THE STATUS OF THE VARIABLE ANNUITY AS A SECURITY: A LESSON IN LEGAL LINE DRAWING

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In law, as in life, lines have to be drawn. But the fact that a line has to be drawn somewhere does not justify its being drawn anywhere. The line must follow some direction of policy, whether rooted in logic or experience. Lines should not be drawn simply for the sake of drawing lines.

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Whether variable annuities should be classified as securities or insurance is a controversy presenting a striking example of the difficulties involved in drawing a clear line of distinction between contrasting legal concepts. The variable annuity made its first appearance in the United States in the early 1950s.[2] The purpose given for its development was to provide the public with a retirement income plan which was secure from the detrimental effects caused by inflation on the purchasing power of the dollar.[3] To achieve this purpose, the variable annuity combined into one retirement plan elements of traditional life insurance and annuity contracts with those elements of an investment contract.[4] This mixture of elements touched off a controversy among insurance companies, investment companies, securities dealers, and state and federal regulatory agencies as to whether a variable annuity contract should be considered insurance or a security for purposes of regulation.[5] This con-

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[1] Pearce v. Commissioner 315 U.S. 543, 558 (1942).

[2] The first major variable annuity program appeared in 1952 and was created by the Teachers Insurance and Annuity Association of America (TIAA), a non-profit legal reserve life insurance company, by special act of the New York legislature. The program was known as the College Retirement Equity Fund (CREF) and was designed to provide a flexible retirement plan for university and college teachers. For a discussion of the TIAA-CREF plan, see Bartlett, *Variable Annuities: Evolution and Analysis*, 19 STAN. L. REV. 150, 151-52 (1966); Day, *A Variable Annuity Is Not a "Security"*, 32 NOTRE DAME LAW. 642, 662-65 (1957); Dorsey, *The Place of "Variable Annuities" in Law and Economics*, 34 NOTRE DAME LAW. 489, 492-94 (1959); Galston, ABA Comm. on Insurance and Negligence Law, 1967 Report, 348, 350-51; Kvernland, *Some Economic and Investment Aspects of Variable Annuities*, 1955 INS. L.J. 373, 374-77; Long, *The Variable Annuity: A Common Stock Investment Scheme*, 1956 INS. L.J. 393, 396-98.

[3] *See* S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959). For a discussion of the economic basis for the development of the variable annuity, see Kvernland, *supra* note 2. *See* Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 INS. L.J. 357 357-61; Mearns, *The Commission, the Variable Annuity, and the Inconsiderate Sovereign*, 45 VA. L. REV. 831, 833-34 (1959); Note, *The Classification and Regulation of Variable Annuities*, 42 MINN. L. REV. 1115, 1117-18 (1958); Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206, 206-07.

[4] *See* Morrissey, *Dispute Over the Variable Annuity*, 35 HARV. BUS. REV. 75 (1957); Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206.

[5] As representatives of those who considered the variable annuity as insurance, *see* Day,

troversy culminated in two significant Supreme Court decisions in which the Court held that the variable annuity[6] and its offspring, the flexible fund annuity,[7] were securities for purposes of regulation under the Securities Act of 1933[8] and the Investment Company Act of 1940.[9] These decisions, however, left unanswered many questions concerning the application of federal and state securities laws to variable annuities. The purpose of this article is to discuss these decisions and to analyze the recent developments in this area under both federal and state law. However, for a discussion of this nature to be meaningful, it is first necessary to consider what a variable annuity is, how it operates, and how it compares to other investment and insurance plans.

I. Definition and Operation of Variable Annuities.

A. General.

Since variable annuity contracts are subject to myriad variations in terms, any attempt to derive an all-purpose definition of the term "variable annuity" would be impossible.[10] It can be said, however, that a variable annuity in its most elementary form is a retirement income plan under which the buyer, or annuitant, makes periodic payments over a specified period of time, and the company invests these payments in a portfolio of equity securities[11] such as common stocks and convertible corporate bonds. Upon retirement, the buyer is entitled to receive for the rest of his life periodic payments of income which will vary in amount with the fluctuations in value of the company's investments. Such plans do not guarantee the buyer a minimum fixed dollar payment for the duration of his life. On the contrary, the amount of each payment that the buyer receives will vary with the investment performance of the company's equity securities and with the company's success or failure in man-

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supra note 2; Johnson, *supra* note 3. Expressions of the opposing view may be found in Haussermann, *The Security in Variable Annuities*, 1956 Ins. L.J. 382, in which the author says:

> The sale of a variable annuity is in essence the sale of an interest or participation in a portfolio of common stocks and not the sale of any annuity or insurance in the legal or accepted meaning of those terms.

Id. at 382; *see* Long, *supra* note 2.

6 S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

7 S.E.C. v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

8 48 Stat. 74 (1933), 15 U.S.C. § 77a (1964).

9 54 Stat. 789 (1940), 15 U.S.C. § 80a (1964).

10 See Johnson, *The Variable Annuity—Insurance, Investment, or Both?* 48 Geo L.J. 641 (1960), in which the author says with regard to variable annuities "There simply is no comprehensive definition that will fit every set of facts." *Id.* at 645.

11 *See* Johnson, *supra* note 3, at 359, where the author gives the following definition of equity securities:

> The term "equities" is applied to those investments the market price or dollar value of which tends to vary with economic conditions. They include stocks, convertible bonds, real estate, etc.

aging these investments. Therefore, depending on the company's investment experience, the amount of the buyer's retirement benefits may be more or less than the premiums he paid into the plan.[12] The theory and selling feature of a variable annuity plan is that the value of the retirement benefits payable to the buyer will keep pace with fluctuations in the cost of living and thereby eliminate the adverse effects of inflation upon the purchasing power of the buyer's retirement income.[13]

In operation, the typical variable annuity plan is divided into two significant phases which are customarily referred to as the "pay-in" and "pay-out" periods.

1. Operation of a Variable Annuity Contract During the Pay-in Period.

During the pay-in period, the buyer makes periodic premium payments in the fixed amount specified in the variable annuity contract. From these premiums the company deducts certain managerial expenses and profits. This deduction is generally referred to as a "loading charge."[14] After the deduction of the loading charge, the net premium[15] paid by the buyer is invested by the company, at its discretion, in common stocks and other equity securities. For each premium the buyer pays, the company credits the buyer with a specific number of "accumulation units." The accumulation units represent the buyer's interest in the company's investment fund. The number of accumulation units credited to each buyer is determined by dividing the amount of the buyer's premium by the value of a single accumulation unit.[16] The value of the accumulation units is determined by dividing the amount of the entire investment fund by the number of accumulation units credited to the buyers of the variable annuity contracts issued by the company.[17] As the

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[12] For definitions of a variable annuity, see S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 70 (1959); 1 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 83A (1941); 1 L. LOSS, SECURITIES REGULATION, 498 (2d. ed. 1961); Comment, *The Expanding Jurisdiction of the Securities and Exchange Commission: Variable Annuities and Bank Collective Investment Funds*, 62 MICH. L. REV. 1398, 1399 (1964); Note, *The Classification and Regulation of Variable Annuities*, 42 MINN. L. REV. 1115-17 (1958); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965); Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206; Annot., 18 L. Ed.2d 1557 (1967).

[13] *See* Johnson, *supra* note 3; Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206, 210; 38 TEXAS L. REV. 248, 249 (1959).

[14] See Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965); Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH U.L.Q. 206, 209.

[15] Net premium equals the buyer's premium less the loading charge.

[16] *See* S.E.C v. Variable Annuity Life Ins. Co. of America, 155 F. Supp. 521, 523-24 (D.D.C. 1957); Johnson, *supra* note 3, at 365; Haussermann, *supra* note 5, at 383.

[17] *See* S.E.C. v. Variable Annuity Life Ins. Co. of America, 155 F. Supp. 521, 523-24 (D.C.C. 1957); Johnson, *supra* note 3, at 365; Hausserman, *supra* note 5, at 383.

company acquires more buyers of variable annuity contracts and as the amount of equity securities in the investment fund grows, the value of the accumulation units credited to each buyer will change. As a result of this fluctuation in value, it is necessary for the company periodically to reevaluate the accumulation units credited to each buyer during the pay-in period.[18]

Prior to the maturity of the variable annuity contract, the buyer generally has the right to withdraw from the program and to receive the cash value of his accumulation units as of the date of his withdrawal.[19] If the buyer dies during the pay-in period, the value of his accumulation units will pass to his beneficiary.[20]

2. Operation of a Variable Annuity Contract During the Pay-out Period.

Upon the conclusion of the pay-in period specified in the variable annuity contract, the buyer usually has two choices: (a) to cash his accumulation units for their present value as of the date the pay-in period ends, or (b) to receive periodic cash payments in varying amounts for the rest of his life.[21] If the life payment plan is selected by the buyer, the company will then convert the buyer's accumulation units into "annuity units." Annuity units may be defined as being the units of payment which the buyer will receive periodically for the rest of his life. The number of annuity units the buyer is entitled to is determined mathematically by the use of the appropriate mortality table for the age and sex of the buyer. The conversion of accumulation units to annuity units is comparable to the conversion by an insurance company of premium payments made under conventional life annuity contracts into fixed dollar installments. Once the number of the buyer's annuity units is determined, this number will remain constant throughout his life. The value of the annuity units, however, will continue to fluctuate in direct relation to the company's investment experience.[22]

To more fully understand the nature of variable annuities, it is necessary to compare the characteristics of the variable annuity to those of more well-known retirement plans, i.e., life insurance, conventional life annuities, and mutual funds.

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[18] *See* Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 346 (1965).

[19] *See* Haussermann, *supra* note 5, at 383.

[20] *See id.*

[21] *See* Johnson, *supra* note 3, at 365; Comment, *The Expending Jurisdiction of the Securities and Exchange Commission: Variable Annuities and Bank Collective Investment Funds*, 62 MICH. L. REV. 1398, 1399 (1966); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 346 (1965).

[22] *See* Johnson, *supra* Note 3, at 365.

B. A Comparative Analysis of Annuities and Life Insurance.

Although annuity contracts and life insurance policies are both sold by life insurance companies and have certain superficial similarities, they are fundamentally different concepts, as the following comparison reveals.

