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Administrative Law—Variable Annuity Held to Be Subject to Federal Securities Regulation

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RECENT CASES

ADMINISTRATIVE LAW—VARIABLE ANNUITY HELD TO BE SUBJECT TO FEDERAL SECURITIES REGULATION

United Benefit Life Insurance Company[1] offered a "flexible fund" annuity under which the premiums were invested primarily in common stocks. A purchaser was entitled to withdraw all or part of his proportionate share of the total fund at any time before maturity. Alternatively he was guaranteed a cash value measured by a percentage of his net premiums. At maturity, the purchaser could elect to receive the cash value of his policy, measured by the larger of his interest in the fund or the net premium guarantee, or he could elect to convert his interest into a life annuity under conditions specified in the contract. The Securities and Exchange Commission brought an action to enjoin United Benefit from offering its "flexible fund" without complying with the registration requirements of the Securities Act of 1933,[2] and to compel United Benefit to register the fund itself as an investment company, under the Investment Company Act of 1940.[3] Judgment for the company was entered in the United States District Court for the District of Columbia, and the Commission appealed. The Court of Appeals for the District of Columbia circuit affirmed,[4] and certiorari was granted.[5] Reversing, the Supreme Court *held*, the deferred annuity contract was an "investment contract" within the terms of the Securities Act[6] and could not be offered to the public without conforming to the registration requirements of the Act.[7] *Securities and Exchange Commission v. United Benefit Life Insurance Company*, 387 U.S. 202 (1967).

The Securities Act of 1933 was enacted to safeguard the investing public from "fraudulent devices and tricks used in the sale of securities."[8] This Act requires that "any note, . . . stock, . . . bond, . . . investment contract . . . or in general any interest or investment commonly known as a security . . ."[9] be registered[10] and a prospectus published[11] before sale to the public. The Act's philosophy is that full disclosure of information relating to the company's directors, majority stockholders, capitalization, assets, liabilities, and estimated profits[12] will allow investors to make more objective and intelligent decisions.[13] Though Congress thought it necessary to regulate securities, they specifically exempted insurance and annuity contracts from federal regulation.[14] "Any insurance . . .

1. Hereinafter referred to as United Benefit.
2. 15 U.S.C. § 77e (1964).
3. *Id.* § 80a-8.
4. SEC v. United Benefit Life Ins., 359 F.2d 619 (D.C. Cir. 1966).
5. 385 U.S. 918 (1965).
6. 15 U.S.C. § 77b(1) (1964).
7. *Id.* § 77e.
8. Thorn v. Austin Silver Mining Co., 171 Misc. 400, 12 N.Y.S.2d 675 (1939).
9. 15 U.S.C. § 77(b)1 (1964).
10. *Id.* § 77e.
11. *Id.* § 77j.
12. *Id.* § 77aa.
13. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).
14. 15 U.S.C. § 77c(a)(8) (1964).

or annuity contract . . . issued by a corporation subject to the supervision of the insurance commissioner . . . of any State . . ." is exempt from this registration requirement.[15] To protect investors in investment companies from mismanagement,[16] the Investment Company Act of 1940[17] requires that companies "investing, reinvesting, and trading in securities"[18] be registered before their stock can be sold through interstate commerce.[19] Even though insurance companies are investment companies, they are exempt from this federal regulatory requirement.[20] Federal securities regulation, which emphasizes disclosure, is improper for insurance regulation.[21] An insurance policyholder is not as concerned with the company's investment or management policies as he is with "the solvency and adequacy of the company's reserves;"[22] that is, whether the company will be able to meet its future obligation to him. While the philosophy of federal securities regulation is disclosure, the philosophy of state insurance regulation is more paternalistic. State insurance regulation attempts to safeguard the best interests of the policyholders, rather than leaving them to care for themselves. By controlling the investment policies of insurance companies,[23] insurance commissions can assure policyholders that the companies will in fact have adequate reserves to meet their obligations. In 1869,[24] the Supreme Court held the issuing of a policy of insurance not to be a transaction of commerce, and that its regulation should be left to the states. In 1943,[25] perhaps influenced by violations of the Sherman Antitrust Act[26] by the insurance industry,[27] the Supreme Court reversed this previous decision. Not wanting the burden of federal regulation, the insurance industry's powerful lobby caused Congress to enact the McCarren-Ferguson Act,[28] which states: "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 . . . ."[29] Apparently underlying this preservation of state power was the premise that the states had superior experience and adequate legislation to regulate insurance.[30]

Having a guarantee of fixed periodic payments for life,[31] the purchaser of an ordinary annuity receives protection against outliving his capital. The com-

