VARIABLE ANNUITIES, VARIABLE INSURANCE AND SEPARATE ACCOUNTS†

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PART I: VARIABLE ANNUITIES AND VARIABLE INSURANCE

I. INTRODUCTION

The variable annuity is a novel retirement plan. It was devised to minimize the inadequacies of a fixed-dollar annuity as a retirement device. Inflation[1] and an accelerating standard of living have left persons receiving fixed-dollar annuities with only a fraction of the income required to meet their needs.

The variable annuity was the result of a study published by the Teachers Insurance and Annuity Association of America (TIAA) in 1951. The study showed that over a long period of time, the average performance of equity securities far exceeded the rise in the cost of living. This study led, in 1952, to the establishment of the College Retirement Equities Fund (CREF), a fund invested in equity securities in order to provide a variable annuity for its members.[2] Benefits under this annuity are not fixed-dollar amounts. They vary according to the investment performance of a fund; hence the name "variable" as distinguished from "fixed" annuity.[3]

The new concept greatly appealed to some, but by no means all, insurance companies. The industry was bitterly split between the advocates of variable annuities, led by Prudential Insurance Company of America, and the more conservative "establishment" life insurance companies, represented by Metropolitan Life Insurance Company.[4]

The split among life insurance companies is not new.[5] For decades small

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1 The search for a hedge against inflation is continuing. The Occidental Life Insurance Company has produced an annuity tied to the U.S. Labor Department's consumer price index. Business Week, Nov. 23, 1968, at 126. See also Note, Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies, 82 Harv. L. Rev. 435, 438 (1968).

2 W. Greenough, A New Approach to Retirement Income 33-45 (1964).

3 Id. at 4. The TIAA continues to offer fixed-dollar annuities. It was recognized that the higher yield of equity securities might be offset by a higher risk to capital; therefore, not more than 50% of the total paid to both TIAA and CREF can be placed in CREF. Id. at 9-10. This was increased to 75% on January 1, 1967. G. Johnson & D. Grubbs, The Variable Annuity 15 n.9 (1967).

4 Institutional Investor Study Report of the Securities and Exchange Commission, H.R. Doc. No. 64, 92d Cong., 1st Sess. pt. 2 at 530 (1971) [hereinafter cited as SEC Investor Report]. 1 L. Loss, Securities Regulation 498 (2d ed. 1961); see Note, Regulation and Taxation of the Variable Annuity, 33 St. John's L. Rev. 118, 127-28 (1958); Note, Regulation of Variable Annuity Sales: The Aftermath of SEC v. VALIC, 1959 Wash. Univ. L.Q. 206.

5 The split in the industry is manifested in its two organizations: The Life Insurance Association of America (LIAA) and the American Life Convention (ALC). The efforts of

insurance companies have been competing with larger companies by offering specialty policies, a large variety of arrangements representing combinations of insurance and income-promising contracts. Some of these policies, such as tontine and semi-tontine policies are speculative,[6] and even those that are not, such as charter and coupon policies,[7] easily lend themselves to misrepresentation. The more speculative brands of these policies have been virtually eliminated from the market by restrictive legislation.[8] Yet, recently, there has been a resurgence of specialty policies, and they have been increasingly regulated by state legislation.[9] Small insurance companies have protested that their bigger brethren are using these regulations to exclude the smaller companies from the market.[10]

True to industry tradition, the variable annuity, essentially a specialty policy, was first introduced by three comparatively small life insurance companies.[11] The arguments advanced against variable annuities were similar to earlier arguments advanced against conventional specialty policies. It was said that the annuities were incompatible with insurance,[12] amenable to misrepresentation and were confusing because they combined elements of insurance and investment.[13] In short, opponents of the variable annuity believed that insurance should remain "pure" insurance.

A survey of insurance companies conducted in 1959 showed the extent of their opposition to variable annuities, though the opposition was greater to individual than to group variable annuities. Of 314 life insurance companies polled, 257 replied. Of these, 210 or 81.7 percent opposed, 21 or 8.2 percent were undecided, and only 26 or 10.1 percent were in favor of individual variable annuities.[14] But by May 1969, the dispute seems to have been settled. The Metropolitan Life Insurance Company established its variable

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the United Benefit Life Ins. Co. to persuade LIAA and ALC to file an amicus brief in the Supreme Court, in SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967), were unsuccessful. Evans, Flexible Fund Annuity and the Securities Act of 1933 and the Securities Exchange Act of 1934, Proceedings of the Legal Section Am. Life Convention 102, 106 (1967). In 1967, however, the two organizations united in a joint effort to represent their interests before the SEC and Congress, and have been working closely ever since. See Finnegan & Garner, The Separate Account as an Investment Company: Structural Problems of the "Ectoplasmic Theory," 3 Conn. L. Rev. 106, 118 n.31 (1970).

6 1 J. Appleman, Insurance Law and Practice § 13 (rev. ed. 1965) [hereinafter cited as 1 Appleman].

7 1 Appleman § 10.

8 Kimball & Hanson, The Regulation of Specialty Policies in Life Insurance, 62 Mich. L. Rev. 167, 186-88 (1963) [hereinafter cited as Kimball & Hanson].

9 Id. at 188.

10 Id. at 179-80.

11 Variable Life Insurance Company of America (Valic), Equity Annuity Life Insurance Company (Ealic) and Participating Annuity Life Insurance Company (Palic). Valic later absorbed Ealic and both "became subsidiaries of orthodox insurance companies." 4 L. Loss, Securities Regulation 2517 (Supp. 1969).

12 SEC Investor Report at 530.

13 Morrissey, Dispute Over the Variable Annuity, 35 Harv. Bus. Rev., Jan.-Feb. 1957, at 75, 78; Pyle, The Case Against Variable Annuities, 1956 Ins. L.J. 776; Long, The Variable Annuity: A Common Stock Investment Scheme, 1956 Ins. L.J. 393.

14 McDougal, Variable Annuities and Separate Accounts, The Investment Company Act of 1940, Proceedings of the Legal Section Am. Life Convention 78, 80-81 (1967).

annuity fund.[15] At the beginning of that year some 175 life insurance companies were engaged in the sale of variable annuities and other equity products.[16] After a decade of resistance, the individual variable annuity was coming into its own.[17] The sale of variable annuities has not, to date, been a pronounced success[18] and the predominant type of variable contracts presently sold has been tax-deferred group contracts.[19] There is, however, no sign that this has deterred insurance companies from entering the field.[20]

The reason for this drastic shift in attitude by the majority of insurance companies lay in the decline of the insurance industry's share of the public's savings dollars. Since 1950 the competition for these savings dollars has become very intense. Mutual funds grew enormously;[21] banks entered the market by offering portfolio management services through commingled funds; and industrial conglomerate corporations became active in the insurance field.[22]

Insurance companies labored under a number of competitive disadvantages. They could not give competitive investment return to pension-plan customers. Their group annuity contracts were inflexible, and the tax treatment of their contracts as compared to mutual fund shares resulted in inequities.[23] Under these circumstances the attempt of the insurance companies to recapture a part of the market by seeking legislative authority to offer equity insurance products seemed inevitable.[24]

The offer and sale of equity insurance products by insurance companies raised a difficult regulatory problem. Traditionally, insurance companies were regulated by the states. In fact, the federal McCarran-Ferguson Act supports this tradition.[25] But since variable annuities have many of the earmarks of securities, the question of whether they should be regulated under the federal securities acts arose. When the Variable Life Insurance Company of America (Valic), the Equity Annuity Life Insurance Company

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15 SEC News Digest, Issue No. 69-105 at 2 (File 2-3322, 1969).

16 Remarks of Robert W. Haack, President of the New York Stock Exchange, to the Second Annual Institutional Investor Conference, Jan. 22, 1969, [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,667 (1969).

17 Business Week, May 10, 1969, at 147.

18 As to individual variable annuities see SEC Investor Report at 532. As to variable annuities in general see id. at 536. The reasons for poor sales may be the disagreement within the industry and the litigation with the SEC that preceded sales, the dual regulation that insurance companies allege is burdensome and the difficulties of marketing a complex product. Id. at 534.

19 Id. at 534, 648.

20 Id. at 534.

21 Wall Street Journal, Nov. 28, 1967, at 34, col. 1; Routier, The Mutual Fund Approach to Equity Products, Proceedings of the Legal Section Am. Life Convention 13 (1968).

22 SEC Investor Report at 508-11.

23 Id. at 774.

24 Insurance companies may also resort to speculative investments for their own account within the statutory limitations. See, e.g., a description of investments in new, risky, but promising ventures by State Mutual Life Assurance Co., N.Y. Times, June 13, 1971, § 3 (Business and Finance), at 2.

25 15 U.S.C. §§ 1011-15 (1964). See pp. 209-12 infra.

(Ealic) and the Participating Annuity Life Insurance Company (Palic) were organized in the mid-fifties to sell variable annuities to the public, the Securities and Exchange Commission (SEC) sought to enjoin Valic and Ealic from selling variable annuities without compliance with the Securities Act of 1933[26] and the Investment Company Act of 1940.[27]

In 1959 the Supreme Court held that variable annuities issued by Valic were securities within the meaning of the federal securities laws and were not insurance contracts, which are exempt from federal regulation.[28] The decision resulted in the application of the Securities Act of 1933 and, implicitly, the Securities Exchange Act of 1934 to variable annuities and the application of the Investment Company Act of 1940 to Valic. The 1940 Act excepts from the definition of an investment company an insurance company if the company is organized as an insurance company, if the primary and predominant business activity of the company is the writing of insurance, and if the company is subject to supervision by state authorities.[29] Since Valic dealt primarily in variable annuities, once the annuity contracts were classified as securities, the company fell within the definition of an investment company.

In 1963 the SEC decided that the *Valic* ruling applied to variable annuities issued by Prudential Insurance Company of America, an old-line insurance company that was excepted from the definition of an investment company under the 1940 Act.[30] This resulted in the dual regulation of variable annuities by state insurance authorities and by the SEC.

The *Valic* and *Prudential* decisions dealt only with variable annuities. Insurance companies in this country have been considering the issuance of variable life insurance policies, that is, insurance policies providing benefits that may vary with the investment performance of an equity fund.[31] But the insurance industry has been slow to act, at least partly because the

26 15 U.S.C. §§ 77a-77aa (1964).

27 54 Stat. 789 §§ 1-53, 15 U.S.C.A. §§ 80a-1 to -52 (1971) as amended [hereinafter cited as 1940 Act] by Investment Company Amendments Act 1970, 84 Stat. 1413 [hereinafter cited as 1970 Act].

28 SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

29 §§ 2(17), 3(c)(3); 15 U.S.C.A. §§ 80a-2(17), 80a-3(c)(3) (1971).

30 In re Prudential Ins. Co. of America, 41 S.E.C. 335 (1963), aff'd Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964). For a survey of the double regulation of the insurance industry concerning variable annuities, see Galston, The Regulation of Variable Annuities, 1966-67 ABA Section of Ins., Negligence and Compensation Law 348 (1967).

31 In 1961, one of the pioneers in the field of variable annuities predicted that variable life insurance will in all likelihood be sold in this country. Equity investment can be integrated with regular life insurance; or it can be combined with a participating policy so that part of the reserve is invested in an equity securities fund and the dividends from the fund and the participating business are combined; or a specified percentage of the reserve can be allocated to the equity securities fund; or the investment part of an endowment policy can be so invested, and so on. The variety of variable life insurance, like that of life insurance itself, is great. G. Johnson & D. Grubbs, The Variable Annuity 67-72 (1967). In other countries, especially in Canada, the field is developing. See Report of the Canadian Committee on Mutual Funds and Investment Contracts 129-30 (1969).

SEC has not yet taken a position on the question of whether the federal securities acts apply to variable insurance.[32]

This article is divided into two parts. The first part discusses variable annuities and variable life insurance and their classification as either insurance or securities under the federal securities acts. It examines the concepts of insurance and investment and identifies the components of each within variable life insurance contracts. In addition, it views the competing state and federal regulatory systems, the evils they are designed to curb, and the need for the particular kind of protection that they offer. Following this analysis tests are proposed to determine whether a specified variable life insurance policy is exempt from federal regulation, and the necessary characteristics that make a variable insurance policy so exempt are enumerated.

The second part of this article concerns the application of the 1940 Act to the issuer of an equity insurance product. In *Prudential*[33] variable annuities were offered by an insurance company excepted from the definition of an investment company under the 1940 Act.[34] The SEC identified a security within the variable annuity, and identified the issuer of the security as a "separate account."