Life insurance is generally defined as a

> [C]ontract, whereby one for a stipulated consideration, customarily called a premium, agrees to pay another a certain sum of money upon the happening of a given contingency which is the death of the insured under the ordinary contract. . . .[23]

Under the ordinary life insurance contract, the benefits which the insured purchases through the payment of his premiums are payable in a fixed dollar amount specified in the policy to some designated beneficiary or beneficiaries other than the insured.[24] Consequently, in purchasing a life insurance policy, the insured creates an "immediate estate for the benefit of others"[25] payable in a fixed amount upon his death, regardless of the number of premiums the insured has paid. Upon the creation of the contract, the insurance company immediately assumes the risk of loss in the event of a premature death of the insured.[26] This assumption of the risk of loss on the part of the insurance company is a primary requisite for a true life insurance contract.[27]

By contrast, an annuity contract is payable during the life of the buyer rather than upon his death.[28] Under such a contract, the buyer pays a fixed sum either periodically or in a single payment, and the company is obligated under the contract to pay the buyer upon his attaining a certain age a specified income for the rest of his life. Under an annuity contract the company does not assume the risk of premature death; rather, it only assumes the risk that the buyer might outlive his life expectancy or that the return from the company's investments might be less than the amounts payable to the buyer under the terms of the annuity contract.[29]

The variable annuity contract contains an additional distinguishing factor not present in the conventional life annuity, that under such contracts there is no guaranteed minimum amount payable to the buyer upon his reaching retirement.[30] On the contrary, the amounts payable to the buyer will vary according to the investment experience of the company

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[23] 1 G. COUCH, INSURANCE § 1:68 (2d. ed. 1959).

[24] *See* 1 J. APPLEMAN, *supra* Note 12 § 83.

[25] *See id.*

[26] *See id.* at 114.

[27] *See* 1 G. COUCH, *supra* note 23 at § 1:3.

[28] *See* 1 J. APPLEMAN, *supra* note 12 at § 83; 1 G. COUCH, *supra* note 23 at § 1:18; 19 G. COUCH, INSURANCE § 81:2 (2d ed. 1968).

[29] *See* 1 J. APPLEMAN, *supra* note 12 § 83; 1 G. COUCH, *supra* note 23 at § 1:18; 19 G. COUCH, INSURANCE § 81:2 (2d ed. 1968).

[30] 1 J. APPLEMAN, *supra* note 12 at § 83a; 19 G. COUCH, *supra* note 28.

issuing the contract.[31] As it will be explained later, the variable annuity contract's failure to guarantee that at least some fraction of the contract's benefits will be payable in a fixed dollar amount was a significant factor in the final determination that such agreements were not insurance.[32]

The only similarity between life insurance and annuity contracts other than the use of certain common terminology is that, by the application of mortality tables in connection with both annuities and life insurance, the issuing company assumes the risk of adverse mortality experience. The presence of this single factor has not been enough to bring annuities within the definition of insurance.

C. A Comparative Analysis of Conventional Life Annuities and Variable Annuities.

Generally, an annuity is defined as being "a contract to pay the insured, or a named person or persons, a sum or sums periodically during life or for a certain period."[33] There are a variety of types of annuities differing from each other in duration of payments, participation, and refund features.[34] However, for the purposes of our discussion, we will be concerned only with the conventional life annuity[35] issued by life insurance companies. As it has been mentioned, the conventional life annuity, in contrast to life insurance, provides for income during the life of the recipient rather than against the contingency of the recipient's death.[36] Therefore annuities are generally regarded as investments rather than insurance.[37] Despite the investment feature of conventional life annuities, the courts have generally regarded the sale of conventional life annuity contracts as insurance business to be regulated by the state insurance laws and not by the Blue Sky Laws.[38]

Conventional life annuities and variable annuities have some of the following characteristics in common: (1) both types of annuities are usually payable in periodic installments; (2) under both types of annuity contracts, the benefits will continue until the death of the buyer of the contract; (3) the benefits paid to the buyer under both contracts are

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31 *Id.*

32 S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

33 1 G. COUCH, *supra* note 23 at § 1:18.

34 *See* Johnson, *supra* note 10.

35 For a definition of the conventional life annuity, *see* Johnson, *supra* note 3, at 361-62.

36 *See generally* Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206, 209; 38 TEXAS L. REV. 248, 249 (1959).

37 *See* Carroll v. Equitable Life Assurance Soc'y of United States, 9 F. Supp. 223 (W.D. Mo. 1934); Johnson, *supra* note 10, at 662.

38 *See* S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 69 (1959); Spellacy v. American Life Ins. Ass'n, 144 Conn. 346, 131 A.2d 834 (1957); Johnson, *supra* note 10, at 662-63.

payable from income and principal; and (4) under both types of annuities, the company, by use of mortality tables in calculating benefits payable, assumes the risk that the buyer will outlive his actuarially calculated life expectancy.

Variable annuities, however, differ significantly from the conventional life annuity in the following respects: First, the premiums paid under a conventional life annuity contract are invested in low-yield debt securities, such as corporate bonds and mortgages. The premiums paid under variable annuity contracts are generally invested in their entirety in equity securities, such as common stocks and convertible securities, the value of which will vary with the investment experience of the company. Second, unlike the conventional life annuity,[39] the buyer of a variable annuity does not acquire the right to a payment of a predetermined amount for the rest of his life but, rather, acquires an interest in a certain number of units which vary with the rise and fall of the value of the company's equity securities. This second feature of variable annuity contracts places upon the buyer the risk that his actual cash payments under the contract might be greatly diminished or wholly eliminated through a failure in the securities market or poor management on the part of the company. This shifting of investment risk from the company to the buyer proved to be the decisive factor relied on by the Supreme Court in denying variable annuity contracts the insurance exemptions of the federal securities laws.[40]

D. A Comparative Analysis of Variable Annuities and Mutual Funds.

The typical mutual fund investment plan involves the organization of two separate companies, a management company and a mutual fund company, which are controlled by a single group of investment experts. In return for a fee, the management company serves as the investment adviser or manager for the mutual fund company. A mutual fund company issues shares of stock in itself to the public and invests the proceeds in various securities under the direction and advice of the management company. The individual investor who purchases shares of stock in a mutual fund company obtains proportionate ownership in the securities held by the mutual fund. The price paid by the individual investor for his shares in the mutual fund company represents the "current net asset value" of the securities held by the mutual fund. The current net asset value is determined by dividing the current value of all securities and cash held by the fund by the number of outstanding shares in the com-

[39] *See* Johnson, *supra* note 3, at 363, where author questioned the fixed nature of conventional life annuities and suggested several variable features possessed by conventional life annuities.

[40] *See* S.E.C. v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); S.E.C. v. Variable Annuity Life Ins. Co of America, 359 U.S. 65 (1959).

pany. To this amount is added the premium, which consists of a management fee and a sales load. Having become a shareholder in the mutual fund, the individual investor shares on a pro rata basis with all other investors the expenses, income and profits of the company. The investor may at any time redeem his shares in the mutual fund at their current market value.[41]

Although both variable annuities and mutual funds allow a similar arrangement whereby the investor or the annuitant buys shares or units in the issuing company's fund of equity securities, mutual funds differ from variable annuities in the following significant features:

(1) The income, dividends and capital gains realized by a mutual fund company from its investments are allocated directly to the individual investor, whereas under the typical variable annuity contract, these benefits are reinvested in the company's fund.

(2) Under a mutual fund plan, the individual investor is free to purchase as many or as few shares at any time that he cares to; however, a buyer of a variable annuity contract is required by the terms of the contract to make periodic payments of a predetermined amount for a time period specified by the contract.

(3) The company issuing a variable annuity contract guarantees the number of annuity units payable each year in accordance with a specified mortality table applicable to the age and sex of the annuitant. This guaranteed mortality factor is not present in a mutual fund plan.

(4) Under the federal income tax laws, a mutual fund must distribute on a current basis virtually all of its earnings and capital gains to avoid being taxed. A mutual fund shareholder is allowed to treat his capital gains as long-term, despite the fact that he may not have owned his shares for the customary six months. On the other hand, it has been specifically ruled by the Internal Revenue that variable annuities will be treated as other annuities; therefore, the buyer under the variable annuity plan incurs no tax liability for the dividends or capital gains credited to his accumulation units by the company. On distribution during the pay-out period, the buyer is taxed in accordance with the provisions relating to conventional life annuities.[42]

Despite these basic differences, mutual funds and variable annuities are alike in one important feature.[43] Neither a mutual fund shareholder nor a buyer of a variable annuity contract is guaranteed by the issuing company a fixed dollar income. The value of the individual's shares

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[41] Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345-50 (1965).

[42] *See* Carter, *Mutual Investment Funds*, 27 HARV. BUS. REV. 715 (1949); Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961); Morrissey, *supra* note 4.

[43] Two authors have taken the position that there is no similarity between variable annuities and mutual funds. *See* Day, *supra* note 2, at 669; Johnson, *supra* note 3, at 364.

or units are directly dependent on the investment performance and managerial competence of the issuing company. Consequently, under both arrangements, the individual must bear the risk that his shares or units might become worthless.

It seems, then, apparent that the variable annuity cannot be placed in any one specific category but is a hybrid concept,[44] combining traditional insurance, annuity and mutual fund principles into one ingenious plan. Unfortunately for the originators of this concept, the security and insurance laws were not designed to accommodate hybrids, but instead require such plans to be either insurance or securities for purposes of regulation. Thus, it is now possible to discuss considerations that influenced the Supreme Court in drawing its line distinguishing variable annuities as securities instead of insurance.

II. FEDERAL REGULATION OF VARIABLE ANNUITIES.

A. *Background of the Controversy.*

Shortly after the first appearance of variable annuities, a controversy over their proper classification arose between various segments of the financial community. Instead of treating variable annuities as a new entity composed of various elements of different types of investment and retirement programs, the controversy centered on whether variable annuities should be classified as securities or insurance for purposes of regulation. On one side of the dispute were the security dealers, mutual fund companies, and insurance companies not offering variable annuity contracts. Their position was that variable annuities fail to guarantee the buyer a fixed dollar value for the units his premiums purchased; therefore, these contracts are securities and should be regulated under the Securities Act of 1933 and Investment Company Act of 1940.[45] As one advocate for their position stated:

> The sale of variable income contracts is obviously fraught with misunderstanding and misrepresentation, innocent though it be. Any representation as to the number of accumulation units or contract units or amount of income is necessarily a misrepresentation, because each is speculative. . . . Stripped of theory, hope and expectation, the variable income contract is in essence a participation in a common stock pool.[46]

On the other side of the dispute were the insurance companies offering, or proposing to offer, variable annuity contracts to the public. This group's position was that variable annuities, like life insurance and conventional life annuities, utilize mortality tables in assuming the risk of

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[44] Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965).

