experience suggests that such changes would not be overly difficult to effect.[107]

Experience in other countries, as well as the marked overall increase in public interest in equity investments in the United States, appear to indicate that variable life insurance would have a definite market appeal.[108] However, despite these favorable auspices, the first variable life insurance policy has yet to be sold in the United States. The reason: the unresolved key question of whether, or to what extent, the federal securities laws will be applied to this new product.

B. *Potential Federal Regulatory Problems*

Aware of the problems arising from regulation of variable annuities, the insurance industry is not particularly anxious to see any form of federal securities regulation applied to variable life insurance. Dual federal and state regulation of the product will inevitably result in overlapping and conflicting requirements, added complexities, and extra expense. This was, and to some extent continues to be, the case with variable annuities, and there is no reason to assume that it would

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[105] See Proceedings of the National Conference on Variable Life Insurance (March, 1971) containing Blakeslee, A Unit Variable Life Insurance Design, at 61; Sternhell, The New York Life Benefit Design and its Practical Implementation, at 70, and Walker, A Fixed Premium Variable Benefit Life Insurance Design, at 83. See also, Variable Life Insurance, 1970 ABA Proceedings, supra note 101.

[106] Wall Street Journal, April 10, 1972, at 26, col. 2. See Institutional Investor Study, supra note 61, at 540; and Variable Life Insurance, 1970 ABA Proceedings, supra note 101, at 286-88.

[107] This is evidenced by the fact that the laws of all 50 states have been amended to permit use of insurance company separate accounts without restrictions upon the nature of investment assets permitted in such accounts. Frankel, supra note 51, at 255 n.125.

[108] See, e.g., Wall Street Journal, April 10, 1972, at 26; Middlebrook and Gingold, supra note 86, at 100.

be any different with respect to variable life insurance.[109] Whether or not regulation of variable life insurance under the federal securities laws would be so onerous as to stunt or prevent its development as a marketable product is perhaps debatable, but the prevailing sentiment among interested companies appears to be that if the SEC is "in" with respect to variable life insurance, then they would prefer to be "out."[110]

It is difficult, however, to find statements which articulate with any degree of specificity the reasons why the industry wishes to avoid SEC regulation. There are a number of factors which could account for this silence. Variable life insurance has not yet been sold in the United States, and in its current embryonic stage the relatively little literature available on the subject primarily concerns matters such as product design, marketability and probable agent response.[111] Since regulation by the SEC though a possibility is by no means a certainty, there exists a certain amount of inertia to be overcome before the industry will feel a pressing need for detailed research into the entire range of difficulties which might arise from the application of the securities laws to variable life insurance.[112]

A few general statements can safely be made concerning regulation of variable life insurance by the SEC, should the Commission conclude that such a product is a security. Registration under the Securities Act of 1933 would be necessary;[113] however, since this Act is principally a disclosure statute, the registration statement itself would constitute the major requirement of compliance. Points of difference would unquestionably arise regarding the appropriate content of the registration statement and prospectus, but it is reasonable to expect that after a sufficient number of filings had been made and declared effective, the pattern of required disclosure would become relatively standardized.

The 1933 Act, then, would presumably create only peripheral problems. The requirements of the 1934 Act that sales personnel be qualified and sales practices regulated would impose far greater burdens. Not all insurers would be affected, however. Those companies

[109] See notes 21 and 81 and accompanying text supra, noting the problems of federal-state regulatory conflicts in the mutual fund and variable annuity areas. Compare Frankel, supra note 51, at 385, calling for application of federal securities laws to some variable life insurance plans, with Middlebrook and Gingold, supra note 86, at 100-04, arguing that variable insurance should be held exempt from existing federal legislation.

[110] Wallach, Variable Life Insurance: An Overview, 121, 123, in Proceedings of the National Conference on Variable Life Insurance (March, 1971).

[111] See articles cited in note 105 supra.

[112] See generally Frankel, Variable Annuities, Variable Insurance and Separate Accounts, 51 B.U. L. Rev. 177, 201 (1971).