The separate account furnishes a fascinating exercise in jurisprudence. One major source of law applicable to the account, the 1940 Act, operates within a framework of corporate business organizations. The other major source, state insurance law, operates within a framework of insurance schemes. Corporate business organizations and insurance schemes are not always compatible. Because no readily available model exists for the account, it is difficult to find a uniform answer to questions such as its organization, the ownership of its assets and their insulation from creditors of the insurance company.

The account can be treated as analogous to a conventional investment company independent from the insurance company. It can also be treated as a fictional entity existing only for the purpose of applying the 1940 Act to it, but for any other purpose, a part of the insurance company. Both approaches raise problems. The second part of this article will examine these problems. The discussion relates, at times, to theoretical questions that are unlikely to arise. The reasons for treating them, sometimes at length, are threefold. Their magnitude alone may warrant attention. Further, a comprehensive theoretical study is a necessary condition to legislation that may be needed. And finally, courts do take, from time to time, a theoretical

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32 See also SEC Investor Report at 540. The industry is now discussing variable life insurance with state and federal authorities. See Middlebrook & Gingold, Mass Merchandizing of Equity Products by Insurance Companies, 3 Conn. L. Rev. 44, 100 (1970); Gustin, Details Industry Task Force Dealings with SEC on Variable Life Product, The National Underwriter, Mar. 27, 1971, no. 13, at 1.

33 41 S.E.C. 335 (1963).

34 1940 Act § 3(c)(3); 15 U.S.C.A. § 80a-3(c)(3) (1971).

rather than a pragmatic view of the problems, which view may result in decisions that upset acceptable practices. The philosophy of this writer is that a business concern that affects thousands of people and involves millions of dollars should be governed by easily identifiable legal principles and be treated, if possible, uniformly with respect to its organizational structure and legal transactions. The fact that no practical problems, except, perhaps, a great deal of irritation, have arisen as yet, is only an additional reason to delve into theories now.

II. VARIABLE ANNUITIES

A. *Variable Annuities and Conventional Annuities*

The variable annuity is a variation of the conventional fixed-dollar annuity. A conventional fixed-dollar annuity has been defined as an obligation, charged to the person of the grantor, to pay a fixed sum of money periodically, usually annually, during the life of the annuitant.[35] An annuity may also constitute an obligation to pay the annuitant a sum of money for life and, should the annuitant die before a specified amount or the principal and interest have been paid to him, to refund the unused principal or another specified amount to a designated beneficiary or to the estate of the annuitant (a refund annuity).[36]

In the past the consideration for the annuity was usually paid in a lump sum by the annuitant or on his behalf.[37] In present-day annuities the consideration is usually paid in installments. When an annuity is purchased with a single premium, annuity payments may start immediately or be deferred. When the consideration is paid by installment, annuity payment is deferred until the consideration has been fully paid (a deferred annuity).[38] In order to insure the integrity of the funds and the yield of the interest, the consideration paid for a conventional annuity is invested conservatively by the insurance company for its own account, usually in bonds and mortgages affording a high degree of security to capital and a low fixed income. Calculation of the annuity is based on the amount of this consideration and on the interest that this consideration is assumed to yield, usually at rates between 3½ percent to 5 percent.

The variable annuity preserves all the features of a fixed annuity contract, except that the consideration paid for the annuity is allocated

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35 1 Appleman § 81; S. Huebner & K. Black, Life Insurance 109-10 (7th ed. 1969) [hereinafter cited as Huebner]. See also Bodine v. Commissioner, 103 F.2d 982, 984 (3d Cir.), cert. denied, 308 U.S. 576 (1939). Note, The Use of Annuities in Retirement and Estate Planning, 53 Iowa L. Rev. 925 (1968).

36 1 Appleman § 81, at 106; Huebner at 111; W. Vance, Insurance 1021 (3d ed. B. Anderson 1951) [hereinafter cited as Vance]. The premiums on this annuity are higher than in a life annuity because the arrangement regarding the refundable amount is, in effect, a pure savings arangement.

37 1 Appleman § 81, at 107.

38 Huebner at 111; Vance at 1020.

to a "separate account" and invested in equity securities.[39] The installment payments of consideration by the contractholder (the pay-in period), and the payments of the annuity to the contractholder, at his option, are adjusted wholly or in part to reflect the investment performance of equity securities in the separate account. Typically, the contractholder undertakes to pay the insurance company a fixed sum annually, starting approximately on the date of the contract and ending at the age of his retirement. Sales and administrative charges are deducted from these payments and the rest is applied to purchase "units" in the separate account (accumulation units). The number of units purchased each year varies, therefore, with the value of the units at the time of the purchase. The "cash value" of the contract at any particular time during this period can be calculated by multiplying the number of units credited to the contractholder by the then value of the units, just as the value of a stockholder's holding is calculated by multiplying the number of shares he holds by the then value of a share.[40]

Up to the retirement age the contract is only a savings device. If on retirement or at any earlier date the contractholder chooses to cash in his contract and terminate his relationship with the insurance company, the contract will have been only a savings device. At retirement the cash value of the contract is calculated. The contractholder is then usually given a variety of options in addition to taking cash. He may choose a fixed annuity. He may choose a variable annuity. He may choose a combination of both. If he chooses a full or partial variable annuity, the variable part is calculated as follows:

a. The amount of a fixed-dollar annuity that could be purchased for a sum designated by the contractholder is computed. This amount includes an assumed income at a fixed rate of interest, usually $3\frac{1}{2}$ percent per annum.[41]

b. The fixed-dollar monthly payment of the annuity is divided by the then value of one unit in the separate account, thus arriving at a number of annuity units. The aggregate value of these units each month determines the annuity payment for that month.[42]

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39 For a description of a variable annuity see Note, A Variable Annuity Is Not a "Security," 32 Notre Dame Lawyer 642, 647-51 (1957); SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Bartlett, Variable Annuities: Evolution and Analysis, 19 Stan. L. Rev. 150, 158 n.35 (1966); P. Campbell, The Variable Annuity ch. 5 (1969) [hereinafter cited as Campbell]; Huebner at 117-19; SEC Investor Report at 531.

40 For example, if the contract provides for net annual payments of $1,000 (above sales and administrative charges) and at the date of the first payment each unit is valued at $10, the annuitant would be credited with 100 units; if the value of the units is $20 the next year, he will be credited with 50 units; if the value of the units is $50 at the third year, he would be credited with 20 units, etc. At the end of the three-year pay-in period, he will have accumulated 100 + 50 + 20 = 170 units.

41 This rate has been recently raised in some states to 5%.

42 For example, the 170 accumulated units would be converted into dollars by multiplying their number by their value, assume $5 a unit. The cash value is, therefore, $850.

During the pay-in period, contractholders make periodic payments and are credited after each payment with an appropriate number of accumulation units. The total value of the units so accumulated represents the full amount of the reserve, or the cash value of the contracts. During the annuity payment period (pay-out period), the number of annuity units remains unchanged and is not affected by payments of the insurance company to the contractholders. The units represent a measure for determining the periodic annuity payments, but not the cash value of the contracts. That value varies with the reserves and depends on other factors in addition to investment performance.[43]

The variable annuity contains an undertaking to pay an annuity throughout a specified period, usually throughout life, either the life of the annuitant or some other designated person.[44] This undertaking, termed mortality guarantee or assumed mortality risk,[45] obligates the company to pay the annuity until the contractholder dies, even if the consideration paid for the particular annuity has been exhausted. The company is also obligated to pay the annuity even if the consideration paid for the annuities by the whole group has been exhausted. This can happen if the mortality experience of the contractholder's age group did not conform to the assumptions in the mortality tables. This can happen, at least in theory, if the statistical data and actuarial calculations proved erroneous, resulting in a failure of projected reserves to satisfy the contract obligations to the group.[46]

Assume that a fixed annuity of $10 a month could be purchased for this amount. (The fixed annuity is determined by the age and sex of the annuitant. It also contains an assumed rate of interest, for example, 3½%.) The monthly payment of $10 is then converted into units, at $2 a unit, fetching 5 units. The first monthly payment will be $10. The subsequent monthly payments will be the value of 5 units minus the assumed 3½% interest. Thus, if the investment performance of the account is 3½%, the annuity payment will remain $10. Any change in the value of accumulation units above or below 3½% will affect the annuity payment accordingly. Most variable annuities are fixed at 3½% because some states do not permit a higher assumed interest. This comparatively low assumed interest tends to cause future annuity payments to increase since the equity fund's investment performance may amount to 12% to 13% a year.

43 The value of the units is only one of the factors in computing the reserves. The reserve is calculated according to mortality tables and depends upon the age and sex of the annuitant. As his age advances, the probability of his dying is greater, the assets required to fund the reserve are reduced. A converse calculation is made in life insurance. Note that most insurance companies use the Progressive Mortality Table, which assumes increased probability of longevity for old men on the ground that in 15 or 20 years human life will be longer. This means smaller annuity payments. In a life insurance policy the mortality table does not contain this assumption.

44 Campbell at 44. Variable annuities offer a variety of options for the pay-out period. For example, New York Life Ins. Co. offers the following: the annuity is payable during the life of the contractholder or for ten years, whichever period is longer. Instead of this payment period the contractholder may choose (1) income for a specified period, up to 30 years, or (2) an annuity for life with certain period, that is payments for a period of 5, 10, 15 or 20 years (the certain period) and thereafter for the remaining life of the contractholder or (3) an annuity for the life of two persons.

45 Until recently the guarantee was termed "mortality guarantee." The staff now requests the use of the term "assumed mortality risk."

46 J. Magee, General Insurance 89-90 (6th ed. 1961) [hereinafter cited as Magee].

The insurance company also provides an expense guarantee, a guarantee that its charges will not exceed a certain percentage of the value of the assets in the separate account, regardless of what its real expenses might be. The guarantee presumably covers the fees for the services given by the insurance company as an investment adviser.[47]

The standard variable annuity contract provides that the contractholder has an option to cash in his accumulation units during the pay-in period. Such an annuity can be funded by two separate funds, one for the pay-in period and one for the pay-out period. If one fund is used, two accounting or bookkeeping systems are employed, one for each period. There are diverse opinions as to the desirability of creating two completely separate funds instead of one fund having two accounting systems.[48] Against having two separate funds it has been argued that, first, the fund is not sufficiently large, at least at the beginning, to sustain the additional expense resulting from the separation. Second, transfers from one fund to another require shifting of securities independently of investment performance. Third, discrepancies in the performance between the two funds can be embarrassing to the company. It has been argued in favor of separation that the two periods may call for different investment policies that should be pursued, even though under the 1940 Act two policy statements in the prospectus might be required, and perhaps two investment companies would have to be registered.[49]

The variable annuity can also have one unit and one accounting system. Under this type of annuity, contractholders are credited after each installment payment with "benefits" or annuity units. At retirement age, annuity payments will begin automatically and no option to receive cash is available. This method is sometimes used in group contracts.[50] But most issuers employ the two-unit, one-fund approach.

Individual variable annuity contracts usually provide that if a contractholder exercises his option on retirement to purchase an annuity, the schedule of annuity rates in effect at the time of the date of the contract, rather than, perhaps, a higher rate that might then be in effect, will be applied to him. In other words, the contracts provide for an annuity-rate protection for the life of the contract. In group contracts this protection is generally limited to payments received in the first one, two, three, five or ten years. In its variable annuities contracts, the Prudential Insurance Company of America charges 25 cents per $100 of annuity for "annuity

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47 Campbell at 32-33.

48 Campbell at 33.

49 There exists a conflict of interest between the various contractholders as to investment objectives. Contractholders in the pay-out period may be more security oriented whereas in the pay-in period they may look for growth. Campbell at 33. If the account also funds beneficiaries of a life policy, their investment objectives may vary with their age and financial situation.

50 Campbell at 32.

rate protection rights," which must be purchased with each purchase of accumulation units.[51]

At the outset it should be noted that the relationship between variable annuity contractholders and the insurance company, as well as the type of interest that contractholders have in the separate account, is different from that of the fixed annuity contractholders'. Under the common law an annuity is a chose in action, a debt, chargeable upon the person of the grantor.[52] The traditional annuity is a right to receive payments. It bestows no right to the fund or source from which the payments are derived.[53] There are those who argue that the same relationship is created in the variable annuity, that contractholders have no interest in the fund and are merely creditors of the insurance company.[54] However, the Supreme Court in *SEC v. Variable Annuity Life Insurance Co.*, spoke in terms of "an interest in a portfolio of common stock or other equities."[55] The Third Circuit in *Prudential Insurance Co. of America v. SEC*[56] and the SEC in *Prudential*[57] spoke in terms of a "trust" in the hands of the insurance company, and of the issuance of "interests" in the equity fund to contractholders,[58] connoting, perhaps, some property rights in the fund. The position today is far from clear.[59] But there is no doubt that a basic difference exists between a fixed and variable annuity with respect to the relationship between the contractholders and the insurance company. For example, conventional annuities do not give rise to a right to an accounting,[60] to fiduciary duties by the insurance company,[61] or to any right in the assets funding the annuity contracts.[62] Variable annuities may give rise to these rights.