[45] *See* Haussermann, supra note 5; Long, *supra* note 2.

[46] Long, *supra* note 2, at 395.

adverse mortality experience; consequently, they are actually just another kind of insurance. Their position is best typified by the following statement:

> Aside from the emphasis on common stocks in the investment fund, the predominant feature in a variable annuity is an actuarial, risk-pooling feature. The granting of annuities on a commercial basis is essentially a life insurance company function. . . . Since variable annuities are based upon mortality tables, and upon mortality guarantees, they come within the logical functions of life insurance companies.[47]

This controversy reached its climax in 1957 when the SEC brought suit in the United States District Court for the District of Columbia against the Variable Annuity Life Insurance Company of America (VALIC), a company organized solely for the purpose of selling variable annuities, to enjoin it from selling or offering for sale these contracts unless they were registered with the SEC in accordance with provisions of the Securities Act of 1933 and the Investment Company Act of 1940.[48]

B. The Impact of SEC v. Variable Annuity Life Ins. Co. of America.

1. The Statutes Involved.

Before discussing the contentions of the various parties and the courts' holdings in *SEC v. Variable Annuity Life Ins. Co. of America*, it is first necessary to look briefly at the provisions of the three federal acts, the Securities Act of 1933,[49] Investment Company Act of 1940,[50] and McCarran-Ferguson Act,[51] which the federal courts had to reconcile and apply in passing on the merits of the case.

The Securities Act of 1933 was enacted for the purpose of disclosing to the investor "facts concerning securities offered for sale and to protect him against fraud and misrepresentation."[52] These purposes are achieved by the Act's registration, prospectus, and anti-fraud provisions. The Act defines the term "security" as being

> [A]ny note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as "security," or any certificate of interest or participation in,

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[47] Day, supra note 2, at 665-66.

[48] S.E.C. v. Variable Life Ins. Co. of America, 155 F. Supp. 521 (D.D.C. 1957).

[49] 48 Stat. 74 (1933), 15 U.S.C. § 77a (1964).

[50] 54 Stat. 789 (1940), 15 U.S.C. § 80a (1964).

[51] 59 Stat. 33 (1945), 15 U.S.C. § 1011-15 (1964).

[52] 1 L. Loss, Securities Regulation 178 (2d ed. 1961).

> temporary or interim certificate for, receipt for, guarantee of, or warrant of right to subscribe to or purchase any of the foregoing.[53]

The Securities Act, however, exempts specifically from its provisions

> Any 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.[54] (emphasis added)

Congress's aim in enacting the Investment Company Act of 1940 was to protect the investing public from the flagrant abuses indulged in by the management of investment funds during the 1920's.[55] Although the Investment Company Act does not purport to "regulate investment judgment,"[56] it is definitely a regulatory act and goes far beyond the disclosure and registration requirements of the Securities Act of 1933 and Securities Exchange Act of 1934.[57] The Act states that an "investment company"

> [I]s or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading securities.[58]

Like the Securities Act of 1933, the Investment Company Act specifically exempts from its coverage insurance companies. The Act defines an "insurance company" as

> [A] company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a state; or any receiver or similar official or any liquidating agent for such a company in his capacity as such.[59]

Finally, in deciding *SEC v. Variable Annuity Life Ins. Co. of America*, it was necessary for the court to consider the applicability of the McCarran-Ferguson Act. The McCarran-Ferguson Act was enacted in 1945 for the purpose of settling the doubts which arose from the Supreme Court's decision in *United States v. South-Eastern Underwriters Ass'n*[60] as to the authority of the states to regulate the insurance industry.[61] There

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[53] 15 U.S.C. § 77b(1) (1964).

[54] 15 U.S.C. § 77c(8) (1964).

[55] See generally 1 L. Loss, SECURITIES REGULATION 144-46 (2d ed. 1961); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 352-54 (1965).

[56] Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 352 (1965).

[57] *Id.*

[58] 15 U.S.C. § 80a-3(a)(1) (1964).

[59] 15 U.S.C. § 80a-2(a)(17) (1964).

[60] 322 U.S. 533 (1944).

[61] *See* FTC v. Travelers Health Ass'n, 362 U. S. 293 (1960).

the Court overruled a series of cases which held that "the business of insurance is not commerce" and held instead that

> No commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory power of congress under the Commerce Clause. We cannot make an exception of the business of insurance.[62]

To exempt the insurance industry from the possible adverse effects of regulation by both state and federal agencies, the McCarran-Ferguson Act specifically reserved to the states the right to regulate and tax the insurance industry. As stated in the Act,

> The business of insurance . . . shall be subject to the laws of the several states which relate to the regulation or taxation of such business. . . . No act of congress shall be construed to invalidate, impair or supersede any law enacted by any State for the purpose of regulating the business of insurance. . . .[63]

Subsequent to the passage of the McCarran-Ferguson Act, the Supreme Court held that the provisions in the McCarran-Ferguson Act which make the Federal Trade Commission Act applicable to the insurance industry apply only to areas in which insurance is not regulated by the states.[64]

2. Analysis of the Decisions.

In the district court,[65] court of appeals,[66] and Supreme Court,[67] the parties to *SEC v. Variable Annuity Life Ins. Co. of America* took basically the following positions: The SEC contended that (a) variable annuities are securities within the meaning of and subject to the provisions of the Securities Act of 1933; (b) VALIC, by selling variable annuities, was operating as an investment company and, therefore, was subject to the provisions of the Investment Company Act of 1940; (c) variable annuities shifted the burden of investment risk to the buyer; thus, variable annuities were not insurance and were not entitled to the insurance exemption[68] under the Securities Act or the Investment Company Act; and (d) the McCarran-Ferguson Act does not exempt the sale of variable annuities or the companies offering such contracts from regulation by the SEC.[69]

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[62] 322 U.S. 533, 553 (1944).

[63] 15 U.S.C. § 1012(a), (b) (1964).

[64] FTC v. National Casualty Co., 357 U.S. 560 (1958). For a general discussion of the application of the McCarran-Ferguson Act to variable annuities, *see* Day, *supra* note 2, at 679-80; Comment, *The Flexible Fund Annuity: VALIC Revisited*, 115 U. PA. L. REV. 600 (1967).

[65] 155 F. Supp. 521 (D.D.C. 1957).

[66] 257 F. 2d 201 (D.C.Cir. 1958).

[67] 359 U.S. 65 (1959).

[68] 15 U.S.C. § 77c(a)(8) (1964); 15 U.S.C. § 80a-3(c)(3) (1964).

[69] See S.E.C. v. Variable Annuity Life Ins. Co. of America, 257 F. 2d 201 (D.C.Cir. 1958);

VALIC contended that (a) variable annuities were insurance because such contracts utilized mortality tables and the companies issuing these contracts assumed the risk of adverse mortality; (b) VALIC was a chartered insurance company and was subject to regulation by the insurance commissioners of the states and the District of Columbia in which it was authorized to do business; and (c) the McCarran-Ferguson Act gives the states and the District of Columbia exclusive jurisdiction to regulate variable annuities.[70]

The district court concluded that variable annuities embody both traditional insurance and security concepts; therefore, it was impossible to classify them exclusively as either securities or insurance.[71] As the court stated:

> The logic of the law applied to the established facts seems to bring the variable annuity contract within the purpose and intendment of the Secrities Act, and the defendants within the terms and plans of the Investment Company Act.[72]

However, the district court denied the injunction on the grounds that VALIC was licensed and regulated by the insurance departments of the District of Columbia and the states where it was operating; therefore, under the McCarran-Ferguson Act, such contracts and companies were not subject to federal regulation.[73]

The court of appeals affirmed the district court's holding and in its opinion emphasized that variable annuity contracts contained the important insurance feature of shifting of the risk of adverse mortality to the company. The court stated:

> But perhaps the most important risk that the purchaser desires to shift when he buys an annuity is the risk that he will live longer than his funds will last.[74]

The court of appeals gave passing consideration to the failure of variable annuities to guarantee the buyer that his investment will have some value upon retirement; however, the court dismissed this feature by saying that such a risk seemed "to be inherent in the nature of this experiment" in annuity contracts.[75] Like the district court, the court of appeals

155 F. Supp. 521 (D.D.C. 1957); Dorsey, *supra* note 2, at 501-02; Note, *The Classification and Regulation of Variable Annuities*, 42 MINN. L. REV. 1115, 1119 (1958).

[70] See S.E.C. v. Variable Annuity Life Ins. Co. of America, 257 F. 2d 207 (D.C. Cir. 1958); 155 F. Supp. 521 (D.D.C. 1957); Dorsey, *supra* note 2, at 501; Mearns, *supra* note 3, at 838; Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206, 208.

[71] See S.E.C. v. Variable Annuity Life Ins. Co. of America, 155 F. Supp. 521, 526 (D.D.C. 1958).

[72] *Id.*

[73] 155 F. Supp., at 528.

[74] S.E.C. v. Variable Annuity Life Ins. Co. of America, 257 F. 2d 201, 204-05 (D.C. Cir. 1958).

[75] *Id.* at 205.

ultimately concluded that, since VALIC's variable annuity contracts had been approved by the Superintendent of Insurance of the District of Columbia and by the insurance commissioners of the states in which the company was licensed, they were not subject to federal regulation under the Securities Act or the Investment Company Act.