[113] "[V]ariable life in all forms should be exempt from 1933 Act regulation by virtue of § 3(a)(8)" [see note 73 supra]. Middlebrook and Gingold, supra note 86, at 100-01.

already selling mutual funds and/or variable annuities have already qualified their sales personnel as registered representatives and established supervision procedures, and practically all have membership in the NASD, either directly or through a broker-dealer subsidiary. Hence the effort and expense which qualification under the 1934 Act entails would weigh most heavily upon a company desiring to enter the variable life field but lacking previous involvement with equity products. A considerable number of companies may find themselves in such a position; many companies have chosen to avoid SEC regulation by declining to enter the mutual fund or variable annuity business. Funds and annuities, however, do not compete directly with permanent fixed-benefit life insurance, whereas variable life insurance obviously would. It has even been suggested that, should variable life insurance be successfully marketed, a company offering only fixed-benefit policies might find that it has effectively taken itself out of the life insurance business.[114] While this proposition may be an overstatement, it represents a real possibility, and many insurers with product lines not previously subject to SEC regulation might consider it necessary to enter the variable life business for competitive reasons. Hence the potential scope of SEC regulation of the insurance business appears broad indeed. Legal issues aside, a legitimate question arises regarding the practicality of sustaining SEC regulation over so broad an area.

No one has yet suggested that it would be impossible to sell variable life insurance subject to the provisions of the 1933 and 1934 Acts. The Investment Company Act of 1940 is another matter. Considerable doubt has been expressed as to whether variable life insurance could survive regulation as an investment company security.[115] The major difficulty arising from such regulation would appear to be the Act's relatively low limit on sales loads, a limit that would require that agents selling variable policies be content with far lower commissions than they receive for selling fixed-benefit policies. It is strongly suspected that successful marketing of variable life insurance may be contingent upon the industry's ability to compensate agents on an identical basis for sales of both fixed-benefit and variable benefit policies,[116] thereby eliminating a possible bias on the part of the agents extraneous to the actual needs and desire of a prospective policyholder. Indeed, it would seem difficult to overemphasize the inherent conflict

114 Gustin, Federal Regulatory Aspects of Variable Life Insurance, in Proceedings of the National Conference on Variable Life Insurance 18, 19 (March, 1971).

115 Beck, supra note 99, at 4.

116 Wallach, Variable Life Insurance: An Overview, in Proceedings of the National Conference on Variable Life Insurance 123 (Mar. 1971); Wall Street Journal, April 10, 1972, at 26, col. 2.

of interests an agent would face if he had to choose between selling an ordinary fixed-benefit policy, which would yield a commission usually exceeding fifty percent of the first-year premium, and a variable benefit policy, which, if sold as an investment company security, would probably carry a maximum commission of nine percent.[117]

There are, to be sure, other problems that regulation under the Investment Company Act would pose with respect to variable life insurance. Those provisions of the Act regulating such matters as joint transactions[118] have caused difficulty in the mutual fund and variable annuity areas and presumably would do so in this instance.[119] Another significant problem could arise if the SEC found that variable life policies were periodic payment plans subject to the provisions of Section 27 of the 1940 Act.[120] Section 27 requires that, under certain circumstances, an investment company make full or partial refunds of payments made by customers under a periodic payment plan.[121] As applied to variable life insurance, however, full refunding would be repugnant to the industry, since the return of anything beyond unearned premiums—or, where applicable, nonforfeiture values—would erode and conceivably could even destroy the actuarial basis upon which premium payments are calculated. This particular problem illustrates the type of difficulty which can arise from the application of a 1940 statute, designed primarily for the regulation of mutual funds, to an essentially insurance-type product not yet conceived of when the statute was drafted.