B. *Variable Annuities and Mutual Funds*

Variable annuities are hybrids of insurance and investment. Their similarity to mutual funds is not difficult to detect. Both arrangements have the same investment purposes. Both invest in equity securities; in both the investor bears the risk of loss and enjoys the chance of profit; and both offer the investor at least a partial solution to portfolio management and diversification by pooling small holdings into one large fund.[63]

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51 Prospectus, Prudential's Investment Plan Account at SP 10 (Apr. 30, 1970).

52 1 Appleman § 81, at 107; Johnson, The Variable Annuity—Insurance, Investment, or Both? 48 Geo. L.J. 641, 652-53 (1960).

53 In re Dwight's Estate, 389 Pa. 520, 525, 134 A.2d 45, 48 (1957).

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

55 359 U.S. 65, 72 (1959).

56 326 F.2d 383, 386-87 (3d Cir. 1964).

57 41 S.E.C. 335, 345 (1963).

58 Id. at 341; 326 F.2d 383, 386-87 (3d Cir. 1964).

59 See pp. 330-32 infra.

60 See pp. 327-30 infra.

61 See p. 327 infra.

62 Id.

63 Wood, Mutual Funds and Variable Annuities: Consumer Purchase Decisions, 23 Chartered Life Underwriters J., Jan. 1969, 8, at 9-10.

Insurance companies entered the equity products field by offering either mutual

The charges under variable annuities and mutual funds are not dissimilar. In mutual funds the charges in front-end contractual plans are 30 percent to 50 percent in the first year and 7 percent to 8½ percent annually for the balance of the term of the plan. The front-end load in variable annuities is about the same, except that the subsequent annual payments are calculated for a period of nine to twelve years. Level load under both arrangements ranges from 7 percent to 8½ percent.

It is emphasized by the insurance industry that in the last few years the load pattern of variable annuities has been changing from front-end load to level load, whereas most mutual fund shares are sold on a contractual basis and charged a front-end load. Thus, the equity insurance product offers a fairer load system.[64]

On the other hand, it has been pointed out by the investment industry that management fees charged to mutual funds range from 0.45 percent to 0.65 percent of the assets of the fund, sometimes scaled down on the assets above a stipulated level, whereas insurance companies charge contractholders 1 percent to 1.5 percent of the assets of the fund. These fees, however, include a charge for mortality and expense guarantees. The breakdown between these two components varies greatly among insurance companies.[65] This fact supports the contention that the charges for mortality and expense guarantees do not represent actual expenses or reserves but are mostly income, and that the division between advisory fees and guarantee charges is affected mainly by tax considerations. Whether the mortality charge is income depends on the evaluation of the mortality guarantee risk.[66] If under state law this charge must be allocated to a specific reserve fund, it should not be classified as income. If the insurance company allocates the charge to a special reserve fund, absent such statutory command, it may nevertheless still not be income. But when the charge

fund shares or variable annuities. (Only Prudential Insurance Co. offered both simultaneously.) The advantages of mutual funds were that they were well established and accepted products, and their regulation was well defined. Also, an insurance company that starts a mutual fund can use it later to establish separate accounts registered under the 1940 Act as unit investment trusts. The disadvantages of mutual funds for insurance companies were that they constituted a basic departure from traditional insurance, that life insurance salesmen might find them hard to market and that they may compete with, rather than complement, life insurance. Variable annuities on the other hand do not constitute a drastic departure from insurance and are viewed as complementing life insurance. SEC Investor Report at 520-21. On the different ways in which insurance companies enter the mutual fund field, see id. at 522. See also, Routier, The Mutual Fund Approach to Equity Products, Proceedings of the Legal Section Am. Life Convention 13 (1968), Townsend, Variable Annuity Approach Separate Acount Investments in the Company, Proceedings of the Legal Section Am. Life Convention 21 (1968).

64 A contractholder who paid a front-end load will incur a loss if he terminates the contract in early years. This inequity was partially ameliorated by § 27(d)-(h) of the 1940 Act. See pp. 310-12 infra.

65 Wood, note 63 supra, at 8, 10.

66 The charge for mortality guarantee forms the largest source of earnings for the insurance company, together with the investment advisory fees. However, the mortality guarantee is also uncertain and therefore risky. If retired contractholders live longer and the market performs well, the insurance company may incur a substantial loss. Blakeslee, The Variable Annuity Today, 22 Chartered Life Underwriters J., Apr. 1968, 9. See also Campbell at 33.

is allocated to the general assets of the company it may be classified as income. Members of the insurance industry have justified this charge on the ground that it is needed to cover operating and administrative expenses of separate accounts in their early years. It has been argued that insurance companies, unlike mutual funds, cannot take advantage of the services of banks and must set up their own expensive system of operation. The argument may provide reason for a higher management fee for insurance companies but it tends to show that charges for the mortality guarantee are income. In sum however, the differences in the load charged by mutual funds and insurance companies reflect the nature of the issuers rather than the nature of the contract or security.

In the pay-in period, the variable annuity and the mutual fund share make identical promises—maximization of profits through the medium of an investment company. In fact, during the pay-in period variable annuities can be viewed, among other things, as an installment purchase plan of mutual fund shares, except that they provide an option to purchase an annuity.

In the pay-out period, a variable annuity contract contains a mortality guarantee. This guarantee has been viewed as a promise that the contractholder will not outlive the liquidation of his income and capital.[67] Mutual funds may provide an option for the systematic liquidation of shares too. But the mortality guarantee is missing in their arrangement. Mutual funds claim that this guarantee is superficial since in reality the insurance company bears no risk. Even so, the guarantee is valuable to an individual who seeks protection against the risk of outliving his resources. This protection is available only by the pooling and distribution of the mortality risk.[68] Herein lies a major difference between the two arrangements.

The second significant difference between mutual funds and variable annuities is in their tax treatment.[69] This difference may yet be bridged, at least for the pay-in period. In 1969 Prudential Insurance Company of America (Prudential) requested and received for its separate account that funded non-qualified individual annuities during the pay-in period, tax treatment similar to that of a mutual fund under Subchapter M of the Internal Revenue Code.[70] In general, however, the question of tax treatment of variable annuities has not yet been settled.

A third difference between the two economic arrangements is a reflection of the difference between a systematic liquidation of shares and an annuity. In a share-liquidation plan all capital gains and dividends on the investment inure in full to the shareholder. In an annuity during the pay-out period not all capital gains and dividends on the investment or reserves are distributed to the contractholders. They receive only such dividends

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67 See pp. 232-33 infra.

68 Wood, note 63 supra; Magee at 85, 89.

69 SEC Investor Report at 521-22; Note, Regulation and Taxation of the Variable Annuity, 33 St. John's L. Rev. 118, 129-30 (1958); Int. Rev. Code of 1954, § 801(g).

70 Prospectus, Prudential's Investment Plan Account at SP 10, 11 (Apr. 30, 1970). Int. Rev. Code of 1954, §§ 851-855.

and capital gains as have been realized by the monthly liquidation of the number of annuity units representing their monthly annuity. Therefore, contractholders who live longer inevitably receive, proportionately, more of the investment appreciation. This feature is a result of the insurance aspect of the arrangement. The pay-out-period annuity payments do not squarely represent a *pro rata* share in the fund, or any part of it.[71]

To sum up: in the pay-in period a variable annuity and a share in a mutual fund are virtually the same. They are investment arrangements, though variable annuities tend to emphasize long-term savings. The mortality guarantee in the variable annuity introduces an insurance element that constitutes the only significant difference between the two arrangements. An understanding of how insurance functions is therefore essential to the understanding of variable annuities.

C. *Conventional Life Insurance*

"Insurance is an arrangement for risk transference and distribution under which one . . . contracts to do something that is of value to another . . . upon the occurrence of a specified harmful contingency."[72] In order to constitute insurance, the following elements must be present: there must be risk of loss (in life insurance it is loss of income assumed to result from premature death); the risk must be assumed by another, the insurer; the technique that the insurer must use to cover the loss is pooling and distribution; the main purpose of the contract must be protection of people depending upon, or interested in, the insured's life, and the benefits are usually paid to one other than the insured.[73]

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71 The staff of the Commission argued in In re Prudential Ins. Co. of America, 41 S.E.C. 335, 354 n.48 (1963), that such an arrangement constitutes a semi-tontine policy. The Commission refused to become involved in what it considered an "insurance regulation" matter. See also Bartlett, Variable Annuities: Evolution and Analysis, 19 Stan. L. Rev. 150, 157-159 nn.34 & 35 (1966).

72 R. Keeton, Basic Insurance Law 483 (1960). The definition, the author warns, is neither conclusive nor exhaustive. The following are the prevalent types of life insurance:

a. *Whole life insurance,* providing coverage for the whole lifetime and maturing only on death of the insured. This type may be subdivided into: 1. Ordinary or straight life insurance (whole life insurance, in which premiums are payable either throughout the lifetime of the insured, or else until he has reached an advanced age, e.g., eighty-five). 2. Limited payment life insurance (whole life insurance, in which premiums are paid only during a specified number of years, e.g., fifteen to twenty, or until a specified event, namely, death of the insured). 3. Single premium life insurance. 4. Joint life insurance.

b. *Endowment life insurance,* providing for payment of a specified amount, either in the event of death within the endowment period, commonly twenty years, or upon survival on the maturity date.

c. *Term life insurance,* providing for payment of a specified amount, only if death occurred within a certain period (this type is used on hiring an irreplaceable employee, e.g., an actor for movie making).

d. *Modified life insurance,* containing a combination of term and ordinary life insurance characteristics. Id. at 54.

See also Huebner at 3.

73 Ross v. Odom, 401 F.2d 464, 470 (5th Cir. 1968): "The nature of insurance arrangements are almost infinite, reflecting generally the coalescence of four things. One is the

1. Risk

Risk means uncertainty. In life insurance the uncertainty pertains to the time of insured's death. If either the insured or the company knew that date, there would be no insurance. If the insured knew that he would have a long life, he would invest the premiums more profitably than at the low assumed interest under the insurance policy. If the insurance company knew that the insured would die before he completed his premium payments, it would not undertake to pay him a larger amount.

Not all risks are insurable. Only pure risks, involving only the possibility of loss are insurable. Speculative risks, involving the possibility of both loss and gain, are not insurable. The risk of fire is a pure insurable risk. The risk of investment is not. To be sure, it is a risk; and it can be shifted from one to another. But it cannot be pooled and distributed. Speculative risks may be nullified by a process of "hedging." For example, a manufacturer orders raw material, which he plans to use over a period of a few months. To insure himself against loss through decline in the price of raw material at the time of anticipated sale of the finished product, he can sell short a quantity of raw material equal to the quantity originally purchased. Loss on either transaction will equal the gain on the other, thus nullifying both loss and gain.[74]

Loss resulting from speculative risk can, therefore, be avoided by offsetting it against profit. Loss resulting from a pure risk cannot be so offset. It can only be indemnified. Insurance does not minimize risk; it covers it.

2. Shift of Risk

It has been said than an insured exchanges the possibility of great loss while young for a fixed calculated loss each year. He can budget for the loss and absorb it without financial disaster. Since the amount of the death benefits remains fixed while the insured continues to pay premiums, he may have paid in the full amount of death benefits received by his beneficiaries[75] if he has a long life. If his life is short, the company may pay death benefits far exceeding the amount of premiums paid.[76]

existence of a risk either of occurrence, or time (or both). The second is the business need to underwrite risk of such loss. The third is the price to be charged for that protection. The fourth, a blend of all, the terms and conditions on which all or any given part of such loss is to be undertaken." See also Tyler v. Treasurer and Receiver General, 226 Mass. 306, 115 N.E. 300 (1917).