The Supreme Court in a five to four decision reversed the district court and court of appeals and held that variable annuities were securities and subject to regulation under the Securities Act and the Investment Company Act.[76] Justice Douglas, speaking for the majority, based his opinion on the following grounds: First, the Court concluded that the terms "insurance" and "annuity" are federal terms for purposes of interpreting federal acts; therefore, state decisions defining these terms are not controlling. Second, the Court analyzed the nature of a variable annuity and recognized that it combines elements of both insurance and securities into one contract. However, the Court concluded that the presence of the traditional insurance device of shifting the mortality risk to the company was only a superficial feature of the contract and not sufficient of itself to bring variable annuities within the meaning of "insurance" for purposes of exemption from the Securities Act and the Investment Company Act. Finally, the Court reasoned that, since variable annuities place the entire investment risk upon the buyer, they must be classified as "securities."[77] The Court stated that

> . . . in common understanding "insurance" involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts. . . . The companies that issue these annuities take the risk of failure. But they guarantee nothing to the annuitant except an interest in a portfolio of common stocks or other equities—an interest that has a ceiling but no floor. There is no true underwriting of risks, the one earmark of insurance as has commonly been conceived of in popular understanding and usage.[78]

The immediate impact of *SEC v. Variable Annuity Life Ins. Co. of America* was to subject variable annuities to the registration and antifraud provisions of the Securities Act of 1933. The case, however, left unsettled three important questions:[79] First, does the Investment Company Act of 1940 extend to insurance companies who sell variable annuities as only part of their over-all insurance business? Second, will an annuity contract which balances the variable income feature with a minimum fixed dollar guarantee qualify for the insurance exemptions of the Securities Act and the Investment Company Act? Third, do the pro-

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[76] S.E.C. v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

[77] *Id.*

[78] *Id.* at 71-73.

[79] *See* Dorsey, *supra* note 2, at 507, where the author made the following observation: "The Supreme Court's opinion is not a panacea for the legal problems attendant on the 'variable annuity.' It is only a catalyst."

visions of the Securities Exchange Act of 1934 also apply to insurance companies selling variable annuities?[80]

C. *Regulation Under the Investment Company Act of 1940.*

1. Impact of *Prudential Insurance Company of America v. SEC.*[80A]

Once variable annuities were classified as securities, it was clear that VALIC and its companion company, Equity Annuity Life Insurance Company (EALIC), were subject to regulation under the Investment Company Act of 1940. Both companies were organized primarily for the purpose of selling variable annuities; as a result, their activities brought them both squarely within the Act's definition of "investment company" in that they were "engaged primarily or proposed to engage primarily, in the business of investing, reinvesting, or trading in securities."[81] However, *SEC v. Variable Annuity Life Insurance Company of America* left unanswered the question of whether the Investment Company Act of 1940 would apply to an insurance company whose variable annuity business was merely one segment of its over-all insurance business.[82]

Shortly after the Supreme Court's decision in *SEC v. Variable Annuity Life Insurance Company of America*, Prudential Life Insurance Company of America (Prudential) applied to the SEC for a ruling that its proposed variable annuity program was not subject to regulation under the Investment Company Act.[83] In its application, Prudential conceded that variable annuities were "securities" within the meaning of the Securities Act of 1933 and were subject to regulation under that Act.[84] However, Prudential argued that it qualified as an "insurance company" as defined by section 2(a)(17)[85] of the Investment Company Act, since its "primary and predominant business activity is the writing of insurance,"[86] and it is also "subject to supervision by the insurance commis-

[80] For a discussion of the various unanswered questions raised by S.E.C. v. Variable Annuity Life Ins. Co. of America, *see* Bartlett, *supra* note 2; Dorsey, *supra* note 2, at 507-09; Comment, *The Expanding Jurisdiction of the Securities and Exchange Comission: Variable Annuities and Bank Collection Investment Funds*, 62 MICH. L. REV. 1398, 1402 (1964); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 347 (1965); Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206, 213-19; *see generally* 38 TEXAS L. REV. 248 (1959).

[80A] 326 F.2d 383 (3rd cir.) *cert. denied*, 377 U.S. 953 (1964).

[81] 15 U.S.C. § 80a-3(a) (1964); *see* Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 347 (1965).

[82] *See* authorities cited in note 80, *supra.*

[83] Prudential Ins. Co. of America, SEC Investment Co. Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963); *see* Bartlett, *supra* note 2, at 156-62; Note, *Variable Annuities—SEC Regnlation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965); 1963 DUKE L. J. 807.

[84] *Id.*

[85] 15 U.S.C. § 80a-2(a)(17) (1964).

[86] *Id.*

sioner or a similar official or agency" of the states in which Prudential does business.[87] Thus being an insurance company within the meaning of the Act, Prudential argued that its variable annuity program was excepted from regulation by section 3(c)(3), which excludes insurance companies from the Act's definition of "investment company."[88] Prudential sought to distinguish its variable annuity program from that of VALIC and EALIC on the basis that it was primarily engaged in the selling of insurance, whereas VALIC and EALIC were organized primarily to sell variable annuities. The SEC was not persuaded by these arguments and denied Prudential's request for exemption from the Investment Company Act.[89]

In its decision, the SEC recognized that Prudential is an insurance company as that term is defined in the Investment Company Act and is itself excluded from the coverage of the Act. However, the SEC held that Prudential's proposed sales of variable annuities would create an investment fund[90] and that this fund would itself be an "issuer"[91] of securities and, therefore, an investment company as defined by section 3(a)(1)[92] of the Act. Thus the SEC treated the variable annuity fund as an entity separate from the rest of the insurance company and not exempted from the Investment Company Act. The Commission said:

> Thus, Prudential is not itself an investment company, but it is the creator of one—and proposes to be its "investment advisor" and "principal underwriter." That an exempt insurance company performs these functions is irrelevant. . . . Where, however, an insurance company (or any other entity) creates a fund exclusively for investment, and sells equity interests in the fortunes of that fund, the exemption does not carry over to the fund.[93]

Prudential appealed to the Third Circuit Court of Appeals, which upheld the SEC's ruling.[94] On appeal, Prudential argued that the Investment Company Act did not apply to its fund because the term "company" as used in the Act refers only to "identifiable business entities with some sort of internal organization."[95] Prudential contended that an investment fund created by the sale of its variable annuities did not possess the

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[87] *Id.*

[88] This section of the Act excludes from the definition of investment company "any bank or insurance company."

[89] Prudential Ins. Co. of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963).

[90] 15 U.S.C. § 80a-3 (1964).

[91] 15 U.S.C. § 80a-2(a)(21) (1964).

[92] 15 U.S.C. § 80a-3(a)(1) (1964).

[93] Prudential Life Ins. Co. of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335, 340-41 (Jan. 22, 1963).

[94] Prudential Life Ins. Co. of America v. S.E.C., 326 F. 2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964).

[95] 326 F. 2d at 386.

necessary "internal organization" to make it subject to regulation under the Act.[96] Relying on the legislative history of the Investment Company Act, the court of appeals rejected Prudential's contention and concluded that the terms "company" and "fund" used in the Investment Company Act were not restricted to recognizable business entities but were broad enough to include a fund which constituted "a combination of distinct individual interest."[97] The court said:

> As we have previously seen, the Investment Fund is a completely segregated account, devoted to investing in securities. The cash from these investments is derived from payments made by the purchaser of the variable annuity contract. Though the proceeds of the fund are held for the sole benefit of the annuitant, it is this fund, and no other entity, in which he has an interest. Thus the fund is severable from the insurance company which, as the Supreme Court noted in VALIC "guarantees nothing to the annuitant except an interest in a portfolio of common stock or other equities." . . .[98]

The significance in the holding of *Prudential Insurance Company of America v. SEC* is that a company issuing variable annuities will not be exempted from regulation under the Investment Company Act simply because its primary business is writing insurance. However, the Investment Company Act was originally intended primarily to regulate open-end investment companies such as mutual funds; therefore, many of its provisions do not coincide with the operations and activities of an insurance company. Instead, in many situations, the Act overlaps and conflicts with state insurance laws.[99] Recognizing the difficulties involved in applying investment company regulations to insurance companies, the SEC has granted a limited number of exemptions from various provisions of the Act to certain companies issuing variable annuities. These exemptions will be the subject of the next section of this article.

2. Specific Exemptions From the Investment Company Act of 1940.

To relieve possible hardships that could arise from a literal application of all the provisions of the Investment Company Act to the various types of investment companies that might be created, Congress, by section 6(c),[100] gave the SEC broad discretionary power to exempt, either conditionally or unconditionally,

> [a]ny person, security, or transaction, or any class or classes of persons, securities, or transactions from any provision or provisions of this sub-

[96] *Id.*

[97] *Id.* at 387.

[98] *Id.*

[99] *See generally*, Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345 (1965); 1963 DUKE L. J. 797.

[100] 15 U.S.C. § 80a-6(c) (1964); *see* Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 354-56 (1965).

> chapter or of any rule or regulation thereunder, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this subchapter.[101]

After the Supreme Court's decision in *SEC v. Variable Annuity Life Insurance Company of America*, both VALIC and Prudential applied to the SEC for specific exemptions from various sections of the Investment Company Act. As it has been previously mentioned, Prudential's application was conditioned first on a request that its program be exempted entirely from coverage of the Investment Company Act and, in the alternative, that under section 6(c), it should be granted exemptions from various provisions of the Act. A discussion of each exemption asked for by these companies and the action taken on their requests by the SEC is beyond the scope of this article; however, it is important to note briefly some of the more important exemptions requested by companies issuing variable annuity contracts and the action taken thereon by the SEC.

(a) Exemption From Prohibition on the Issuance of Senior Securities.

Section 18(f)(1)[102] of the Investment Company Act prohibits an open-end investment company from issuing or selling senior securities. A senior security is defined for purposes of the Act as "any bond, debenture, note or similar obligation or instrument constituting a security and evidencing an indebtedness and any stock of a class having priority over any other class as to distribution of assets or payment of dividends. . . ."[103] The principal purpose of section 18(f)(1) is to prevent the common stock of open-end companies from becoming too speculative. The speculation problem that section 18(f)(1) is intended to eliminate arises because the common stock of an open-end investment company is freely redeemable. As this common stock is redeemed, the company's assets decrease in a reverse ratio to the company's debts, thus causing a situation where the company's assets might not be sufficient to cover the company's securities which are senior to the freely redeemable common stock.[104]

The SEC found that VALIC's variable annuities were clearly senior securities because the holders of these contracts were entitled to full satisfaction upon the company's liquidation or dissolution before any distribution of assets could be made to the common stockholders. However, the variable annuities issued by VALIC differed from the ordinary senior security in that they did not represent a fixed amount but varied in

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[101] *Id.*

[102] 15 U.S.C. § 80a-18(f)(1) (1964).

[103] 15 U.S.C. § 80a-18(2)(g) (1964).