15. *Id.*
16. Breswick & Co. v. United States, 134 F. Supp. 132 (S.D.N.Y. 1955).
17. 15 U.S.C. § 80 (1964).
18. *Id.* § 80a-3(a)(1).
19. *Id.* § 80a-8.
20. *Id.* § 80a-6(a)(8).
21. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 77 (1959).
22. *Id.*
23. *E.g.*, N.Y. Ins. Law §§ 79-89 (1966).
24. Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1869).
25. United States v. Southeastern Underwriters Assoc., 322 U.S. 533 (1944).
26. 15 U.S.C. §§ 1-7 (1964).
27. *See* 1945 U.S. Code Cong. Serv. at 670.
28. 15 U.S.C. § 1011 (1964).
29. *Id.* § 1012(b).
30. Note, 71 Harv. L. Rev. 562, 563 (1958).
31. *See* Johnson, *The Variable Annuity: What It Is And Why It Is Needed*, 1956 Ins. L.J. 357; Johnson, *The Variable Annuity-Insurance, Investment, or Both?* 48 Geo. L.J. 641 (1959); Haussermann, *The Security in Variable Annuities*, 1956 Ins. L.J. 382.

pany issuing the annuity invests the annuitant's capital in fixed-yield debt instruments and actuarially calculates how much of the principal and income will be needed to meet these payments for the duration of the annuitant's expected life.[32] Variable annuities, one of the insurance industry's more recent developments, are intended to meet the need for a retirement plan which will guarantee payments until death, as does an ordinary annuity, yet provide for appreciation of capital, as a share of common stock.[33] The variable annuity resembles the ordinary annuity in that it presumably shifts the risk of outliving capital to the issuing company, but the annuitant receives no guarantee of fixed payments. Instead the annuitant purchases units corresponding to his proportionate share in a fund that is primarily invested in common stocks. The annuitant's periodic payments are based on his proportionate share in the fluctuating fund. Appreciation of the total assets through capital gains will increase the value of his interest, and thus protect him against inflation. However, either a sharp decline in the market or poor company management will cause the annuitant's payments to be small, or possibly nothing;[34] therefore, the annuitant bears the entire risk of adverse investment experience.[35] Because of this dual nature, the variable annuity has created substantial problems as to the proper scope of federal securities regulation.[36] In determining if federal securities regulation is appropriate, the Supreme Court, in *SEC v. Joiner*,[37] considered the character of the instrument as determined by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect. For purposes of the Securities Act, an investment contract is a transaction or scheme whereby a person invests his money in a common enterprise, and is led to expect profits solely from management by a third party.[38] Because a variable annuity possesses these characteristics of a security, federal securities regulation seems applicable. However, the refund of premiums in case of death before maturity, in addition to standard incontestability and assignment clauses,[39] tends to give variable annuity characteristics of insurance so that state insurance regulation seems applicable. The Supreme Court first considered the problem of the variable annuity in the the case of *SEC v. Variable Annuity Life Insurance Company* (VALIC).[40] The Securities and Exchange Commission brought an action to enjoin VALIC from offering its annuity contracts to the public without registering them under the Securities Act and the Investment Company Act. VALIC claimed it was selling a form of

32. Note, *Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC*, 1959 Wash. L.Q. 206, 209.
33. Comment, 61 Mich. L. Rev. 1374, 1375 (1963).
34. Note, *supra* note 32, at 210.
35. *Id.* at 210 n.39 gives a mathematical example of the workings of a variable annuity under different market conditions. *See also* Mearns, *The Commission, The Variable Annuity, and the Inconsiderate Sovereign*, 45 Va. L. Rev. 831, 835, (1959).
36. Comment, 61 Mich. L. Rev. 1374, 1376 (1963).
37. SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352 (1943).
38. SEC v. W.J. Howey Co., 328 U.S. 293 (1946).
39. SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 205 n.5 (1967).
40. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959) [hereinafter cited as VALIC].