74 Magee at 80. But loss of value of property, including securities, is insurable.

75 This sum will not include the assumed interest, which is comparatively low.

76 1 Appleman § 2, at 11-13: Ordinary or whole life insurance,

> . . . is written upon the life of an individual for a fixed amount at a definite annual premium. A premium is paid upon it each year in the same amount during the entire lifetime of the insured. . . . That type of contract is the underlying basis of all life insurance, and other types of contracts are merely modifications or conveniences adopted and tacked thereon. . . . [I]mmediately upon the payment of the first premium, the insured attains an estate, in the event of his death . . . . [I]n the first few years, a very substantial loss is suffered by the insurer. Theoretically, if the insured then lives to the exact age fixed for him by the mortality tables, the insurance company breaks even, whereas if he lives beyond that period, the company is the gainer. It is the equal offset of premature deaths and deaths occurring

The risk of loss, namely, the risk that the insured will die before he can accumulate an amount equal to the death benefits, must be shifted to the insurance company. When payment of the premium is not based on the calculation of probabilities, and the insurance company simply undertakes to repay the amount paid to it as premium, there is no risk-shifting or distribution, and hence there is no insurance.[77] "An essential element of any insurance contract is that the insurer, as one of the conditions of the contract and as consideration, at least in part, for the periodical payment of premiums, assumes some risk of being required to pay the beneficiary a larger sum of money than the amount, with interest, paid in."[78]

This principle was applied to determine whether certain arrangements were insurance, the proceeds of which were entitled to exemption from state inheritance tax and the federal income tax.[79] When elderly persons simultaneously purchased a single-premium life insurance policy without a medical examination, and a single-premium life annuity policy, and the insurance company would not have sold them the life insurance without the annuity, there was no true insurance risk. What the insurance company would have lost on one contract it would have gained on the other.

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beyond the average span which renders the mortality tables accurate and permits the insurer to assume such risks with safety.

. . . The net premium, in turn, is divided into two parts, the current year 'mortality element' and the current year increase to 'policy reserve.' Since the reserve is built from the insured's own money, the company, therefore, uses the insured's own money plus interest accumulations thereon to reduce his risk each year. If death occurs . . . the company, in effect, returns a portion of the insured's own funds to him which have been built up as reserves and pays the balance from the mortality pool. Thus, the company's risk is reduced as the death rate increases, so that they offset each other. . . .

As the insured ages, less and less goes into the reserve, and more of the payment must go to net premiums until a point is reached where the entire premium not only goes to pay the net premium on the risk, but a portion of the interest earning upon the reserve must be applied to mortality.

[77] Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954).

[78] In re Fidelity Assurance Ass'n, 42 F. Supp. 973, 982 (S.D.W. Va. 1941) (refund annuity contracts not insurance).

[79] Annot., 73 A.L.R.2d 157, §§ 10-16, 21, 22, 32 (1960); Tilney v. Kingsley, 43 N.J. 289, 204 A.2d 133 (1964). To the same effect is Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954). See In re Smiley's Estate, 35 Wash. 2d 863, 216 P.2d 212 (1950). A plan provided for a stipulated return for retired employees during their lifetime, and a disposition after their death of whatever remained of the sum paid for or by them to a designated beneficiary. This payment was not exempt as insurance and was subject to income tax, particularly in the view of the absence of an element of risk of loss which must be present in life insurance. Zimmermann v. Commissioner, 241 F.2d 338 (8th Cir. 1957), held that a fixed-term annuity policy or a policy which provided for the return, without interest, of the single premium paid if the annuitant died before the beginning of the pay-out period was not insurance. See also Old Colony Trust Co. v. Commissioner, 102 F.2d 380 (1st Cir. 1939), holding that an annuity paid on a purely voluntary basis, even though designed to afford partial protection to dependents of employees, does not, ipso facto, transform into insurance, at least for internal revenue purposes. For the application of the same principles, see All v. McCobb, 321 F.2d 633, 637 (2d Cir. 1963).

But payments of premiums by employees is not a condition precedent to insurance. See Ross v. Odom, 401 F.2d 464, 467, 470 (5th Cir. 1968). A plan whereby 20,000 employees participated, and which was based on actuarial computations, was insurance. There was risk shifting and risk distribution. Employees were contributing fixed, small amounts. See also Commissioner v. Treganowan, 183 F.2d 288, 290 (2d Cir. 1950).

It should be noted that in these single-premium cases the company did retain the investment risk, that the capital might be lost or that profits would not cover the assumed interest. The courts recognized that this risk was different from insurance risk and insufficient to sustain the classification of insurance. This principle was reiterated in *SEC v. United Benefit Life Insurance Co.*,[80] discussed below. There the Court held that investment risk-taking in and by itself did not create an insurance contract.[81]

3. Distribution of Risk

Risk-distribution is an indispensable element of insurance. It is not enough that the insurance company undertakes to pay the loss. The scheme that it uses to cover that payment must involve risk-distribution.[82]

> Risk shifting emphasizes the individual aspect of insurance: the effecting of a contract between the insurer and insured each of whom gamble on the time the latter will die. Risk distribution, on the other hand, emphasizes the broader, social aspect of insurance as a method of dispelling the danger of a potential loss by spreading its cost throughout a group. By diffusing the risks through a mass of separate risk shifting contracts, the insurer casts his lot with the law of averages. The process of risk distribution, therefore, is the very essence of insurance.[83]

The insurer does not bear the risk of loss of any one individual insured, even though that risk is shifted to him. By using the law of great numbers,[84] by pooling many risks, the insurer is able to calculate with a great degree of accuracy the probability of occurrence of loss to the group. The only risk that the insurance company undertakes, in addition to the investment risk of loss of the funds committed to it, and perhaps failure to secure a conservative income, is the risk that the mortality tables containing calculation of probabilities upon which premium payments are based are inaccurate.

The relationship between this insurance device and the calculation of premiums should be noted. Assume that 10,000 individuals aged 57 insure their lives for one year for $1,000. Standard mortality tables indicate that at this age the death rate per 1,000 is 21. The life insurance company could, therefore, count on 210 deaths that year, or payments equal to $210,000.

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80 387 U.S. 202 (1967).

81 Id. The Court cited Helvering v. Le Gierse, 312 U.S. 531 (1941), in which the term "insurance" was interpreted for the purposes of inheritance tax. The insurance company in that case issued to an uninsurable person a life insurance policy and a non-refundable annuity simultaneously. Viewing the two contracts as one economic transaction, the Court held that there was no insurance risk since whatever the company might lose on the death of the insured by virtue of the policy, it would gain on the annuity contract. The assumption of investment risk, per se, did not create an insurance contract.

82 Day v. Walsh, 132 Conn. 5, 42 A.2d 366 (1945). In a true life insurance policy the contract is a part of a general scheme to distribute losses among a large group of persons in the same class, and the insured is required to make a ratable contribution to the general fund from which the losses are paid.

83 Note, The New York Stock Exchange Gratuity Fund: Insurance That Isn't Insurance, 59 Yale L.J. 780, 784 (1950).

84 Huebner at 3-4; Magee at 89-90.

Since there are 10,000 in the group, each pays $21. The company's loss or gain will depend on whether or not the mortality prediction was accurate.[85] If the company collects only $5 from each member, it will probably become insolvent unless it is able to augment the insurance premium income by enough investment income (which is unlikely). The plan is therefore a gamble rather than insurance. Inversely, if each insured pays not $21 but $1,000, in consideration for which the company promises to pay the insured the same amount, the contract is an investment. There is no transfer or distribution of risk and hence there is no insurance. A corollary to this statement is, that the higher the premiums or payments by the insured, the more rights he acquires to receive his premiums back, even in the event that he does not sustain the loss against which he is insured. Thus, a pure life insurance policy, which promises nothing but a specified sum upon death, can be obtained at a lower premium than a policy that promises, in addition to death benefits, a "cash value."[86] Such a policy is less expensive than an endowment policy, which promises to pay the death benefits to the insured if he is alive at the end of a certain period.[87]

4. Protection

The main purpose of a life insurance contract must be the protection of beneficiaries. If the predominant purpose of the contract is other than protection—for example, the provision of health services,[88] the service and repair of fluorescent lights,[89] or investment services[90]—the contract is not a contract of insurance, even though it contains some insurance features. In evaluating the contract, the whole arrangement must be examined:

> That an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If attention is focused only on that feature, the line between insurance or indemnity and other types of legal arrangement and economic function becomes faint, if not extinct.[91]

State law usually requires that the contract be actuarially sound. In years past, contracts of insurance that contained unsound actuarial calculations were permitted. In these contracts the wagering element was predominant.

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85 Magee at 590.

86 1 Appleman § 2, at 13.

87 McKee v. Columbus Mut. Life Ins. Co., 171 Okla. 250, 252, 42 P.2d 831, 833 (1935); 1 Appleman § 5, at 19.

88 Jordan v. Group Health Ass'n, 107 F.2d 239 (D.C. Cir. 1939); California Physicians' Serv. v. Garrison, 28 Cal. 2d 790, 172 P.2d 4 (1946).

89 Higger v. Radziminsky & Zeger, Inc., 8 App. Div. 2d 967, 191 N.Y.S.2d 69 (1959); cf. Transportation Guarantee Co. v. Jellins, 29 Cal. 2d 242, 174 P.2d 625 (1946) (dictum).

90 State ex rel. Clapp v. Federal Inv. Co., 48 Minn. 110, 50 N.W. 1028 (1892). But see Joseph v. Law Integrity Ins. Co., 2 Ch. 581 (1912); Vance at 89-90.

91 Jordan v. Group Health Ass'n, 107 F.2d 239, 247-48 (D.C. Cir. 1939). See generally Vance at 88-90.

Tontine,[92] semi-tontine [93] and other speculative arrangements[94] were sold to the public without hindrance. Speculative assessment insurance business was not found to be fraudulent or against public policy.[95] Eventually such arrangements were modified or outlawed altogether by legislation.[96] Protection in the sense of a sound insurance business arrangement is, therefore, not an indispensable requirement for the definition of insurance. Rather, it is a policy declared by state legislatures and followed for the past fifty years.[97]

D. *Conclusion*

As will be shown, there are differences between life insurance and annuities. Nonetheless, annuities that are based, at least in part, on life contingencies, utilize the technique of risk coverage which is unique to insurance. The premiums and the annuity are calculated according to mortality tables, and the risk of longevity is pooled and distributed. In the pay-in period the variable annuity is a savings and investment device like a share in a mutual fund.

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92 Tontine policies are policies under which members in a group pay fixed payments into a common fund. After a specified period, for example, fifteen years, the surviving members share pro rata in the fund. Those who die lose all. See, e.g., Gadd v. Equitable Life Assurance Soc'y, 97 F. 834 (S.D.N.Y. 1899); Vance at 64. See also 1 Appleman § 13; Kimball & Hanson at 184-201.

93 A semi-tontine policy, developed later, provides that the beneficiaries of a deceased member will receive the full face value of the policy. Capital gains and dividends are paid pro rata, sometimes to remaining living members after the expiration of a specified period, and sometimes also to beneficiaries of members together with death benefits. See, e.g., New York Life Ins. Co. v. Miller, 22 Ky. L. Rptr. 230, 56 S.W. 975 (1900); Gourley v. Northwestern Nat'l Life Ins. Co., 94 Okla. 46, 220 P. 645 (1923). See also In re Equitable Reserved Fund Life Ass'n, 131 N.Y.S. 354, 30 N.E. 114 (1892).

94 Fawcett v. Supreme Sitting of Order of Iron Hall, 64 Conn. 170, 194, 205-08, 29 A. 614, 622, 626-27 (1894). A so-called fraternal society carried on an endowment policy business on an assessment basis promising, by implication, that monthly assessments of not more than $2.50 would result in benefits of $1,000. Few of the first participants profited, but tens of thousands lost their investment when the company became insolvent. Dissenting Judge Hamersley argued that the contract was fraudulent and against public policy. The business scheme of the company was such as to make insolvency inevitable. He said: "All insurance has a wagering element, and by the common law of this state wagering contracts are unlawful. In insurance, however, the wager is not the controlling element. The object of the contract is protection . . . in life insurance, protection of the value of a man's life to his family or his creditors. But in any such case, if the element of protection is eliminated, if there is no insurable interest, if the contract is a mere speculative bet on contingencies, if nothing but the wagering element remains, then the contract becomes obnoxious to the law which pronounces wagers illegal." Id. at 204-05, 29 A. at 626.

95 Fawcett v. Supreme Sitting of Order of Iron Hall, 64 Conn. 170, 29 A. 614 (1894). The majority held that the business was not, as a matter of law, fraudulent. As to the inadequacies of assessment insurance see Magee at 593-95.

96 Kimball & Hanson at 186-88. Most states require distribution of dividends, annually or every five years, and a few states prohibit the tontine by departmental regulation.

97 Unlike the practice in England, "state governments have assumed control of practically every aspect of the companies' business and operations." The author questions the merit of "limitations imposed by certain states on investment powers, on the amount of new business, on expenses, and on surplus funds . . . ." J. Maclean, Life Insurance 505 (9th ed. 1962) [hereinafter cited as Maclean]; Huebner at 728-53.