[104] *See* Note, *Variable Annuity—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 356-58 (1965); 13 STAN. L. REV. 412 (1961).

amount according to the company's investment experience. Furthermore, the variable annuities were redeemable, whereas the common stock which was junior to the variable annuities was not redeemable.[105] Considering these factors, the SEC concluded that the speculative conditions which section 18(f)(1) was aimed at remedying were not present in VALIC's variable annuity program; therefore, a limited exemption was granted to VALIC, provided that VALIC would co-insure their present and future obligations under the life and disability policies they had written as a part of the variable annuity package and, further, that they would recapitalize their company so as to have only one class of outstanding capital stock.[106] Prudential did not have the problem of the senior security since it was a mutual company with no outstanding capital stock.[107]

(b) Exemption From Redemption Requirements.

Both VALIC and Prudential requested the SEC to exempt their variable annuity programs from the redemption requirements of sections 22(e)[108] and 27(c)[109] of the Investment Company Act. Under both Prudential and VALIC's variable annuity programs, the buyer's accumulation units were freely redeemable during the pay-in period, but his annuity units credited to him upon retirement were not redeemable during the pay-out period. Section 22(e) prohibits any investment company regulated by the Act from postponing redemption of any redeemable securities more than seven days after request for redemption is made.[110] The purpose of this section is to prevent investment companies from delaying redemption for extended periods of time so that investors' securities would drop in value as the market fluctuates.[111] VALIC sought permission to postpone redemption of its buyers' accumulation units until the end of each calendar month so that redemption could coincide with VALIC's monthly valuation of its accumulation units.[112]

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[105] *Id.*

[106] Variable Annuity Life Ins. Co. of America, 39 SEC 680 (1960).

[107] Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 356-58 (1965).

[108] 15 U.S.C. § 80a-22(e) (1964), which provides:

> No registered investment company shall suspend the right of redemption or postpone the date of payment or satisfaction upon redemption of any redeemable security in accordance with the terms for more than seven days after the tender of such security to the company. . . .

[109] 15 U.S.C. § 80a-27(c)(1) (1964), which provides:

> It shall be unlawful for any registered investment company issuing periodic payment plan certificates . . . to sell such certificate unless—
>
> (1) such certificate is a redeemable security. . . .

[110] 15 U.S.C. § 80a-22(e) (1964).

[111] *See* Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 364 (1965).

[112] *See* Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960); Note, *Variable*

Prudential requested the SEC to allow its accumulation units to be redeemed over a thirty-six month period to comply with the law of New Jersey, which governed the other aspects of Prudential's insurance business.[113] Both requests for exemption from section 22(e) were denied by the SEC.[114]

Redemption of the accumulation units during the pay-in period does not disrupt the over-all variable annuity program; however, redemption of the annuity units during the pay-out period is irreconcilable with the company's assumption of the mortality risk.[115] The problem of redemption during the pay-out period results from variable annuities' being considered "periodic payment plan certificates." Being periodic payment plan certificates, the variable annuities are, therefore, subject to section 27(c)(1) of the Act, which prohibits an investment company from issuing or selling a periodic payment plan certificate "unless . . . such certificate is a redeemable security. . . ." If section 27(c)(1) were applied literally to variable annuities, the issuance of such contracts would be impossible, since the redeemable feature during the pay-out period would render the actuarial computation of mortality meaningless. In VALIC's application for exemptions, the question of redemption during the payout period was not raised; however, Prudential specifically requested an exemption from section 27(c)(1) during the pay-out period. The SEC, recognizing that, without this exemption during the pay-out period, variable annuity programs would not be possible, exempted Prudential's variable annuities from the requirements of section 27(c)(1).[116]

(c) Exemption From the Voting Rights Requirements.

As it has been previously discussed, the Investment Company Act not only requires disclosure and registration, but also allows investors a certain degree of control over the management and investment policies of investment companies. Investor control is provided in the Act by section 18(i), which requires that "every share of stock hereafter issued by a registered management company . . . shall be a voting stock and

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Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940, 19 RUTGERS L. REV. 345, 364 (1965).

[113] *See* Prudential Ins. Co. of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963); Barltlett, *supra* note 2, at 156; Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 364 (1965).

[114] *See* Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960); Prudential Life Ins. Co. of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963).

[115] *See* Prudential Life Ins. Co. of America, SEC Investment Company Act Release No. 3620 41 S.E.C. 335 (Jan. 22, 1963); Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 364-65 (1965).

[116] *Id.*; Bartlett, *supra* note 2, at 156-60.

have equal voting rights with every other outstanding voting stock. . . ."[117] In addition, the Act provides that investors shall elect the company's directors,[118] approve investment advisor and underwriter contracts,[119] review and approve changes in the company's classification, proposed loans, and changes in investment policies,[120] and ratify the selection of independent accountants and auditors.[121] These investor controls present few problems for companies which were organized primarily for the purpose of selling variable annuities, such as VALIC. VALIC submitted to the SEC its proposed voting formula by which each variable annuity holder would be given a vote weighted according to the value of his contract. The SEC concluded that VALIC's voting formula substantially complied with section 18(i); thus, no exemption was necessary.[122]

The voting requirements of the Investment Company Act presented a more serious problem to large mutual life insurance companies such as Prudential. In addition to its variable annuity contract holders, Prudential had numerous life insurance policyholders whose voting rights were strictly limited by New Jersey law. Prudential contended that, if the voting requirements of the Investment Company Act were applied to it, it would be necessary for Prudential to change completely its corporate structure. For this reason, Prudential requested that the SEC exempt its program from all the voting requirements of the Act and allow the variable annuity holders the same voting rights as Prudential's other life insurance policyholders. The SEC denied Prudential's request for this exemption, saying:

> Prudential's proposals on these points do not approach substantial compliance with either the letter or the spirit of the Act. In effect, Prudential proposes to keep to itself the power to designate in perpetuity the management, policy and operation of the fund. The variable annuity contract holders will vote for the managers of their assets only in conjunction with approximately seventeen million policyholders who do not share their interests.[123]

(d) Exemptions for Group Variable Annuity Programs.

Although the SEC was reluctant to grant broad exemptions from the provisions of the Investment Company Act to variable annuity pro-

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[117] 15 U.S.C. § 80a-18(i) (1964).

[118] 15 U.S.C. § 80a-16(a) (1964).

[119] 15 U.S.C. § 80a-15(a), 15(b) (1964).

[120] 15 U.S.C. § 80a-13(a) (1964).

[121] 15 U.S.C. § 80a-31a (1964).

[122] *See* Variable Annuity Life Ins. Co. of America, 39 S.E.C. (1960); Bartlett, *supra* note 2, at 153-54.

[123] Prudential Life Ins. Co., of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963); *see* Bartlett, *supra* note 2, at 160-61; Note, *Variable Annuities —SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 366-70. *See generally* 1963 DUKE L. J. 797.

grams designed for individual buyers, it was considerably more lenient in its consideration of group variable annuities. These group plans usually are employee benefit plans by which an employer contracts with an insurance company for a single variable annuity policy to cover all of his employees. The SEC in two releases issued in 1963[124] and 1964[125] exempted from the provisions of the Investment Company Act group variable annuities issued by insurance companies, provided that these group plans met certain conditions. The significant conditions are: (1) the plan must cover at least twenty-five employees; (2) the plan must qualify under section 401 or section 404(a)(2) of the Internal Revenue Code; and (3) such programs must provide for payment of guaranteed annuities upon retirement of the employees in fixed dollar amounts.[126]

3. Proposed Rules Granting Exemptions From the Investment Company Act for an Insurance Company Issuing Variable Annuities.

In January of 1969, the SEC proposed a group of new rules which, if adopted, would grant exemptions from certain provisions of the Investment Company Act to insurance companies wishing to sell variable annuities.[127] To benefit from these new rules, it is necessary that the insurance company wishing to sell variable annuities have established and registered a "separate account" as that term is defined by proposed rule O-1(e). Rule O-1(e) defines the term "separate account" as

> [a] legally segregated asset account established and maintained by an insurance company pursuant to the law of any state or territory of the United States or the District of Columbia, 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, the assets of which account have a value at least equal to the reserves and other contract liabilities with respect to such account; and that portion of such assets, which have a value equal to the reserves and other contract liabilities of such account, is not chargeable with liabilities arising out of any other business which the insurance company may conduct.[128]

The separate accounts envisioned by rule O-1(e) must be "inviolable,"[129] i.e., free from the liabilities or claims arising from the other business

[124] *See* SEC Investment Company Act Release No. 3605 (Jan. 7, 1963).

[125] *See* SEC Investment Company Act Release No. 4007 (July 2, 1964).

[126] *See* Investment Company Releases No. 3605 (Jan. 7, 1965) and No. 4007 (July 2, 1964); Bartlett, *supra* note 2, at 161; Note, *Variable Annuities—SEC Regulation of a Hybrid Under the Investment Company Act of 1940*, 19 RUTGERS L. REV. 345, 370-71 (1965).

[127] *See Notice of Proposed Rules Relating to Registered Separate Accounts Established by Insurance Companies to Provide for Variable Annuity Contracts*, Investment Company Act Release No. 5586 (Jan. 24, 1969) CCH Fed. Sec. L. Rep. § 77649 (1969).

[128] *Id.*

[129] *Id.*

conducted by the insurance company. The SEC pointed out that in some states it is possible under the insurance laws for insurance companies to establish separate accounts for issuing variable annuities which will not be immune from the liabilities and claims arising out of the company's other insurance business. For an insurance company operating in such states to qualify for exemptions granted by these proposed rules, the SEC has stated that the insurance company must provide that certain assets contained in the separate account will be immune to claims and liabilities resulting from the company's other business.[130]

Once an insurance company's variable annuity fund has qualified as a separate account under rule O-1(e), the company will be entitled to the following exemptions specified in the proposed rules:

(a) Proposed Rule 14a-2: Exemption from the $100,000.00 Net Worth Requirement of Section 14(a).

Section 14(a) of the Investment Company Act[131] prohibits an investment company or its principal underwriter from publicly offering its securities for sale unless (1) the company's net worth is at least $100,000.00; (2) the company has previously made a public offering of its securities at a time when its net worth was at least $100,000.00; or (3) the company has provided in connection with registration of its securities that, prior to the effective date of the public offering, it will have firm agreements with no more than twenty-five responsible people to purchase its securities in an amount which, when combined with the net worth of the company, will equal at least $100,000.00.[132] The $100,000.00 net worth requirement of section 14(a) makes it difficult for variable annuities to be utilized in connection with tax-benefited pension and profit sharing plans under sections 401, 403(b), or 404(a)(2) of the Internal Revenue Code, since variable annuities usually operate on small periodic payments by or on behalf of a large number of employees.