insurance and was therefore exempt from federal securities regulation. The Court stated that it would not undertake to limit the concepts of insurance to what they were when the federal regulatory acts were first passed. However, the concept of insurance involves investment risk-taking on the part of an insurance company, and the issuer of a variable annuity that has no element of a fixed return has assumed no true risk in the insurance sense. Because VALIC did not offer its purchasers any guarantee of a fixed return, the Court held the variable annuity was not insurance, and therefore was not entitled to the insurance exemption from federal regulation. As a result of this decision, the Prudential Life Insurance Company, anticipating the sale of variable annuities as a part of its regular business, applied to the Securities and Exchange Commission for exemption from the requirements of the Investment Company Act.[41] Prudential claimed that it was entitled to exemption under the Act's definition of "insurance company,"[42] for, unlike VALIC, it was not formed for the purpose of selling variable annuities, but was an existing company engaged primarily in the business of insurance. The Commission, in refusing the exemption, held that "if an insurance company sells equity interests to the public and creates an investment fund, the insurance company exemption from federal regulation does not carry over to the investment fund which is treated as a separate entity."[43] In affirming the decision, the United States Court of Appeals[44] emphasized that Prudential would not assume any investment risk, as all insurance must if it is to be exempt from federal securities regulation. Following the decisions in *VALIC* and *Prudential*, United Benefit offered its "flexible fund" to the public. The "flexible fund" is a deferred, or optional annuity plan having characteristics somewhat similar to those of the variable annuity, which the Supreme Court in *VALIC* had held to be subject to the Securities Act. The main difference was that the "flexible fund" did guarantee some fixed payments to the annuitant based on a percentage of his net premiums. Because of these differences United Benefit claimed it was eligible for the insurance exemption of the Securities Act,[45] and that the fund itself was entitled to the "insurance company" exemption of the Investment Company Act.[46] The Securities and Exchange Commission contended that the portion of the "flexible fund" which dealt with the pre-maturity period was separable and a security within the meaning of the Securities Act. Both United Benefit and the Commission agreed that the provisions dealing with the operation of the fixed payment annuity were purely conventional insurance

41. 15 U.S.C. § 80a-6 (1964): "a . . . the following companies are exempt from the provisions of this subchapter: (5) Any company which . . . is organized and operating under the insurance laws of any State . . . ."

42. *Id.* § 2(a)(17): "Insurance Company means 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 . . . of a State."

43. Prudential Insurance Co. of America, SEC Investment Co. Act Release No. 3620 (Jan. 22, 1963).

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

45. 15 U.S.C. § 77c-a(8).

46. *Id.* § 80a-6(a)(5) (1964).

terms, and thus beyond the purview of the Commission. The United States District Court for the District of Columbia held that the guarantee of a fixed-payment annuity of a substantial amount gave the entire contract the character of insurance. The Court of Appeals for the District of Columbia,[47] in affirming, rejected the Commission's basic premise that the contract should be fragmented and that the risk during the deferred period only should be considered.

In reversing, the Supreme Court found that United Benefit had not assumed a substantial investment risk. During the first portion of the "flexible fund" contract, United Benefit promised to serve as an investment agency, allowing the policyholder to share in its investment experience. At maturity, United Benefit was obligated to produce no more than a guaranteed minimum. However, this minimum was so low that the risk of not being able to meet it was insignificant. In holding that the "flexible fund" need not be characterized in its entirety, the Court found that the contract contained distinct and separable promises that came into being at a fixed point in time. The second portion of the contract, which gave the annuitant his choice of either his cash value in the fund or a regular life annuity, came into being at the end of the investment contract. The Court assessed independently the operation of the "flexible fund" during the deferred period to determine whether that separable portion of the contract fell within the insurance exemption of the Securities Act, and if not, whether the contract constituted a "security" as defined by the Act. In finding that the "flexible fund" did not fall within the insurance exemption of the Securities Act, the Court said that while the guarantee of a cash value based on net premiums substantially reduced the investment risk, the assumption of some investment risk does not by itself create an insurance provision for federal regulatory purposes. Using the test of the *Joiner* case,[48] the Court held that the accumulation provisions constituted an "investment contract" within the terms of the Securities Act, that the purchaser of such a plan should be afforded the same advantages of disclosure which inure to a mutual fund purchaser, and that this portion of the fund does constitute a "security" under the Securities Act. The Court then noted that, unlike VALIC, United Benefit was essentially an insurance company, exempt from the requirements of the Investment Company Act. This exemption made it difficult for the Court to decide whether the "flexible fund" could be separated from United Benefit's other activities and considered an "investment company" in and of itself. The Court, also concerned with possible conflicts between federal securities regulation and state insurance regulation, remanded the case to the Court of Appeals for the District of Columbia for further proceedings consistent with their opinion.

In deciding *United Benefit* and the problem of how to regulate the variable annuity, the Supreme Court was faced with conflicting statutes.[49] Thus far, the

47. SEC v. United Benefit Life Ins. Co., 359 F.2d 619 (D.C. Cir. 1966).
48. *See* text at *supra* note 35.
49. Securities Act of 1933, 15 U.S.C. § 77 (1964); Investment Company Act of 1940, 15 U.S.C. § 80a (1964); McCarren-Ferguson Act, 15 U.S.C. § 1011 (1958).