III. *Valic* AND *United* DECISIONS

A. *Variable Annuities Are Securities*

In *SEC v. Variable Annuity Life Insurance Co. of America*,[98] the Supreme Court held that for the purposes of the federal securities laws, variable annuities were securities, not insurance contracts and, therefore, were not exempt from federal regulation. The variable annuity offered by Valic differed from a conventional annuity in that it transferred the investment risk from the insurance company to the contractholder. This transformed the annuity from an exempt insurance product into a security. The Court held that the "concept of 'insurance' involves some investment risk-taking on the part of the [insurance] company. . . . [a] guarantee that at least some fraction of the benefits will be payable in fixed amounts."[99] Valic did provide mortality and expense guarantees. But the Court did not consider these guarantees sufficient to sustain the insurance classification: "In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense."[100] The Court did not specify the conditions and the extent of the investment risk that the insurance company would have to take in order to qualify this annuity as an insurance product. It merely required "some investment risk-taking."

Purporting to follow the guidelines established in *Valic*, United Benefit Life Insurance Company (United) prepared an annuity contract that, in the opinion of its experts, satisfied the investment risk-taking requirement.[101] This annuity was again tested in the courts.[102] United's variable annuity differed from Valic's variable annuity in two essential respects. First, during the pay-in period, accumulation units were redeemable at a guaranteed minimum dollar amount. United assumed the investment risk on 50 percent of the premiums paid during the first year of the contracts and up to 100 percent after ten years. Second, no variable annuity was available in the pay-out period. At the end of the pay-in period, the contractholder had an option either to receive cash, or to purchase a fixed-dollar annuity. All agreed that this fixed-dollar annuity was an insurance contract within the meaning of the federal securities laws. United argued that its annuity contract should be considered as a whole, and that since the predominant feature of the contract was a fixed-dollar annuity in the pay-out period—a conventional insurance product—the contract in the pay-in pe-

98 359 U.S. 65 (1959), rev'g 257 F.2d 201 (D.C. Cir. 1958); see Dorsey, The Place of "Variable Annuities" in Law and Economics, 34 Notre Dame Lawyer 489, 496, 500 (1959); Jones, A Discussion and Analysis of the Valic Decision, 5 Vill. L. Rev. 407 (1960); Kern, Variable Annuities, 1968 Ins. L.J. 277; Shea, Implementation of the Valic Decision, 5 Vill. L. Rev. 426 (1960); Note, Federal and State Regulation of the Variable Annuity, 44 Minn. L. Rev. 289 (1959); Note, Regulation of Variable Annuity Sales: The Aftermath of SEC v. Valic, 1959 Wash. Univ. L.Q. 206; Recent Cases, 17 Buff. L. Rev. 495 (1968).

99 359 U.S. at 71.

100 Id.

101 Evans, Flexible Fund Annuity and the Securities Act of 1933 and Securities Exchange Act of 1934, Proceedings of the Legal Section Am. Life Convention 102-03 (1967).

102 SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967), rev'g 359 F.2d 619 (D.C. Cir. 1966).

riod fell into the same category. Alternatively, United argued that the minimum cash guarantee offered during the pay-in period sustained the requirement prescribed in *Valic* of "some investment risk-taking" and that therefore this part of the contract qualified, independently, as an insurance contract.

The Supreme Court disagreed.[103] It held that the pay-in and pay-out periods in the contract were distinct and severable. During the pay-in period in a conventional annuity there is no insurance arrangement, but the insurance company retains the investment risk. It promises to preserve the premiums paid to it by the contractholder and to ensure a fixed income, acting in "a role similar to that of a savings institution . . . ."[104] In the contract offered by United, the investment risk was shifted to the contractholder in the pay-in period, so that the insurance company retained no risk and became merely an investment agent. The Court also held that the minimum investment guarantee offered by the company during the first pay-in period was not sufficient to convert that part of the annuity contract into an insurance contract. The guarantee was too low and the risk assumed by the company was insubstantial. The Court did not decide how high the investment risk should be and what methods should be used to cover it in order to qualify the contract as insurance.

Before discussing the applicability of *Valic* and *United* to variable insurance, it is desirable to analyze the concepts of investment and insurance upon which the decisions rest.

B. *Investment and Insurance*

As used in *Valic* and *United,* the term "investment" has a twofold meaning. First, it means any arrangement for placing capital in order to secure income.[105] In this sense almost every insurance contract contains an investment component. Second, when dealing with investment risk-taking, the term is used in a narrower sense, that of an equity investment in contrast to a fixed-income investment. In an equity investment an investor bears the risk of loss and enjoys the chance for gain. In a fixed-income investment an investor does not bear the risk of loss and has only a limited, but guaranteed, predetermined income. In the following discussion, the term "investment" will be used to convey the first, more general meaning. The term "equity investment" will be used to convey the second, more limited meaning.

Life insurance and investment are two economic tools that differ in purposes, in the type of risks they entail, and in the methods they employ to cover the risks. The main purpose of life insurance is to provide protection for beneficiaries against loss due to the death of the insured. The main purpose of investment is to secure a return on capital. First, in insurance the aggregate amount of premiums paid by the insured before his death bears

103 387 U.S. 202 (1967).

104 Id. at 208.

105 State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938 (1920), cited in SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

no relationship to the amount of death benefits. The aggregate amount of premiums depends primarily on the length of the insured's life, whereas the amount of death benefits is fixed. In investment, the amount invested is a function of the return on the investment, whether this return is fixed, as in a debt, or dependent on investment performance, as in an equity investment. Second, life insurance benefits are paid to a person other than the insured, unless the policy is an endowment policy. [106] In investment, benefits are due and paid to the investor or to someone else by right acquired from the investor. Third, generally insurance creates a right in the beneficiary. This right is created with, and by virtue of, the insurance policy and not as a result of the insured's death or otherwise through him, although it may mature only upon death.[107] Investment creates a right in the investor. Finally, by and large, the relationship between the insured and the insurance company is that of a creditor and a debtor.[108] The insured does not have rights in the assets from which his policy will be paid. He has no say regarding the manner in which his premiums are invested and is generally not entitled to an accounting, except as a creditor.[109] This is true in some jurisdictions even when the payments due to the insured depend upon the investment performance of the insurance company, as under participating policies.[110] The rule may be based, *inter alia,* on the very nature of insurance. The insured cannot have property rights in the premiums since death benefits on other policies might be paid out of his premiums. Investment, on the other hand, may include a variety of profit, loss and risk allocation. Further, an equity investor usually participates in management.[111] Thus, a policyholder in a mutual insurance company participates in management not by virtue of his policy but by virtue of his membership in the company.[112]

Insurance risk-taking and investment risk-taking also differ greatly. First,

[106] G. Richards, The Law of Insurance § 21, at 28 (4th ed. R. Long 1932). This attribute alone is not necessarily proof of life insurance. If an assumption and distribution of risk is absent, the contract may be classified as an investment contract: Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954).

[107] Rights of beneficiaries vary greatly depending on the terms of the policies. R. Keeton, Basic Insurance Law 223-244 (1960); Vance at 656-710. See also Gregg v. Commissioner, 315 Mass. 704, 54 N.E.2d 169 (1944); Garos v. State Tax Comm'n, 99 N.H. 319, 109 A.2d 844 (1954).

[108] Equitable Life Assurance Soc'y v. Brown, 213 U.S. 25 (1909) (applying New York Law); Uhlman v. New York Life Ins. Co., 109 N.Y. 421, 17 N.E. 363 (1888); Fidelity & Cas. Co. v. Metropolitan Life Ins. Co., 42 Misc. 2d 616, 248 N.Y.S.2d 559 (1963), accord, Gourley v. Northwestern Nat'l Life Ins. Co., 94 Okla. 46, 220 P. 645 (1923). But in Kentucky, for some purposes an insurer issuing a participating policy was held to be a trustee. Equitable Life Assurance Soc'y v. Hardin, 166 Ky. 51, 178 S.W. 1155 (1915).

[109] See p. 327 infra.

[110] 3 J. Appleman, Insurance Law and Practice § 1571, at 287-88 (rev. ed. 1967) [hereinafter cited as 3 Appleman]; Townsend v. Equitable Life Assurance Soc'y of United States, 263 Ill. 432, 105 N.E. 324 (1914); Gourley v. Northwestern Nat'l Life Ins. Co., 94 Okla. 46, 220 P. 645 (1923); Ellinger v. Equitable Life Assurance Soc'y of United States, 132 Wis. 259, 111 N.W. 567 (1907).

[111] 5 Fletcher, Cyclopedia of the Law of Private Corporations § 2096 (1967); annot., 154 A.L.R. 934, 939-49 (1945) (regarding distinctions between interest and dividends for income tax purposes).

[112] See pp. 240 infra.

sound insurance risk-taking depends on actuarial expertise and statistical accuracy. Sound investment risk-taking depends on investment know-how and accurate information on market and economic conditions. Second, insurance risk-taking makes use of pooling and distribution of risks, whereas investment risk-taking cannot be affected by the rule of great numbers. In fact, if gain does not materialize, the larger the investment the larger the loss. Third, insurance risk is covered mainly by contributions of insured persons, and only a fraction of it is covered by investment gains, but investment risk is usually covered solely from income. Fourth, insurance risk-pooling and distribution change the nature of the risk borne by the insurer. The transfer of investment risk, however, does not change the nature of the risk to the transferee; the risk remains an investment risk.

The most significant difference between the two types of risk-taking is the method used to cover the risk. All other differences flow from this distinction. If capital or income is specified and if reliable statistical data are available to calculate the probability of risk, and if sufficient number of such risks can be pooled so that the cost of protection is not too great, then the risk of loss of capital or income or both can be a pure insurable risk covered by insurance methods.[113] Insurance techniques have been applied to

[113] See proposed bill S. 588, Jan. 1969, submitted by Mr. Dennis L. McKenna to the Massachusetts General Court to amend Mass. Gen. Laws ch. 175, by authorizing insurance companies to issue policies insuring owners of shares in mutual funds against loss on value of any such shares held for at least ten years.

As far back as June of 1961, at least one American insurance man began efforts to offer a package that would guarantee an investor against loss provided the investor followed dollar cost averaging in a particular mutual fund over a 10-year period. Extensive research was carried out through a casualty company. Of particular note was a study completed by the actuarial firm of Joseph Froggatt & Co. of New York. Froggatt & Co. began their studies of the market in 1929 and carried them through 1961. In this time period the investor whose dollar cost averaged his investments on a monthly basis in the Dow Jones Average, would have obtained a profit in every 10-year period. Armed with these statistics and a rate developed by Froggatt & Co., the casualty company drew a surety bond guaranteeing the principal of such an investor, and had same accepted by the Minnesota Insurance Division. The casualty company then proceeded to assemble a guaranteed mutual fund package with a large and nationally known mutual fund organization. Simply stated, it was intended that through the casualty company the purchaser of a 10-year contractual mutual fund program would be offered a policy guaranteeing that at the end of the specified period the purchaser could redeem his contract for the then net asset value of his fund shares, or could claim under the surety bond by assigning said shares, in which event the investor received the cumulative amount of his monthly investments.

Approval of a state insurance department was but one step toward the various administrative filings which are required for a new variable dollar product. The staff of the SEC questioned the validity of the rate and the amount of capital and surplus in the casualty company, taking the position all the while that the integrated nature of the policy and contractual plan required both to be collectively registered as a separate security. Accordingly, late in 1962, the casualty company requested another actuarial study, this time starting in 1918 and extending through 1938. The results of this study contributed in a major way to the subsequent decision to abandon the attempt to offer to guarantee dollar cost averaging investments. The 1918 to 1938 study showed losses occurring in four 10-year periods; 1922-1931, 1923-1932, 1924-1933, 1925-1934. In all periods studied, a $100 per month contractual program was utilized with the Dow Jones 30 Stock Index as the assumed investment media. The ending value of a $12,000 total investment in the 1922-1931 period was $8,033.26; the 1923-1932 period was $5,944.68; the 1924-1933 ending value was $10,104.23; the 1925-1934 period was $10,400.90. In view of the very high premium which would cover losses due to specified investment hazards, such as debtor insolvency.[114] Similarly, insurance techniques can be applied to insure against loss due to the adverse performance of the stock market. Statistical data regarding past stock-market performance can be used to calculate the degree of probability that the price of a share will fall below a specified amount. Consequently, the cost of protection against loss as a result of price decline below the specified sum can be established. Actuaries have pointed out that this type of insurance is actuarially unsound, since it is based on the questionable assumption that past stock-market performance and rates of redemption are indicative of the future. This insurance also depends on an arbitrary choice of a representative period. Furthermore, it ignores the variants in economic conditions throughout the selected period and the present. Nonetheless, there are at least two companies in this country today that are offering investment insurance.[115] It remains to be seen whether this line of insurance will develop. Skeptics may be reminded that not so long ago life insurance was also based on actuarially unsound and speculative insurance schemes.[116]

C. *Insurance May Contain an Investment Component*

Notwithstanding the differences between investment and insurance, the two arrangements are not mutually exclusive. Actually, they may complement each other by providing a balanced economic arrangement. Under the criteria described above most varieties of life insurance policies contain some measure of investment. The following are the prevalent examples.