Proposed rule 14a-2 would exempt an insurance company's separate variable annuity account from section 14(a), provided the company met the following conditions: (1) its variable annuities were purchased under a plan which qualified for tax benefits under sections 401, 403(b), or 404(a)(2) of the Internal Revenue Code; (2) at the beginning of the sale of the variable annuities, the company had a combined capital and surplus, or assigned surplus,[133] of $1,000,000.00; and (3) the com-

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[130] *Id.*

[131] 15 U.S.C. § 80a-14(a) (1964).

[132] 15 U.S.C. § 80a-14(a)(1)-(3) (1964).

[133] *See* Investment Company Act Release No. 5586 (Jan. 24, 1969) in which the commission explains that "combined capital and surplus" applies to stock companies and "assigned surplus" to mutual companies.

pany did not at any time place non-tax benefited money into the separate variable annuity account.

(b) Proposed Rules 15a-3, 16-1, and 32a-2: Exemption From the Requirements of Voter Approval of the Initial Investment Advisory Agreement, the Board of Directors, and the Selection of the Independent Public Accountant.

Sections 15(a), 16(a), and 32(a) of the Investment Company Act require that the investors approve the initial investment advisory agreement, elect the Board of Directors, and ratify the selection of an independent public accountant.[134] The SEC has recognized that variable annuities utilized in connection with tax-benefited employee pension and profit sharing plans rarely have at the beginning of such programs security holders who are eligible to vote on the matters covered by these sections of the Act.[135] Consequently, proposed rules 15a-3, 16a-1, and 32a-2 would exempt from the requirements of these sections an insurance company with a registered separate account, thus allowing the variable annuity fund's investment advisor, board of directors, and independent public accountant or accountants to act in their respective capacities until the first meeting of the variable annuity contract holders is held.[136] The exemptions provided by these proposed rules are conditioned on the company's holding the first meeting of variable annuity contract holders within one year of the effective date of the variable annuity fund's registration statement under the Securities Act of 1933.[137]

(c) Proposed Rules 22e-1 and 27c-1: Exemption From Redemption Requirements During the Pay-out Period.

Proposed rules 22e-1 and 27c-1 appear to be the result of the SEC's ruling in the *Prudential* case.[138] The SEC has recognized, as it did in *Prudential*, that variable annuities differ from mutual funds in that variable annuity benefits payable during the pay-out period are determined by use of mortality tables. Thus, the insurance company assumes the risk that, during the pay-out period, all annuitants will continue to participate in the fund and receive payments provided for in their contracts. To allow the annuity units credited to a purchaser to be redeemed during the pay-out period would, in the SEC's words, "undermine the actu-

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[134] 15 U.S.C. § 80a-15(a), 16(a) and 32(a) (1964).

[135] *See* Investment Company Act Release No. 5586 (Jan. 24, 1969).

[136] *Id.*

[137] *Id.* The SEC refers to "sec. 32(a)" as the section pertaining to stockholder ratification of accountant. This seems to be incorrect and that they meant "section 3(a)."

[138] *See* Prudential Life Ins. Co. of America, SEC Investment Company Act Release No. 3620, 41 S.E.C. 335 (Jan. 22, 1963).

arial basis of the contracts."[139] Therefore, these proposed rules provide an exemption during the pay-out period from the section 27(c)(1) requirement[140] that variable annuity units be redeemable securities, and section 22(e)'s requirement[141] that a company cannot suspend redemption or withhold redemption for more than seven days after a request by the purchaser. Taken together, these proposed rules prevent redemption during the pay-out period. These proposed rules, however, apply only to variable annuities under which benefit payments are based upon life expectancies.[142]

It should also be noted that these rules do not apply to redemption of variable annuity units during the pay-in or accumulation period. Consequently, it must be assumed that sections 22(e) and 27(c)(1) still authorize redemption of accumulation units during the pay-in period. Furthermore, these proposed rules are not limited to variable annuities qualifying for an exemption from section 14(a) of the Act under proposed rule 14a-2.

(d) Proposed Rules 27a-1, 27a-2, and 27a-3: Rules Pertaining to the Sales Load Requirement.

Sections 27(a)(1), 27(a)(3), and 27(a)(4) impose certain requirements concerning the "sales load" charged by investment companies for the sale of their securities.[143] A "sales load" charged by investment companies selling periodic payment plan certificates, which include variable annuities, is defined as

> [t]he difference between the price of a security to the public and that portion of the proceeds from its sale which is received and invested or held for investment by the issuer . . . less any portion of such difference deducted for trustee's or custodian's fees, insurance premiums, issue taxes, or administrative expenses or fees which are not properly chargeable to sales or promotional activities. In the case of a periodic payment plan certificate, "sales load" includes the sales load on any investment company securities in which the payments made on such certificate are invested, as well as the sales load on the certificate itself.[144]

Section 27(a)(1) prohibits the sales load on a periodic payment plan certificate from exceeding 9% of the total payments made on such certificate.[145] This section, however, fails to specify a time period in which the sales load must be brought within the 9% limit. Proposed rule 27a-1

[139] *See* Investment Company Act Release No. 5586 (Jan. 24, 1969).
[140] 15 U.S.C. § 80a-27(c)(1) (1964).
[141] 15 U.S.C. § 80a-22(e) (1964).
[142] *See* Investment Company Act Release No. 5586 (Jan. 24, 1969).
[143] *See* 15 U.S.C. § 80a-27(a)(1), (3) and (4) (1964).
[144] 15 U.S.C. § 80a-2(a)(34) (1964).
[145] 15 U.S.C. § 80a-27(a)(1) (1964).

attempts in the case of variable annuities to provide such a time limit by specifying that the sales load will not exceed 9% total payments as of a date not later than the end of the twelfth year of such payments.[146] Should the variable annuity contract be issued for a period shorter than twelve years, the 9% limitation must be complied with during the shorter period.[147]

Section 27(a)(3) prohibits the sales load deducted from any one of the first twelve monthly payments on a periodic payment plan certificate from exceeding proportionately the amount deducted from any other payment on such certificate.[148] It also prohibits a sales load deducted from any subsequent payment on the certificate from exceeding proportionately the amount so deducted from any other subsequent payment.[149] Proposed rule 27a-2 exempts variable annuities from section 27(a)(3) and provides that the proportional amount of the sales load deducted from any payment in the first twelve month period shall be the same throughout such period and that a proportional amount of the sales load deducted from any payment in any twelve-month period subsequent to the first twelve month period shall not exceed the proportional amount deducted in any prior period.[150]

Section 27(a)(4) prohibits the first payment on a periodic payment plan certificate from being less than $20.00 and any subsequent payment from being less than $10.00. Proposed rule 27a-3 exempts from this section variable annuities issued in connection with plans qualifying for tax benefits under sections 401, 403(b), or 404(a)(2) of the Internal Revenue Code. The rule also exempts variable annuities which permit no sales load deduction in excess of 9% from any payment.[151]

These proposed rules are not a panacea for all the problems arising from the application of the Investment Company Act for the insurance companies issuing variable annuities. However, they will settle some of the confusion in the area and, therefore, should be adopted.

4. Recent Developments with Regard to Representations in Investment Company Literature.

Before leaving this discussion of the problems inherent in the regulation of variable annuities under the Investment Company Act, it is important to take notice of a recent policy statement by an official of the

[146] *See* text of proposed rule 27a-1, Investment Company Act Release No. 5586 (Jan. 24, 1969).

[147] *Id.*

[148] 15 U.S.C. § 80a-27(a)(3) (1964).

[149] *Id.*

[150] *See* text of proposed rule 27a-2, Investment Company Act Release No. 5586 (Jan. 24, 1969).

[151] Investment Company Act Release No. 5586 (Jan. 24, 1969).

SEC concerning certain representation by insurance companies in their variable annuity sales literature. In a speech before the Twentieth International Mutual Fund Dealers Conference, the Director of the SEC's Division of Corporate Regulation observed that various insurance companies selling variable annuity contracts were including in their sales literature projections of hypothetical investment returns on their variable annuities.[152] The following example was given of such representations:

> [A] 45 year old man purchased a variable annuity by making an annual payment of $1,000.00 for twenty years, and if a "hypothetical" annual net investment rate of 7% were employed, he would, at age 65 have an interest worth $40,796.00. And if he then elected to receive variable annuity payments, he would receive $261 in the first month of his retirement, $346 for the month which is at the mid-point between the date of his retirement and the end of his life expectancy, and $459 for the month which is at the end of his life expectancy. . . .[153]

Although the sales literature contained warnings that these calculations were merely hypothetical, the Director stated that such hypothetical return projections were contrary to the SEC's statement of policy on investment company sales literature[154] which provides that it is materially misleading:

> To represent or imply an assurance that an investor will receive a stable, continuous, dependable, or liberal return or that he will receive any specified rate or rates return.[155]

It seems apparent from these remarks that, for purposes of advertising literature, the SEC will treat variable annuities and mutual funds alike.

D. *Regulation of Variable Annuities Under the Securities Exchange Act of 1934.*

Another question which was left unanswered by the Supreme Court in *SEC v. Variable Annuity Life Ins. Co. of America* was whether the issuers and sellers of variable annuities would be subject to the regulation and registration requirements of the Securities Exchange Act of 1934.[156] In a recent release issued in August of 1968,[157] the SEC sought to clarify this situation by stating its position on the applicability of the following rules and regulations of the Act to variable annuities:

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[152] *See* Remarks of Solomon Freedman, Director of SEC Division of Corporate Regulation, 20th Annual International Mutual Fund Dealers' Conference, San Francisco, California, CCH Fed. Sec. L.R. § 77, 625 (Oct. 22, 1968).

[153] *Id.*

[154] Statement of Policy of the Commission Relating to Advertising and Sales Literature Used in the Sale of Investment Company Shares, 17 CFR 271.2621 (Nov. 5, 1957).

[155] *Id.* § (b)(2).