Admittedly, regulation by the SEC did not prove fatal to the variable annuity, although it may well have impeded its growth as a marketable product since, as noted above, it has flourished principally in areas where exemption has been available.[122] It is possible, then, that the marketing of variable life insurance may prove viable, even should SEC regulation be imposed. This issue, however, may become academic if the industry is successful in its efforts to convince the SEC that variable life insurance merits exemption from federal securities regulation.

C. *The Industry's Case for Exemption*

Despite its firm belief that variable life insurance should not be subject to federal securities legislation, the industry appears determined to avoid a repetition of the protracted and litigious disputes

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[117] Investment Company Act of 1940 § 27(a), 15 U.S.C. § 80a-27(a) (1970). See also Rules 27a-1, -2, 17 C.F.R. § 270.27a-1, -2 (1971).

[118] Id. § 17(d), 15 U.S.C. § 80a-17(d) (1970).

[119] See notes 29-32 and accompanying text supra.

[120] 15 U.S.C. § 80a-27 (1970).

[121] 15 U.S.C. § 80a-27(c) (1970).

[122] See pp. 1210-13 supra.

with the SEC which attended its entry into the variable annuity business. To this end the two dominant trade associations, the American Life Convention and the Life Insurance Association of America, approached the Commission and its staff some time ago to determine whether any agreement could be reached concerning the status of variable life insurance under the federal securities laws.[123] It was hoped that the Commission could be persuaded to "decide not to assert jurisdiction over variable life insurance policies which are so designed that their basic and predominant purpose and function is to provide protection against death."[124] This was the policy that the industry urged in its formal Memorandum of October, 1970, which set forth certain basic characteristics of variable life insurance contracts. The associations believed that these characteristics would insure that the insurance function and purpose of the contracts would predominate, and argued that contracts having such characteristics should be found to be outside the scope of the federal securities laws.[125]

The SEC staff responded with a request for additional detailed information, which the associations furnished.[126] A number of months of relative inactivity ensued; then in July, 1971, the SEC staff informed the associations that a formal proceeding would be required to settle the issues involved.[127] The industry and the Commission agreed upon a rule-making proceeding,[128] and on November 29, 1971, industry representatives filed a formal Petition for such a proceeding.[129]

The Petition requests that the Commission issue exemptive rules which would, in effect, remove a specified class of variable life insurance contracts from SEC jurisdiction.[130] The class of contracts in ques-

[123] Harman, 1970 Report on Federal Legislation and Regulation 175, 206, in 1970 Proceedings of the Legal Section, American Life Convention.

[124] Gustin, supra note 114, at 21, quoting American Life Convention—Life Insurance Association of America Task Force on Variable Life Insurance, Memorandum to the SEC (Oct. 28, 1970).

[125] Id. at 21-24.

[126] Id. at 24-28.

[127] Routier, Federal Securities Regulation 1971, Paper Presented Before the Legal Section, American Life Convention 72 (Oct. 26, 1971). To be reprinted in 1971 Proceedings of the American Life Convention [citations are to manuscript pages].

[128] Id. at 75-76.

[129] Petition for Insurance and Amendment of Rules and Rule Making Proceeding Therefor, filed by American Life Convention and Life Insurance Association of America (Nov. 29, 1971) [hereinafter cited as Petition].

[130] The Petition seeks exemption from the securities laws based on the following provisions of each Act. Sections 6(c) and 38(a) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-6(c), 38(a) (1970); § 19(a) of the Securities Act of 1933, 15 U.S.C. § 77s(a) (1970); Sections 3(a)(12) and 23(a) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78c(a)(12), w(a) (1970); and §§ 202(a)(11) and 211(a) of the Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-2(a)(11), -11(a) (1970). Petition, supra note 129, at 2-6.

tion would have, in essence, the four basic characteristics outlined in the associations' 1970 Memorandum. Briefly summarized, these are:

(1) the contract must provide lifetime insurance coverage, hence endowment-type contracts are excluded;[131]
(2) the contract at issue must bear a stated minimum death benefit and must guarantee payment of at least this minimum amount upon death, irrespective of the investment performance of the separate account;[132]
(3) the minimum death benefit payable in any year must equal or exceed a minimum multiple of the gross premium payable in such year, a characteristic which, given sufficiently high multiples for each issuance bracket, limits the price of premiums which may be charged and thus is designed to prevent the introduction of increased investment elements through the charging of higher-than-necessary premiums;[133] and
(4) the contract must be fully subject to state insurance laws, including all required approvals by state commissioners, so that state supervision of insurance companies, guaranteeing fiscal responsibility and fair sales methods, will be assured.[134]

The industry's argument, essentially, is that any variable life policy incorporating these basic features is predominantly a contract of insurance and therefore is not an appropriate subject of regulation under the federal securities laws.[135] The four characteristics have been designed purposely to maximize the insurance element. The first two, by providing for coverage for the duration of the insured's life and guaranteeing payment of a minimum stated face amount of death benefit, are traditional insurance features. These would clearly seem to meet the standard set by the Supreme Court in the *VALIC* case, where the majority held that "the concept of 'insurance' involves some investment risk-taking on the part of the company" and that "in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts."[136] If upon payment by the insured of a premium of some several hundred dollars on a variable life policy, the insurer becomes obligated to pay a minimum benefit of perhaps $10,000 should the insured die shortly there-

[131] Id. at 14.
[132] Id. at 14-15.
[133] Id. at 15-17.
[134] Id. at 17.
[135] "For purposes of determining the applicability of federal securities regulation the key inquiry has to be in terms of which element [investment or insurance] is predominant and central to the main purpose and function of the policy for the policy holder." Gustin, supra note 114, at 21.
[136] 359 U.S. 65, 71 (1959).

after, then the insuring company has indeed incurred a substantial risk. Because of the whole-life feature, this risk continues until the insured dies, although, as in ordinary fixed-benefit insurance, the possible loss to the company decreases as the number of years for which premiums have been paid increases.

The third characteristic, providing for standardized ratios between yearly premiums payable and minimum death benefits due, is designed to prevent the shifting of risk to the policyholder by means of inflated premiums. A ceiling is placed on the level of premiums which may be charged for any given minimum face amount of coverage under a variable life policy by requiring that such minimum face amount equal or exceed a stated multiple of the gross annual premium. Under the table of stated multiples proposed in the Petition, there would be a reasonable correlation between the premium charged on a fixed-benefit policy and the premium charged on a variable policy with a minimum guaranteed death benefit equal to such fixed benefit.[137] To the extent that premiums for the same face amount of protection are roughly equivalent under both types of policies, the amount of risk-taking by the company is about the same in both cases, and the industry's argument for exemption is correspondingly buttressed.

The final characteristic, regulation of the contract under state insurance laws, is intended to bring into play the exclusion of insurance from federal regulation provided for in the McCarran-Ferguson Act.[138] Should variable life insurance be found to be a security, the exclusion would, of course, be inapplicable—witness the subjection of the variable annuity to federal regulation.[139]

The Petition does not address itself to the status of contracts lacking these characteristics, nor does it concede the applicability of federal securities laws to contracts with such characteristics.[140] Rather, the stated purpose of the Petition is to eliminate, so far as the class of contracts defined therein is concerned, "any question as to compliance with such laws."[141]

In response to the Petition, the SEC on February 15, 1972, issued notice of, and an order for, a public rule-making proceeding to be held with respect to the exemptive rules requested by the insurance associations.[142] The evidence-gathering portion of the proceeding began in

137 Petition, supra note 129, at 15.

138 15 U.S.C. § 1011 (1970). See note 76 supra.

139 See p. 1208 supra.

140 Petition, supra note 129, at 7.

141 Id. Note that the SEC does not have to decide the ultimate jurisdictional issues in order to grant the exemptions requested; it may do so as a matter of administrative discretion. The SEC reserved the option to use this course of action. Securities Act Release No. 5234 (Feb. 15, 1972).