1. Cash Surrender Value

Life insurance in its simplest form, term insurance written on a year-to-year basis, provides for no other payment except death benefits. The benefits are paid only to the beneficiaries. No amount is due to the insured. Term insurance premiums are low while the insured is young—when the probability of his death is low. They become prohibitively high as the insured gets older. The inadequacies of term insurance, as manifested in assessment insurance and one-year term insurance,[117] were corrected by the

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have to be charged to cover such losses, it seemed best to abandon the "magic" of a guaranteed mutual fund.

D. Thornsjo, The Variable Dollar Frontier Revisited, Best's Life News 14, 18 (July 1966).

114 On credit insurance see Vance at 1026-29.

115 Rumford Ins. Co., Providence, R.I., and Harleysville Mutual Ins. Co., Harleysville, Pa. The chairman of the company that underwrites Harleysvilles' policies, Mr. Philip C. Smith of National Securities, believes there is "an enormously large market for this type of program." Wall Street Journal, May 13, 1971, at 22, col. 3. The study conducted by United covered the period of 80 years. If the period of 1918-1938 were representative, the cost of this insurance would be too high. However, if this period were eliminated and only the years 1933-1960 were considered, then the risk undertaken by United was indeed negligible. The Commission's brief based its arguments on the 1933-1960 period. Brief for Petitioner at 6 n.5, 34, 35, SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

116 E.g., life insurance through assessments, Magee at 594-95.

117 Id. at 593-95. On inadequacies of term insurance see Huebner at 9-10, 78-83.

level-premium plan.[118] Under this plan, which is prevalent today, premiums, paid at regular intervals, are constant throughout the premium-paying life of the contract. In the earlier years of the policy, the amounts paid are substantially in excess of the cost of protection. The excess is invested and the accumulated fund is used to cover the difference between the lower amount of protection that the same premium purchases in later years and the face amount of the policy.[119] The difference between the cost of term life insurance in its earlier years and the policy premium actually paid is the "reserve,"[120] the "unearned premium."[121] This amount is approximately the cash surrender value,[122] and represents savings for the insured.

> [I]n level-premium life insurance, while the motive for taking it may be mainly protection, the business is largely that of savings investment. The premium is in the nature of a savings deposit.[123]

It should be noted, however, that the reserve is not pure investment because it is part of an insurance scheme and depends on the mortality rate of a group. The reserve is not only an investment, but also an average figure based on a group, a figure that in the opinion of one writer, has no real significance when applied to an individual policy. "If all the healthy lives were to surrender their policies and were to be paid the full amount of the reserves, the total amount of reserve remaining would be insufficient because the rates of mortality among those who did not surrender (the 'unhealthy' lives) would be much greater than those assumed for *all* insured."[124]

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118 Huebner at 9-10; A. Mowbray, R. Blanchard & C. Williams, Insurance 436 (6th ed. 1969); Penn. Mut. Life Ins. Co. v. Lederer, 252 U.S. 523 (1920).

119 The cost of protection, at any given year, is not calculated on full amount of the policy, but only on that part which together with the excess of premiums paid covers the full amount.

120 Maclean at 14:

> The level-premium plan, in fact, introduces an entirely new element into the scheme of operation: the invested fund formed by the excess payments. This fund is called the *reserve*, which is rather an unfortunate term since it is really not a reserve . . . implying *surplus* but a fund which the company must maintain if it is to be able to pay all death claims and without which it would be insolvent. . . . [u]nder [level-premium policy] . . . the accumulated reserve . . . [is] available as part of the "face amount" payable. Consequently, as the reserve increases, the actual insurance . . . decreases. Thus the increasing death rate is offset by a decreasing effective amount of insurance, and the cost is kept down . . . .

See also 3A J. Appleman, Insurance Law and Practice § 1764, at 62-63 n.23.35 (rev. ed 1967) [hereinafter cited as 3A Appleman]; Huebner at 358-59; A. Mowbray, R. Blanchard & C. Williams, Insurance 314 (6th ed. 1969); Prudential Ins. Co. of America v. Howell, 29 N.J. 116, 148 A.2d 145 (1959); Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954).

121 Maclean at 445-46.

122 Prudential Ins. Co. of America v. Howell, 29 N.J. 116, 148 A.2d 145 (1959); 3A Appleman § 1764, at 62-63 n.23.35; Huebner at 401-02; Maclean at 177-79; A. Mowbray, R. Blanchard & C. Williams, Insurance 314 (6th ed. 1969).

123 Penn. Mut. Life Ins. Co. v. Lederer, 252 U.S. 523, 531 (1920). For the purpose of taxation dividends paid to policyholders of a mutual life insurance company were essentially profits on investments. The source of the dividends was an indicator of the type of payment.

124 Maclean at 177.

2. Endowment Policies

A larger component of investment exists in an endowment insurance policy, a policy under which the amount of death benefits is paid to the insured if he is alive at the expiration of a specified number of years.[125] The higher the amount due to the insured, the larger the investment component in the life insurance policy. Further, the larger the investment component in a life insurance policy, the higher the premium.[126] But even under endowment policies, the amount of a premium is determined according to mortality tables, by using the insurance technique of pooling and distribution of risk.

3. Specialty Policies

The investment or savings in a level-premium policy and an endowment policy is a fixed-income investment, and not an equity investment. Specialty policies offer a variant on the insurance-investment combination. The premiums on these policies are higher than premiums on ordinary life insurance policies, and the excess over the cost of protection is invested in part of the business of the insurance company. The company pays a dividend, either at the discretion of its management or at a fixed rate with or without an additional discretionary dividend, or at a predetermined fixed percentage of the declared dividend. Policyholders may also receive a residual amount of a declared dividend after the stockholders receive a fixed percentage.[127] Policyholders may share in the profits of the company and bear, to the extent of the excess premiums, the risk of loss. The investment portion in these policies might not be greater than that in an endowment policy, but the nature of the investment is different. It is an equity investment in which the insured bears the risk of loss.

D. *Application of* Valic *and* United *to Variable Insurance*

A variable insurance policy is a policy under which the death benefits and cash surrender value vary wholly or partially with the investment performance of a fund of equity securities. Variable life insurance can be expressed fully in units. The premiums, policy values, reserves and death benefits will be expressed in terms of shares. This will result in higher pre-

[125] 1 Appleman § 4, at 16-17 (1965); Huebner at 98-108; Magee at 592; G. Richards, The Law of Insurance § 21, at 28 (4th ed. R. Long 1932). See also Carr v. Hamilton, 129 U.S. 252 (1889); Zimmermann v. Commissioner, 241 F.2d 338, 340 (8th Cir. 1957); State v. Orear, 144 Mo. 157, 45 S.W. 1081 (1898). It would not require much change in the form of an endowment policy to take it completely out of the realm of insurance. Thus, a contract which provides that the insured would be paid a fixed amount on a certain date, but that if he died before that date the contract would be void, was held not to be an insurance contract under Massachussetts law: Curtis v. New York Life Ins. Co., 217 Mass. 47, 104 N.E. 553 (1914). See also Industrial Life Ins. Co. v. Hunt, 335 Pa. 305, 6 A.2d 781 (1939). Upon maturity the life insurance is extinguished and an endowment policy becomes simply an evidence of a debt: Anderberg v. Metropolitan Life Ins. Co., 269 App. Div. 640, 58 N.Y.S.2d 120 (1945) (rehearing denied).

[126] 1 Appleman § 2, at 13.

[127] Kimball & Hanson at 170-71.

miums when the stock market is up. Policyholders may not be willing to undertake the payment of uncertain sums, especially if, a short time later, the unit price may fall. Fixed-dollar amounts is the more acceptable form of premiums. Investment earnings may then be used in a variety of ways. They may be used to purchase additional paid-up insurance.[128] If the investment earnings should drop below the assumed rate, the cash values of the paid-up insurance might be temporarily reduced to purchase a "negative" paid-up insurance. Investment earnings may be applied to reduce the premiums, or may be accumulated and reinvested.[129] Whether a variable policy is a security subject to federal securities regulation may depend on the type and terms of the policy. Some variable insurance policies may be securities. Policies that have the characteristics as discussed below may be exempt.

Valic and *United* reveal two lines of reasoning. One line of reasoning is concerned with an analysis of the concept of insurance in contrast to investment, and the application of this analysis to the characteristics of the variable annuity contract.[130] The other is concerned with the characteristics of the variable annuity contract as a security, and the resultant need for protection.[131] State and federal regulatory patterns are analyzed in order to determine whether state regulation alone affords the necessary protection.[132] The first line of reasoning led the Court in *Valic* to the conclusion that variable annuities lack an essential characteristic of insurance: investment risk-taking by the insurance company. The second line of reasoning led Justice Brennan, in his concurring opinion, to the conclusion that the purchasers of variable annuities are in need of protection by federal securities laws because state regulation does not afford them adequate or relevant protection.

1. The Analytical Approach

The majority in *Valic* held that "the concept of 'insurance' involves some investment risk-taking on the part of the company . . ."; that "in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts . . .";[133] and that "traditionally and customarily they [annuities] have been fixed annuities, offering the annuitant specified and definite amounts . . . ."[134] The Supreme Court in *United* reiterated the same principle.[135]

128 Underhill, How New York Insurance Department Looks at Variable Life Insurance, The National Underwriter, Apr. 3, 1971, no. 14, at 5.

129 Id. See also Walker, Variable Life Insurance, Address, delivered at the Association of the Bar of the City of New York, Apr. 28, 1971.

130 SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 69-71 (1959); SEC v. United Benefit Life Ins. Co., 387 U.S. 202, 209, 211 (1967).

131 359 U.S. at 91 (Brennan, J., concurring); 387 U.S. at 211-12.

132 359 U.S. at 73-93.

133 Id. at 71.

134 Id. at 69.

135 387 U.S. at 210.

It can be argued that *Valic* and *United* are limited to variable annuities and that the underlying policy considerations in these decisions, when applied to variable insurance, lead to different results. There are basic differences between annuities and life insurance.

(a) *The Risk.* The risk in variable annuities is fundamentally different from the risk in life insurance. In life insurance the risk is premature death. In annuities the risk is the reverse—longevity. As Professor Huebner used to say, "Life insurance is really *death* insurance and an annuity is *life* insurance."

The mortality tables used to calculate the premiums and reserves for annuities assume a longer life expectancy than that assumed in life insurance mortality tables.[136] The tables are designed to minimize the probability of loss to the insurance company. It is reasoned that mortality tables based on life insurance experience are not suitable for annuities because most annuities, at least those purchased with a single premium for immediate income, are issued at advanced ages and are purchased as a rule only by persons who are in good health. The mortality experience of this group is lower than that of a life insurance group. This reasoning cannot be validly applied to deferred annuities purchased fifteen to twenty-five years before retirement. Further, unlike life insurance mortality tables, the tables used for annuities are divided by sex,[137] on the ground that women as a group live longer than men. Mortality tables used for annuities also contain "projected life improvements," on the ground that, since technology will constantly improve life expectancies, current projected life expectancies are too short, so that a man with a current life expectancy of eighty will have a still greater expectancy when he reaches the age of seventy. It has been argued that the showing of improvement in the average life expectancy is misleading since much of this is due to a decline in infant mortality. The average improvement does not mean a longer life span for older persons, at least not at the rate suggested.[138] In any event, the reasons for changes in mortality tables used for annuities are equally applicable to life insurance. The use of these tables might perhaps reduce the insurance risk in annuities as compared with life insurance.

The quantity of risk involved in annuities is smaller than the risk involved in life insurance. The risk of longevity is low because there is a high degree of certainty that death will occur at an advanced age, and an absolute certainty that it will occur eventually. This risk is lower than the risk of premature death. It should be emphasized, however, that even though there is a low probability that death will occur later than the age predicted, the losses to the company from longevity are unpredictable. In

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136 In both cases the result is to raise the amount of premiums, or to lower the amount payable by the company to the insured. Some life insurance companies use the more conservative mortality table for variable but not for fixed annuities in order to create additional revenue to cover the mortality guarantee. Campbell at 34.