[156] *See* 15 U.S.C. § 78a-hh (1934); Dorsey, *supra* note 2, at 508.

[157] Exchange Act Release No. 8389 (August 29, 1968).

1. Application of the Broker-Dealer Registration Requirements to Variable Annuities.

Under the Securities Exchange Act, any individual or business entity which comes within the Act's definition of the term "broker"[158] or "dealer"[159] is required under section 15(a)(1)[160] to register with the SEC. The SEC has determined that insurance companies selling variable annuities are both brokers and dealers, since the companies purchase and sell securities on behalf of the variable annuity account and distribute the benefits of the variable annuity account to the variable annuity holders.[161] Therefore, an insurance company selling variable annuities must register as a broker-dealer under section 15(a) (1). The SEC, however, has recognized one exception from the registration requirements of section 15(a)(1). If the insurance company establishes a wholly-owned subsidiary company to sell the variable annuities, the SEC has indicated that it will not require the parent insurance company to register if the subsidiary company registers as a broker-dealer with the SEC.[162] The SEC has made it clear that this exemption from registration does not relieve the parent insurance company from the responsibilities imposed by the Act upon persons directly or indirectly controlling broker-dealers.[163]

2. Use of Form BD by Insurance Companies Selling Variable Annuities

Form BD is the prescribed form for application for registration as a broker-dealer under the Securities Exchange Act. The SEC has stated that insurance companies registering as broker-dealers for the purpose of selling variable annuities do not have to list in their Form BD all the officers of the insurance company. The SEC only requires that the company list the president, secretary, treasurer and such vice presidents as have authority to act for the president and such other officers who deal directly or indirectly with the company's variable annuity program.[164]

3. Exemptions for Variable Annuities from the Statement of the Financial Condition Requirement.

Rule 15b1-2(a)(b) requires every broker-dealer filing an application for registration to include with this application a financial statement dis-

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158 15 U.S.C. § 78c(a)(4) (1934).

159 15 U.S.C. § 78c(a)(5) (1934).

160 15 U.S.C. § 780 (1934), as amended (1964).

161 *See* Exchange Act Release No. 8389 (August 29, 1968).

162 *Id.*

163 15 U.S.C. § 780(b)(5) (1934), as amended (1964); Exchange Act Release No. 8389 (August 29, 1968).

164 *See* Exchange Act Release No. 8389 (August 29, 1968).

closing his assets and liabilities, including a list of all securities in which the broker-dealer has an interest. The rule also requires that this financial statement disclose the broker-dealer's net worth as of a date within thirty days of the filing date of the application. The SEC has indicated that insurance companies proposing to sell variable annuities will be exempted from the requirement that their financial statement show their net worth within thirty days of their application's filing, if such statement contains the most recent financial information the company has and is accompanied within thirty days of its filing by a verified statement by a responsible financial official of the company that the company's financial position is not materially different from that reflected in its financial statement. Furthermore, the SEC has indicated that the company making application for registration will be exempted from the requirement of filing a list of securities valued at market within thirty days of the filing of the Form BD, if the company files its most recent schedule of securities containing market valuations and, at the end of the year, the company files its year-end schedule of securities containing valuations at market at the end of the company's year.[165]

4. Exemption for Variable Annuities from Net Capital Requirements.

Rule 15c3-1 requires that every broker-dealer have sufficient net capital so that his aggregate indebtedness to all persons shall not exceed two thousand per centum of his net capital, and his net capital shall not be less than $5,000.00, unless he meets certain requirements which would allow him to maintain a minimum net capital of $2,500.00. The rule defines "net capital" as being the excess of total assets over total liabilities adjusted by certain specified factors. One of the factors in determining net capital is that all fixed assets and assets not readily convertible into cash, such as real estate, fixtures, loans and cash accounts, must be deducted from the excess of the total assets over total liabilities. Recognizing that many life insurance companies selling variable annuities are required by state law to invest most of their proceeds in real estate and real estate mortgages which, when deducted from the company's net worth, would not allow the company to meet the aggregate indebtedness and net capital requirements of rule 15c3-1, the SEC has exempted insurance companies from these requirements, provided that the company's financial statement shows "substantial assets as well as unassigned surplus or net worth, with the bulk of liabilities consisting of policy reserves." In addition to this requirement, the SEC also requires these things: that the company maintain a fidelity bond covering all officers, employees, and agents; that all customer payments be paid directly to the

165 *Id.*

company and not to sales personnel; that all certificates be mailed directly to the customer; that the company maintain restrictions on withdrawal of funds and securities from the separate account; and that the company have internal and independent audit systems.[166]

5. Application of Supervision and Control Requirements to Insurance Companies Maintaining Subsidiary Companies for the Sale of Variable Annuities.

Section 15(b)(5)(E)[167] specifies that the SEC may censure, deny registration to, suspend or revoke registration of any broker-dealer who "has failed reasonably to supervise, with a view to preventing violations of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision."[168] This section of the Act further provides that the person will have complied with the reasonable supervision requirement, if he has established procedures and systems of control for the detection and prevention of violation of the federal security acts.[169]

Many insurance companies entering the variable annuity business have formed subsidiary companies to actually sell and distribute the variable annuity contracts. Under such arrangements, the subsidiary company usually does not keep its own books and records; rather, these records are kept by the accounting department of the parent insurance company which confirms all transactions, pays all benefits to the variable annuity holders, and pays the sales commissions to the variable annuity salesmen, who are usually the company's insurance agents.[170] The SEC has stated that this type of financial arrangement between the parent insurance company and the subsidiary variable annuity company will meet the reasonable supervision requirements of section 15(b)(5)(E), if the following conditions are complied with:

First, the parent insurance company and subsidiary variable annuity company must enter into a binding agreement that the variable annuity company's books will be maintained in conformity with the requirements of rules 17a-3 and 17a-4 of the Act, to the extent possible; that the variable annuity company's books reflect that, in maintaining its books and records, the parent insurance company is acting as agent for the variable annuity company, that the variable annuity company's books and records are subject at all times to inspection by the SEC.

Second, payments by the parent insurance company to the variable annuity company's sales personnel must be a purely ministerial service,

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[166] *Id.*

[167] 15 U.S.C. § 78a(b)(5)(E) (1934) as amended (1964).

[168] *Id.*

[169] *Id.* § (i).

[170] *See* Exchange Act Release No. 8389 (Aug. 29, 1968).

and the variable annuity company's records and books must properly reflect such payments.

Third, the parent insurance company must send confirmation of each payment on variable annuity contracts directly to the variable annuity holder on a confirmation form which shows the facts of the transaction, and the parent insurance company must confirm this sale on behalf of the variable annuity company.

Fourth, the variable annuity company must assume full responsibility for the training, supervision and control of the activities of all persons engaged directly or indirectly in the sale or operation of the variable annuity program.[171]

6. Compliance With the Financial Reporting Requirements.

Rule 17a-5 requires all registered broker-dealers to file yearly financial reports. The SEC has determined that an insurance company which is registered as a broker-dealer for the sale of variable annuities and which has obtained an exemption from the net capital requirements of rule 15c3-1 will be allowed to satisfy the financial reporting requirements of rule 17a-5 by filing with the SEC a copy of its most recent certified financial statement in accordance with the requirements of the Securities Act of 1933. This relieves the insurance company of the necessity of filing the yearly Form X-17A-5 required by rule 17a-5.[172]

In setting out the above guidelines, the SEC did not attempt to cover all the problems which an insurance company issuing or proposing to issue variable annuities might encounter in complying with the Securities Exchange Act. On the contrary, these guidelines were designed to deal with the more common recurring situations the SEC has encountered. Since in *Tcherepnin v. Knight*[173] the Supreme Court determined that investment contracts, which are classified as securities for purposes of the Securities Act of 1933, are also securities within the meaning of the Securities Exchange Act, there can be no doubt that sellers of variable annuities will continue to be faced with difficulties in complying literally with the terms of the Securities Exchange Act. Therefore, it would be reasonable to conclude that this area will merit continued observation.

E. *Regulation of the Flexible Fund Annuity Under the Federal Securities Laws.*

The Supreme Court's decision in *SEC v. Variable Annuity Life Ins. Co. of America* left unresolved the question of whether an annuity program which combined the feature of variable income with the guarantee

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[171] *Id.*

[172] *Id.*

[173] 389 U.S. 332 (1967).

of a life income in a minimum fixed dollar amount could be created so that it would qualify for the insurance exemptions under the federal securities laws.[174]

In an attempt to resolve this question, United Benefit Life Insurance Company introduced the "flexible fund annuity." Under the flexible fund annuity program, the buyer agrees to pay the insurance company a specified periodic premium until the maturity date specified in the contract. The buyer's premiums, less managerial expenses, are accumulated in a separate fund, the major portion of which is invested in common stocks and other equity securities. During the pay-in period, the buyer may withdraw any portion of his interest in the fund; and if the buyer dies during this period, his interest in the fund will pass to his beneficiaries. The flexible fund annuity further guarantees the buyer during the pay-in period a minimum cash value for his interest in the fund of at least 50% of his net premiums, regardless of the company's investment experience, should he desire to withdraw from the fund. After the first ten-year period, this minimum guarantee increases to 100% of the net premiums paid by the purchaser.[175]

At the contract's maturity, the buyer may at his option receive the cash value of his interest in the fund or convert his interest into a conventional fixed-dollar life annuity. Unlike variable annuities, the buyer's interest in the flexible fund varies only during the accumulation period, and, even then, the buyer is guaranteed a minimum value for his investment. If upon the contract's maturity the purchaser elects to receive the conventional life annuity rather than cash, his interest in the fund is transferred from the flexible fund to the insurance company's general reserves, where it is invested along with the funds received from the company's conventional life annuity holders. Thus, the insurance company bears not only the risk of adverse mortality, but also the investment risk during the pay-out period.[176]

Despite the fixed income feature of the flexible fund annuity during the pay-out period and the minimum guarantees furnished the buyer during the pay-in period, the SEC sought to enjoin United Benefit Life Insurance Company from selling flexible fund annuities without first registering them in accordance with the Securities Act of 1933. The Federal District Court for the District of Columbia dismissed the SEC's action, and the Court of Appeals for the District of Columbia affirmed.[177] The

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[174] *See* Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 WASH. U.L.Q. 206; *see generally* Comment, *The Flexible Fund Annuity: VALIC Revisited*, 111 U. PA. L. REV. 600 (1967).