Court has suggested three approaches to resolving this conflict. The first is to treat the variable annuity as a security, subject to federal securities regulation. This approach was taken by the majority in *VALIC.* A second alternative is to view the variable annuity as a new concept in insurance, subject to state insurance regulation. This approach was taken by the dissent in *VALIC.* A third approach is to treat the variable annuity as a combination of security and insurance, subject to both federal securities and state insurance regulation. This was suggested by the Court in *United Benefit.* These approaches suggest that the Court is attempting to place the regulation of variable annuities into one or more of the existing systems of securities or insurance regulation. In making this determination, it appears that the Court is looking to the characteristics of the instrument, rather than the interests of the variable annuity policyholder. The purchaser of a variable annuity is interested in a policy that will best meet the needs of himself and his family. He wants to be able to rely on the issuing company and to trust its salesmen. Realistically, federal securities regulation does not pass on the merits of the company, the effectiveness of the policy, or the integrity of the salesmen. Federal securities regulation promotes disclosure. In order to make investment decisions based on the information disclosed a certain degree of investment sophistication is required which the purchaser of a variabe annuity would probably not have.[50] Not being able to understand the disclosed information, federal securities regulation may be useless to the average annuitant. Although the Investment Company Act does to some extent regulate the investment activities of companies that might issue variable annuities,[51] most variable annuities are sold by insurance companies which are specifically exempt from this statute.[52] The paternalistic attitude of most insurance laws give the annuitant the needed protection against ineffective policies, dishonest salesmen and fraudulent companies. Therefore, it appears that state insurance regulation would offer the annuitant more protection and eliminate the unnecessary burden of dual regulation. Absent minimum government standards, however, this approach would not lend itself to uniformity of regulation. State regulation of variable annuities gives the insurance companies an unfair advantage over mutual funds which sell a nearly identical investment, but are subject to federal regulation. For these reasons, perhaps state regulation of variable annuities is not the ideal solution.

Although not discussed by the Court, a 1964 amendment[53] to the Securities and Exchange Act of 1934,[54] appears to offer an alternative solution to the problem of regulating the variable annuity. In essence, the amendment provides that if an insurance company is regulated by a state insurance commission which

50. Johnson, *The Variable Annuity: What It Is And Why It Is Needed,* 1956 Ins. L.J. 357.

51. 15 U.S.C. §§ 80a-12, 13 (1964).

52. *Id.* § 80a-6(a)(5).

53. *Id.* § 78(g)(2)(G). *See* Philips & Shipman, *Analysis of the Securities Act Amendments of 1964,* 1964 Duke L.J. 706, 747.

54. Securities Exchange Act of 1934, 15 U.S.C. § 78 (1964).

meets minimum government standards, then any security issued by that company is exempt from federal regulation. If, however, the Commission prevails in its contention that variable annuities are subject to registration under the Investment Company Act,[55] then questions concerning the applicability of this amendment become academic because it does not apply to any security issued by an investment company registered under the Investment Company Act. Should the courts hold that the Investment Company Act does not apply to variable annuities issued by insurance companies, then these companies would in most cases be exempt from federal regulation because of the amendment. It could be argued, however, that the variable annuity is not exempt because it is issued not by the insurance company, but by the "separate entity" created pursuant to the variable annuity contract. This position was sustained in the *Prudential Life Insurance* case,[56] with respect to registration under the Investment Company Act. For purposes of the Securities Act of 1933, the issuer of a variable annuity is considered to be the insurance company rather than the separate entity. This position, based on the definition of "issuer" contained in section 2(4) of the Securities Act,[57] assures that there will be a financially responsible party available for purposes of the civil liability provisions of section 11[58] of the Securities Act. Furthermore, it can be argued that the purpose of the insurance company exemption in the 1964 amendment of the Securities and Exchange Act is to avoid dual state-federal regulation of insurance. In view of the requirements of the McCarren-Ferguson Act, the exemption from federal regulation contained in the Investment Company Act, the 1964 amendment to the Securities and Exchange Act, and the unnecessary burden of dual regulation, variable annuities such as the "flexible fund," should be regulated solely by the state insurance commissions. However, the nature of the industry gives rise to the need for adequate protection of the public, a type of protection which cannot be offered solely through existing state insurance or federal securities regulations. A combination of these existing systems appears to create more problems than it would solve. It seems, therefore, that the proper solution to the problem of regulating sales of the variable annuity will eventually come only through a federal administrative agency created to meet the problems of the insurance industry.

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55. SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).
56. Prudential Life Ins. Co. v. SEC, 326 F.2d 383 (D.C. Cir. 1964).
57. 15 U.S.C. § 77b-4 (1964).
58. *Id.* § 77k.