137 Maclean at 77-78.

138 Id. at 86.

this respect the risk of longevity, which the insurance company undertakes, is very high.

In addition, in an annuity, loss due to longevity is spread over monthly payments. In life insurance, on the other hand, more often than not the whole amount of death benefits becomes immediately due.

The risk undertaken under an annuity contract is quantitatively so small that it has been considered an investment risk that can be covered by investment income:

> In a life insurance agreement the insurer loses in the event of the premature death of the insured, but the only risk encountered by the insurer in an annuity contract, except for the possibility that the annuitant may outlive his expectancy, is an investment risk that the capital may shrink in value or that the return may be less than the amounts payable to the annuitant.[139]

The Supreme Court in *Valic* expressed the same sentiment. Mortality risk, it said, "is apparent, not real; superficial, not substantial."[140]

Finally, in a deferred annuity the insurance risk, the mortality guarantee, takes effect only at the beginning of the pay-out period, at retirement, usually fifteen years after the annuity contract is entered into. During the pay-in period there is an investment guarantee of capital and of a specified income, but no insurance risk-taking.[141] In an insurance policy the guarantee against loss due to premature death becomes operative with the effective date of the policy and continues until payment or termination. Thus, the company bears an insurance risk over a much longer period of time.

(b) *The Investment (Savings) Component.* Life insurance contains less investment than annuities. Both variable and fixed annuity contracts are basically a form of investment with an insurance feature.[142] First, the payee

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139 Cruthers v. Neeld, 14 N.J. 497, 504, 103 A.2d 153, 157 (1954). Accord, Fidelity-Phila. Trust Co. v. Smith, 356 U.S. 274 (1958); Helvering v. Le Gierse, 312 U.S. 531 (1941); 1 Appleman § 83, Contra, Lewis & Novack, Reserve for Unmatured Life-Income Options, 16 Transactions of the Soc'y of Actuaries 360-63 (1964). The authors assert that the risk of longevity may prove greater than expected, and the charge collected by insurance companies might not cover additional payments due to change in longevity patterns.

The industry is of the opinion that "no special reserves should be required to correspond to the unused portion of the original mortality risk charge. Warchall, State Variable Annuity Laws and Regulations Contracts and Companies, App. C, Proceedings of the Legal Section Am. Life Convention 214 (1968). It should be noted that CREF does not guarantee mortality tables or expenses. This means that contractholders in CREF are undertaking not only investment but also mortality risk. This risk is expected to be small in relation to the investment risk. Campbell at 32.

140 359 U.S. at 71.

141 Valic provided for a term life insurance on a decreasing basis for five years. This was the "'one true insurance feature . . . though it is ancillary and secondary to the annuity feature." Id. at 73 n.15. In addition, many companies provide that if the contractholder died before the annuity payments started, a death benefit will be paid to a named beneficiary which is the greater of either the value of accumulation units credited or the value of the premiums paid to "purchase" the accumulation units. See, e.g., Prospectus, Investors Syndicate Life Ins. Annuity Co. at 10 (Apr. 21, 1970).

142 1 Appleman § 83, at 114; see also Bodine v. Commissioner, 103 F.2d 982, 986 (3d Cir. 1939); Cruthers v. Neeld, 14 N.J. 497, 103 A.2d 153 (1954).

is the contractholder, and any beneficiary obtains rights through the contractholder and only by virtue of the contractholder's death.[143] Second, since the mortality guarantee is not significant, the insurance company does not in reality undertake to pay the contractholder substantially more than the amount it has received from him; its risks may be described as only an investment risk. This is particularly true of the pay-in period in any annuity since it does not contain any insurance arrangement. Therefore, annuities contain a larger investment component than insurance policies.

> In the last analysis, there is no escaping the fact that there is a continuous spectrum from a one-year term life insurance policy, which is pure insurance, through the various forms of straight life and endowment policies, to the annuities, both fixed and (in varying degrees) variable, to mutual fund shares and ultimately common stock, which represent pure investment.[144]

It should be noted that the differences between annuities and insurance did not escape the Supreme Court in *Valic.* Justice Brennan, in his concurring opinion, mentioned the argument that annuities were not, in fact, insurance contracts.[145] Nevertheless, the decision was not based on this ground. Conventional annuities were found to be insurance regardless of the magnitude of the investment component that they contained.

It is arguable that even if the Court had based its decision only on the fact that holders of variable annuities bear the investment risk, the decision should not apply to insurance. Variable annuities contain a very large investment component, and therefore, the quantum of investment risk that was shifted to the contractholders is very large. In an insurance policy that contains no investment or savings component or contains only a very small component, investment risk-shifting should not result in converting the policy into a security. This argument, however, is based on the fallacy that the quantum of investment risk is a function of the investment or savings component in the policy. It assumes that if a policy does not contain an investment or savings component, there can be little or no investment risk-shifting. Under this assumption a variable insurance policy that provides no payment to the insured, either of endowment or of a cash surrender value, and that is paid for by premiums calculated only to cover the cost of protection, will be classified as insurance even though the premiums are invested in a separate account and the death benefits vary with the performance of equity securities in the account. This policy is clearly a "pure" insurance contract. It passes all the tests of insurance and

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143 See National Shawmut Bank v. Commissioner of Corps. & Taxation, 354 Mass. 350, 237 N.E.2d 290 (1968), benefits of an annuity purchased by a husband, to be paid after his death to his wife, and after her death to his daughter, even though no refund or change in the beneficiaries has been permitted, were not proceeds of a life insurance, and were not exempt from inheritance tax since the right to the annuity vested in the husband and passed to the beneficiaries only through him. See also In re Barr's Estate, 104 Cal. App. 2d 506, 231 P.2d 876 (1951).

144 4 L. Loss, Securities Regulation 2534 (Supp. 1969).

145 359 U.S. at 81 citing 1 Appleman § 83.

none of investment.[146] Yet, the investment risk borne by the policyholder is not less than that borne by a variable annuity contractholder or a mutual fund shareholder. Equity investment risk-shifting is not confined to the investment or savings part of a policy. The investment risk of the reserves, namely the amounts funding the insurance obligations, can be shifted to the policyholder in exactly the same manner and with exactly the same consequences. Therefore, when an insurance product creates for the purchaser the same risks that an investor takes, federal securities laws will apply.

This is not to say that the existence and extent of the investment component is irrelevant. The investment risk that may convert a conventional life insurance policy into a security may have to be larger than the investment risk that converts a fixed-dollar annuity into a security. If an arrangement contains a large and predominant investment component, the arrangement may be classified as an investment, even if the investment risk is not shifted to the insured. Also, since one of the features of a security is that it is considered as such by the public and described as such by the issuer,[147] a change in annuities that will result in an investment product in the eyes of the purchaser may not be sufficient to produce the same result in a conventional life insurance policy. But the existence of an investment component, no matter how large, is not determinative when the risk-shifting test is applied. Therefore, the differences between annuities and insurance, per se, and the fact that annuities contain a larger investment component than most insurance arrangements, limit but do not exclude the application of *Valic*[148] and *United*[149] to variable insurance.

On the other hand, it appears that the Court's statement that conventional annuities have been expressed in specific and definite amounts should be applied only to annuities. First, the Court itself spoke of "specific and definite" payments only with regard to annuities. When talking of insurance the requirement is for a "fixed minimum." Second, the authorities cited in *Valic* for the propositions both that annuities are specific, definite payments and that insurance requires a guaranteed minimum fixed amount, all deal with annuities and endowment policies, and not with insurance.[150] The cited decision, *Spellacy v. American Life Insurance Association*,[151] also

146 There is no payment to the insured. There is no direct relationship between the payments of premiums or the number of units credited to the insured and the number of units constituting death benefits (even though the units' value might also vary with investment performance), and the purpose of the contract is the protection of beneficiaries, not a return on capital. Moreover, the insurance company, notwithstanding the fact that the investment risk would not be borne by it, is bearing the risk of untimely death by the insured and employs exactly the same techniques to cover this risk, as in conventional life insurance.

147 See pp. 227-29 infra.

148 359 U.S. 65 (1959).

149 387 U.S. 202 (1967).

150 1 G. Couch, Cyclopedia of Insurance Law § 25 deals with annuities in general; see also 1 Richards, Law and Insurance § 27; Bellinger, Hagmann & Martin, The Meaning and Usage of the Word "Annuity," 9 Chartered Life Underwriters J., Summer, 1955, 261.

151 144 Conn. 346, 131 A.2d 834 (1957).

dealt with annuities and endowment policies. Its unqualified statement that insurance is a payment of a fixed sum was backed by cited cases, not one of which dealt with the question whether insurance must be in fixed-dollar amounts.[152] Finally, the periodic payment of fixed sums of money is one of the characteristics inherent in the traditional annuity: "Generally speaking, it [an annuity] designates a right—bequeathed, donated or purchased—to receive fixed, periodical payments, either for life or a number of years."[153] It is this characteristic of fixed payments that distinguishes an annuity from income and rents.[154]

In contrast, neither the common law nor state legislation defines insurance in terms of a fixed-dollar amount. Since the question whether variable insurance is a security is a federal question, state authorities are not determinative. But they have a bearing on interpretation by the federal courts, especially if state regulatory schemes are thereby affected.[155]

In some jurisdictions the definition of life insurance includes the ". . . payment of money or other thing of value . . . ."[156] Hence, burial or funeral insurance was held to be life insurance even though the burial company provided goods and services, the value of which might increase or decrease

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152 Id. at 354-55, 131 A.2d at 839.

(a) In Union Cent. Life Ins. Co. v. Woosa, 11 Ind. 335, 39 N.E. 205, rev'g 11 Ind. 335, 37 N.E. 180 (1894), the issue was whether an insurance company had the right to set off a debt owing to it from a deceased husband but not directly connected with the insurance policy, against death benefits due from it to the wife. Whether the sum paid must be not only ascertainable but also fixed, was not discussed.

(b) In McKee v. Columbus Mut. Life Ins. Co., 171 Okla. 250, 252, 42 P.2d 831, 833 (1935), it was held that a limited premium life insurance policy (a policy under which the insured undertook to pay premiums for specified time [20 years] and not through life) was not an endowment policy which entitled him to the amount of the policy upon the expiration of the 20-year period, if alive. In this connection a definition of an endowment policy as a "contract to pay a certain sum" was cited.

(c) In Central States Life Ins. Co. v. Morris, 202 Ark. 969, 974, 155 S.W.2d 333, 335 (1941), it was held that an endowment policy became upon maturity a simple debt, and was not an insurance policy for the purpose of a reinsurance agreement between two insurance companies.

(d) In Silen v. Silen, 44 Wash. 2d 884, 889, 271 P.2d 674, 676 (1954), the court dealt with conversion of an endowment policy into a life policy in alleged violation of a separation agreement between husband and wife.

(e) In State ex rel. Clapp v. Federal Inv. Co., 48 Minn. 110, 50 N.W. 1028 (1892), the distinction between a face-amount certificate business, and the business of issuing endowment policies was discussed. The question of a fixed amount vis-a-vis a variable but ascertainable amount was not at issue.

153 Commonwealth v. Beisel, 338 Pa. 519, 521, 13 A.2d 419, 421 (1940).

154 1 Appleman § 81, at 107-08: "An annuity is distinctly different from rents, interest, or profits, in that an annuity is payable in fixed and non-fluctuating stated amounts, whereas interest and profits depend upon a number of varying items which determine the sum payable."

155 359 U.S. at 67-69; Farrell v. United States, 321 F.2d 409, 416 (9th Cir. 1963).

156 E.g., Mass. Gen. Laws Ann. ch. 175, § 118 (Supp. 1971). See also In re Supreme or Cosmopolitan Council of the Bhd. of the Commonwealth, 193 Misc. 996, 999, 86 N.Y.S.2d 127, 130 (1949). In New York, annuity payments need not be fixed-dollar amounts. Issuance of such annuities constitutes insurance, for the purpose of regulation under state law. 1 G. Couch, Cyclopedia of Insurance Law § 25: "The statutory definition of insurance, adopted from the common law, is an agreement by which one party for a consideration promises to pay money or its equivalent, or to do an act valuable to the insured. . . ."

during the years.[157] An installment contract for the sale of real property that provided that if the purchaser died before full payment, the deed to the property would be delivered to his representatives without further payments to complete the price, was also held to be an insurance contract.[158] These definitions, however, are used to determine whether or not an arrangement is insurance subject to state regulation. Therefore, they embrace all arrangements that are amenable to the kind of abuse that regulation of insurance is designed to curb. They do not furnish a guide to insurance products that need not be classified as securities for added protection.