[175] SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 204-07 (1967).

[176] *Id.*

[177] SEC v. United Benefit Life Ins. Co., 359 F. 2d 619 (D.C. Cir. 1966).

Supreme Court granted certiorari, and in an unanimous opinion found that flexible fund annuities, like variable annuities, are securities within the meaning of the Securities Act of 1933 and, therefore, must be registered with the SEC before they can be offered to the public.[178]

In its opinion the Court rejected the court of appeals' holding that the flexible fund annuity must be viewed in its entirety for determining whether it was a security or insurance. On the contrary, the Supreme Court focused its attention upon the accumulation period of the flexible fund annuity and said:

> We therefore conclude that we must assess independently the operation of the "Flexible Fund" contract during the deferred period to determine whether the separable portion of the contract falls within the class of those exempted by Congress from the requirements of the Securities Act, and, if not, whether the contract constitutes a "security" within § 2 of the Act. . . .[179]

Considering only the pay-in period, the Court found that the flexible fund annuity does not guarantee the buyer the stability usually associated with insurance; rather, it offers him the chance that the value of his investment in the fund will increase as a result of the company's investment experience.[180] The Court recognized that the guarantee of a minimum cash value for the buyer's interest in the fund reduces "substantially the investment risk of the contract holder;"[181] however, the Court reasoned that this assumption of investment risk was not enough of itself to place the flexible fund within the insurance exemption of the Securities Act of 1933. Citing *SEC v. Variable Annuity Life Ins. Co. of America*, the Court concluded that flexible fund annuity contracts are non-exempt securities, subject to the registration requirements of section 5 of the Securities Act of 1933.[182]

The Court's decision in *SEC v. United Benefit Life Ins. Co.* seems clearly to establish the rule that an annuity which at any stage contains a variable income feature will be treated as a "security" for purposes of the Securities Act of 1933, regardless of what insurance features or investor safeguards the annuity may also contain. Although the Court declined to pass on the question of whether the Investment Company Act of 1940 also applied to the flexible fund annuity, there seems little doubt, in the light of the *Prudential* decision, that such annuities will also be subject to the same rules and regulations as variable annuities under the Investment Company Act of 1940.

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[178] 387 U. S. 202 (1967).
[179] 387 U.S. at 209.
[180] 387 U.S. at 211.
[181] 387 U.S. at 211.
[182] *See* 21 Sw. L.J. 701 (1967).

III. Regulation of Variable Annuities Under State Blue Sky Laws.

At the state level, the regulation of variable annuities is a veritable hodgepodge. In some states there seems to be no clear indication of whether the Blue Sky Laws or the insurance laws apply to variable annuities.[183] This uncertain situation has caused one author to suggest that "companies issuing such contracts will have to live with the prospect of dual and sometimes treble, regulation."[184] To further cloud an already murky area, the only guidance that exists in some states as to how variable annuities will be treated is found in opinions of the state Securities Administrator or Attorney General.[185] Such opinions, of course, are subject to change, and companies relying on such opinions do so at their own peril.

A state-by-state analysis of the status of variable annuities under Blue Sky and insurance laws is beyond the scope of this article and would be a proper subject for a separate study. However, it is possible to draw some generalizations with regard to regulation of variable annuities by the various states, particularly states which have adopted the Uniform Securities Act.

The Uniform Securities Act was approved by the National Conference of Commissioners on Uniform State Laws in 1956. Since its approval, twenty-four states,[186] the District of Columbia and Puerto Rico have adopted the Uniform Securities Act or substantial portions of it. In the definition of "security" the Act expressly excludes conventional life insurance and annuity contracts but not variable annuities. Section 401 (1) provides that

> "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period.[187]

The Act further emphasizes that variable annuities are considered securities for purposes of regulation by excluding variable annuities from

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[183] For an excellent discussion of the regulation of variable annuities under state securities and insurance laws, *see* Galston, *supra* note 2, at 358-75.

[184] Galston, *supra* note 2, at 366.

[185] For an example of this situation, see the opinion of the Alabama Attorney General, in which it was stated that the term "'security' means . . . annuity contract issued by an insurance company . . ." and the Alabama Blue Sky Law excludes "variable annuity contract issued by an insurance company." 3 Blue Sky L. Rep. § 76, 591 (1962). *See* Opinion of Attorney General of Oklahoma that variable annuities are insurance and not covered by the Oklahoma Blue Sky Law, 3 Blue Sky L. Rep. § 70, 598 (1962).

[186] These states are: Alabama, Alaska, Arkansas, Colorado, Hawaii, Idaho, Indiana, Kansas, Kentucky, Maryland, Michigan, Missouri, Montana, Nebraska, Nevada, New Jersey, New Mexico, Oklahoma, Oregon, South Carolina, Utah, Virginia, Washington, Wyoming.

[187] Uniform Securities Act § 401(1).

the exemption granted to securities issued or guaranteed by insurance companies. Section 402(a)(5) states:

> [but this exemption does not apply to an annuity contract, investment contract, or similar security under which the promised payments are not fixed in dollars but are substantially dependent upon the investment results of a segregated fund or account invested in securities.][188]

Considering sections 401(1) and 402(a)(5) together, it is clear that variable annuities are subject to all the registration and fraud provisions of the Uniform Securities Act. Although it is not mentioned in the Act's provisions or the official commentary, it seems logical that the Act's language, particularly that of section 402(a)(5), "an annuity contract . . . dependent upon investment results of a segregated fund or account invested in securities,"[189] is broad enough to encompass the flexible fund annuity within its coverage.

In approving the Uniform Securities Act, the authors recognized that some states would desire to regulate all annuity contracts, including variable annuities, under their insurance laws. Therefore, the official commentary to the Act provides that a state that wishes to exclude variable annuities from the definition of "security" may do so by deleting the bracketed language pertaining to variable annuities in sections 401(1) and 402(a)(5).[190] Twelve states which have adopted the Uniform Securities Act have taken this approach and have excluded variable annuities from the Act's definition of "security" by deleting the pertinent language.[191] Also, Arkansas, New Jersey, Nebraska and the District of Columbia, while adopting the Uniform Securities Act or substantial portions thereof, have in their statutory definition of a "security" specifically excluded fixed or variable annuities issued by insurance companies from coverage of their Act.[192] Alabama and Oklahoma, two more Uniform Securities Act states, by attorney general opinions, have excluded from the definition of "security" variable annuity contracts issued by insurance companies.[193]

Four states[194] and Puerto Rico have adopted the definition of "security" contained in the Uniform Securities Act, thus including variable annuities within the coverage of the Act.

In several states which have not adopted the Uniform Securities Act,

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[188] *Id.* § 402(a)(5).

[189] *Id.*

[190] *See* the official commentary to sections 401(1) and 402(a)(5), 3 Blue Sky L. Rep. § 4932.

[191] Colorado, Idaho, Indiana, Maryland, Michigan, Montana, Nevada, Oklahoma, South Carolina, Utah, Washington and Wyoming.

[192] *See* ARK. STAT. ANN. § 67-1247(1) (1966); D. C. CODE ANN. § 2-2401(1) (1967); NEB. REV. STAT. § 8-1101(11) (1965); N.J. REV. STAT. § 49:3-49 (M) (1967); Galston, *supra* note 2, at 360.

[193] *See* text of note 185.

[194] Alaska, Hawaii, Kansas and Kentucky. *See* Galston, *supra* note 2, at 361.

the problem of determining whether variable annuities are subject to the Blue Sky or the insurance laws has been solved by a broad definition of the term "security," like the definition used in the Securities Act of 1933, which would appear to include variable annuities. Two of these states, Massachusetts and Minnesota, have provisions in their insurance laws which state that variable annuities will be subject to the securities act.[195] Texas, another state with a broad definition of "security,"[196] has excluded variable annuities issued by insurance companies from regulation under its Blue Sky Law by an express provision in its Insurance Code.[197] The Blue Sky Law of Tennessee excludes variable and fixed annuities from the definition of "security," provided that such annuities are sold by insurance companies regulated by the Tennessee Commissioner of Insurance and Banking under the state insurance laws.[198] On the other hand, Georgia has excluded from the coverage of its Blue Sky Law life insurance policies and conventional annuity contracts but has expressly included variable annuities.[199]

In summary, the above discussion of the regulation of variable annuities under state Blue Sky Laws does not purport to cover all the problems raised by the application of the Blue Sky Laws and insurance laws to variable annuities. Rather, it is intended only as a brief outline of the positions taken in various states which have faced the problem squarely. The area of state regulation of a variable annuity is an expanding one and bears continuous observation.

IV. CONCLUSION.

For better or worse, at the federal level the line of distinction between a security and insurance with regard to the regulation of the variable annuities and flexible fund annuities seems to be clear. The pivotal factor is whether the annuity possesses at any stage a fluctuating or varying income feature. If such feature is present, it seems safe to predict that the federal courts, in line with decisions in *SEC v. Variable Annuity Life Ins. Co. of America* and *SEC v. United Benefit Life Ins. Co.*, will determine that the annuity is a security for purposes of the federal securities laws. However, the issue of what exemptions from the provisions of the various federal securities acts will be granted to annuities with variable income features remains largely unsolved. The an-

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195 *See* Galston, *supra* note 2, at 362.

196 *See* TEX. REV. CIV. STATS. art. 581 § 581-4 (1957).

197 TEX. INS. CODE ANN. art. 3.72 (supp. 1967). There it is expressly provided that " 'variable annuity contracts' issued under the article 3.72 shall not be deemed to be a 'security' or 'securities' as defined in The Security Act. . . ."

198 *See* TENN. CODE ANN., § 48-1 602(J) (1955).

199 *See* GEORGIA SECURITIES ACT, § 14, 101(i) (1957).

swer will depend, to a great degree, upon the types of problems devised by American business.

The maze of differing types of regulation that exist at the state level emphasizes the need for uniformity in Blue Sky Laws. Some degree of certainty could be achieved by the adoption of the Uniform Securities Act by all states; however, the certainty provided by the Uniform Securities Act is greatly diminished with regard to the variable annuities because of the Act's provision for exclusion of variable annuities from the definition of "security." It is submitted that, in future revisions of the Uniform Securities Act, this escape clause for variable annuities be deleted.