142 [Current] CCH Fed. Sec. L. Rep. ¶78,523, Securities Act Release No. 5234,

April, 1972, and the Commission has started to receive testimony and data concerning the proposed nature, operation and sale of variable life insurance.[143]

The insurance industry's chances for success hinge upon its ability to convince the Commission that the investment element in variable life insurance is substantially outweighed by the insurance element. It is not possible to deny that some investment element would exist in variable life insurance as characterized by the Petition. This fact does not vitiate the industry's argument, however, since the SEC has recognized that even permanent fixed-benefit life insurance has a certain built-in savings or investment component which is a necessary outgrowth of the level-premium concept.[144] As one leading commentator has observed:

> In the last analysis, there is no escaping the fact that there is a continuous spectrum from a one-year term life insurance policy, which is pure insurance, through the various forms of straight life and endowment policies, to the annuities, both fixed and (in varying degrees) variable, to mutual fund shares and ultimately common stock, which represent pure investment.[145]

The industry's goal, then, is to demonstrate to the satisfaction of the SEC that variable life insurance is so sufficiently far removed from the pure investment end of the spectrum that, as in the case of fixed-benefit policies, the protection of the federal securities laws is neither required nor appropriate. In light of the substantial insurance guarantees available to the holder of a variable life policy, and the concomitant shifting of a large measure of investment risk to the issuing company, the industry's prospects for a favorable decision are much better

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Exchange Act Release No. 9494, Investment Company Act Release No. 6999, Investment Advisers Act Release No. 310 (Feb. 15, 1972).

[143] See the SEC's testimony in Hearings on S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., pt. 2 at 1206 (1967).

[144] Industry witness will be presented in support of the Petition. The Commission's order also provides that other interested parties may request to appear at the proceeding and it is almost certain that a number will do so. At present, participation in the proceedings appears safely predictable with respect to two other organizations: the National Association of Insurance Commissioners, which is expected to support the stance of the insurance associations, and the Investment Company Institute, the trade association of the mutual fund industry, which is expected to oppose it. Neither of these positions is surprising. An association of state insurance regulators naturally would endorse the principle that variable life insurance is their business and not that of the SEC. On the other hand, opposition by the ICI merely would reflect the fact that their members do not view further encroachment by insurers into the equity-based products field with any degree of comfort, and would not be happy to see this new product, via the rules requested, escape the same regulatory requirements to which they are subject.

[145] 4 L. Loss, Securities Regulation 2534 (Supp. 1969).

than they were in the case of the variable annuity, where such elements were found not to be present to any significant degree.

Variable life insurance, if ever marketed in this country, may well prove to be a product of major significance. This seems to be the consensus of observers both in and out of the insurance industry, and is apparently the view of the SEC as well.[146] From the industry's point of view, the threshold question of whether variable life insurance feasibly *can* be marketed is now largely in the hands of the SEC.

CONCLUSION

Mutual funds have proven to be the most popular choice of insurance companies expanding their activities into the equity products field. A number of reasons may be advanced to explain this phenomenon. In the first place, mutual funds have been in existence for a longer period of time than have the variable annuities and the still undeveloped variable life insurance. As a result, they are better known to and more widely accepted by the investing public. In addition, the patterns of state and federal regulation are much better established for mutual funds than for variable annuities and, needless to say, variable life insurance. The latter two products present many regulatory problems that are still unresolved, and that may remain so for some time. Further contributing to the popularity of mutual funds is the fact that the formation of a mutual fund operation can serve as a convenient basis for a company's later expansion into sales of annuities.

However, the current prevalence of mutual funds as insurance company equity vehicles should not be allowed to disguise recent developments in federal regulation of group variable annuities. The Investment Amendments Act of 1970 should serve to allow insurers full access to the group variable annuity plan market, formerly dominated by banks. Finally, not to be overlooked is the yet unexplored potential market for variable life insurance, which one day may replace fixed-benefit life insurance as the standard protection device utilized by the American public.

[146] SEC Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 92-64, 92d Cong., 1st Sess. pt. 2, at 541 (1971).