A better guide might be found in traditional forms of insurance, especially insurance contracts that existed when the securities acts were passed. Under these insurance contracts death benefits need not be expressed in fixed amounts. Before the adoption of level-premium plans, neither benefits nor premiums were fixed. Both depended on mortality experience and investment performance of the insurer.[159] Benefits under participating and specialty life insurance policies vary according to the performance of the company's insurance business or the investment performance of its assets, or a similar measure.[160] Both participating and specialty policies, however, provide a fixed-sum death benefit at a fixed cost.

The conclusion is that annuities are inherently fixed-dollar payment arrangements, whereas insurance is not. On the other hand, in most life insurance, even of the variable type, a minimum amount of the death benefits is traditionally expressed in a fixed-dollar sum. Therefore, the holding in *Valic*[161] that a minimum fixed amount, in the sense of an amount that can be calculated under fixed and predetermined factors is inherent in the insurance scheme, applies to variable insurance. The same result is reached through Justice Brennan's approach.

2. The Institutional Approach

In his concurring opinion in *Valic*, Justice Brennan did not put the emphasis on whether a variable annuity is "insurance" or a "security." It contains elements of both. Therefore a discussion along these lines, he said,

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157 Messerli v. Monarch Memory Gardens, Inc., 88 Idaho 88, 397 P.2d 34 (1964). For a discussion of the problem see South Georgia Funeral Homes, Inc. v. Harrison, 183 Ga. 379, 188 S.E. 529 (1936); 2 Op. Att'ys Gen. Mass. 480 (1899-1905). See also Vance at 87.

158 Barna v. Clifford Country Estates, Inc., 143 Misc. 813, 258 N.Y.S. 671 (1932). A contract of insurance was defined as a contract to pay a sum of money or its equivalent, or to do an act valuable to the insured on the destruction, loss or injury of something in which the other party has an interest. The defendant was obligated to convey a substantial interest to the purchaser on the event of death; contract embodied the purpose and function of a life insurance policy.

159 Maclean at 7, 477, 482.

160 For discussion of coupon policies see Kimball & Hanson at 227; for profit sharing policies see id. at 200; for participating policies see 1 Appleman § 9; Huebner at 643-46; Vance at 63.

161 359 U.S. at 69.

might lead to confusion.[162] Instead, he looked to those aspects in the annuity that resembled a security and concluded that the investor in a variable annuity was as much in need of protection as the investor in a security. The deviation from an insurance model—the shift of investment risk from the insurer to the contractholder—opened the door to the abuses that the federal securities acts were designed to curb. Justice Brennan examined state regulation and found that it did not offer sufficient protection to variable annuity contractholders.[163] His conclusion, which he shared with the majority, was that variable annuities were securities subject to federal securities laws.[164]

It should be emphasized that there is a presumption against federal regulation of insurance that had to be rebutted in the case of variable annuities. It has to be rebutted again in connection with variable insurance. In the McCarran-Ferguson Act[165] Congress provided that an act of Congress shall not, by implication, invalidate, impair or supersede state laws regulating the business of insurance.[166] The Act was a reaction to the Supreme Court's decision in *United States v. South-Eastern Underwriters Association.*[167] That decision overruled a long-standing holding to the effect that a state statute may regulate foreign insurance companies without offending the commerce clause because "[i]ssuing a policy of insurance is not a transaction of commerce."[168] This statement was repeated in a long line of decisions[169] that upheld the validity of state statutes regulating and taxing insurance companies. The business of insurance was regarded from its inception as a local matter. When widespread abuses occurred in the twenties, the states rather than Congress took steps to curb them. The principle that the business of insurance is not "a transaction of commerce"

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162 359 U.S. at 80; Comment, The Flexible Fund Annuity; VALIC Revisited, 115 U. Pa. L. Rev. 600, 606 (1967).

163 359 U.S. at 78.

164 Id. at 91.

165 15 U.S.C. §§ 1011-15 (1964). See also Zachman v. Erwin, 186 F. Supp. 691 (S.D. Tex. 1960); United States v. Meade, 179 F. Supp. 868 (S.D. Ind. 1960). For a history of the McCarran Act see also Stern, The McCarran Act—Twenty Years After, ABA Section of Ins. Neg. & Compensation Law 302 (1966).

166 15 U.S.C. § 1012(b) (1964): "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, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance . . . ."

167 322 U.S. 533 (1944).

168 Paul v. Virginia, 75 U.S. (8 Wall.) 168, 183 (1869).

169 "The business of insurance is not commerce." Hooper v. California, 155 U.S. 648, 655 (1895); New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495, 503-04, 510 (1913). See United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 544 n.18 (1944); Colgate v. Harvey, 296 U.S. 404, 432 (1935); Bothwell v. Buckbee-Mears Co., 275 U.S. 274, 276-77 (1927); National Union Fire Ins. Co. v. Wanberg, 260 U.S. 71, 75 (1922); Northwestern Mut. Life Ins. Co. v. Wisconsin, 247 U.S. 132 (1918); Nutting v. Massachusetts, 183 U.S. 553 (1902); New York Life Ins. Co. v. Cravens, 178 U.S. 389, 401 (1900); Noble v. Mitchell, 164 U.S. 367, 370 (1896); Philadelphia Fire Ass'n v. New York, 119 U.S. 110, 118 (1886); Liverpool Ins. Co. v. Massachusetts, 77 U.S. (10 Wall.) 566, 573 (1870); Ducat v. Chicago, 77 U.S. (10 Wall.) 410, 415 (1870).

was used to strengthen state regulation of insurance. In *United States v. South-Eastern Underwriters Association*,[170] the Court was invited to apply this principle not to uphold a state statute, but to strike down an act of Congress and to hold that federal antitrust laws did not apply to the business of insurance. This the Court refused to do. The formulas devised to uphold state statutes, it said, "cannot uncritically be accepted as trustworthy guides to determine Congressional power under the Commerce Clause."[171] Hence, the Court applied federal antitrust laws to the business of insurance. The Supreme Court's decision raised doubts as to the validity of state tax and regulatory laws:

> [I]nsurance companies have refused, while others have threatened refusal to comply with State tax laws, as well as with other State regulations, on the ground that to do so, when such laws may subsequently be held unconstitutional in keeping with the precedent-smashing decision in the Southeastern Underwriters case, will subject insurance executives to both civil and criminal actions for misappropriation of company funds.[172]

To weaken state regulation meant to leave the insurance industry entirely unregulated. The McCarran-Ferguson Act was passed to avoid this result and retain the status quo.

The Act declares that the continued regulation and taxation by the several states of the business of insurance is in the public interest and that silence on the part of Congress shall not be construed to impose limitations on state regulation.[173] The Act states that no act of Congress shall invalidate, impair or supersede state laws regulating the business of insurance except when expressly so applied.[174] On the other hand, legislative history makes it clear that it was not

> the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insurance beyond that which they have been held to possess prior to the decision of the United States Supreme Court . . . .[175]

It has been consistently held that the McCarran Act applies only to "the business of insurance," and not to any other business of insurance companies. The phrase "business of insurance" was meant to cover the relationship between the insurer and insured, such as the type of policies that could be issued and their interpretation and enforcement, the sale and advertisement of policies[176] and the licensing of insurance companies and their agents.[177] The phrase was also meant to cover state statutes

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170 322 U.S. 533 (1944).
171 Id. at 545.
172 H.R. Rep. No. 143, 79th Cong., 1st Sess. 1 (1945).
173 15 U.S.C. § 1011 (1964).
174 15 U.S.C. § 1012(b) (1964).
175 H.R. Rep. No. 143, 79th Cong., 1st Sess. 1 (1945).
176 FTC v. National Cas. Co., 357 U.S. 560 (1958).
177 Cf. Robertson v. California, 328 U.S. 440 (1946).

enacted to preserve the financial integrity of insurance companies for the protection of policyholders.

On the other hand, it has been held that federal mail fraud legislation is applicable to insurance, the McCarran Act notwithstanding.[178] It was reasoned that Congress did not intend to surrender to the states control of the mails, and that enforcing the statute does not interfere with the regulation of insurance business.[179] By the same token, the sale of shares by insurance companies was held not to be the business of insurance and therefore subject to the securities acts.[180]

Variable anuities presented a novel situation. The Securities and Exchange Commission sought for the first time to regulate, not the relations between the insurance company and its shareholders, but the relations between the insurance company and its policyholders who, to a certain extent, were also investors in the insurance company. *Valic* found the classification of variable annuities as securities to be dispositive of the McCarran-Ferguson Act issue.[181] Presumably, Valic ceased to be an insurance company within the definition of the Investment Company Act and was not therefore conducting the business of insurance.

In *United* the Court applied the Securities Act of 1933 to variable annuities issued by an old-line insurance company, but remanded the issue of the applicability of the Investment Company Act without an express reference to the McCarran Act. Nevertheless, the Supreme Court in a later decision interpreted the *United* holding to mean that the McCarran Act does not apply when shareholder protection is involved. In *SEC v. National Securities, Inc.*,[182] an Arizona statute required that the State Division of Insurance approve any merger of insurance companies. This approval depended upon a prior finding that the merger would not substantially reduce the security of policyholders. A merger that was so approved by the Division was attacked on the ground that the shareholders' approval was obtained by false and misleading proxy material in violation of federal securities laws. The Supreme Court held that the state statute was regulating the "business of insurance" since its provisions were aimed at the protection of policyholders.[183] The Court further held that the McCarran Act did not purport to make states supreme in regulating all the activities of insurance companies. The question of the legality of proxies bore only indirectly upon the validity of the merger approved by the state insurance authorities. Therefore, deciding the validity of the proxies would not "invalidate, impair or supersede" state law. The Court further distinguished between an

178 United States v. Sylvanus, 192 F.2d 96 (7th Cir. 1951); 4 L. Loss, Securities Regulation 2516 (Supp. 1969).

179 United States v. Sylvanus, 192 F.2d 96, 100 (7th Cir. 1951).

180 SEC v. American Founders Life Ins. Co., Civil No. 6021 (D. Colo., May 7, 1958), cited in 4 L. Loss, Securities Regulation 2516 (Supp. 1969); In re Armstrong, Jones & Co., Sec. Exch. Act Release No. 8420 at 7 n.12 (Oct. 3, 1968).

181 359 U.S. at 67-68, 73 n.2.

182 393 U.S. 453 (1969).

183 Id. at 462.

issuance of an order and a grant of permission by a state statute. Arizona permitted the respondents to consummate the merger but did not order them to do so. The merger was important to policyholders. But it was just as important to stockholders. Under these circumstances the Court saw no conflict in applying federal law to provide additional protection to stockholders.[184]

In conclusion, *Valic*[185] and *United*[186] held that the sale of variable annuities is not the "business of insurance" within the meaning of the McCarran Act. They held further that when investors' money is managed by others at the investors' risk, the need for protection arises. The fact that the investment arrangement is embodied in an insurance policy is not sufficient to deny investors this protection.

Justice Brennan held that insurance statutes do not provide adequate investor protection. State insurance regulation is adapted to the nature of the insurance policy and the nature of the insurance business. The insured is basically a creditor of the company.[187] He has no control over the management of the company's business or over the use of the reserves funding his policy. State regulation follows this relationship between the parties to the insurance contract in that it provides protection to the insured not by giving him a say in management, but by direct state intervention in the business of insurance.[188] Insurers must be qualified and licensed and the soundness of their business scheme tested.[189] The substance of the contracts is checked for fairness, equity and disclosure.[190] The investment of the reserves is limited and strictly supervised.[191] State regulation is, therefore, aimed at protecting creditors who have no voice in management and are mostly interested in the security of the funds and the soundness of the business of their debtor.

The securities acts, using the device of disclosure, were not applied to traditional insurance. As pointed out by Justice Brennan in *Valic*,[192] disclosure is irrelevant when

> obligations of the company were measured in fixed-dollar terms and where the investor could not be said, in any meaningful sense, to be a sharer in the investment experience of the company.[193]

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184 Id. at 463.

185 359 U.S. 65 (1959).

186 387 U.S. 202 (1967).

187 See pp. 327-30 infra.

188 359 U.S. at 77. On the history of state regulation see Magee at 19-30; Vance at 27-29, 36-50.

189 E.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971). On computation of the reserve see 19 J. Appleman, Insurance Law and Practice § 10762 (1946) [hereinafter cited as 19 Appleman]. On periodic examinations of insurance companies by state agencies see 19 Appleman §§ 10451-60; Vance at 42.

190 E.g., Mass Gen. Laws Ann. ch. 175, §§ 132G, 132, 132B; 19 Appleman § 10422; Vance at 45.

191 Mass. Gen. Laws Ann. ch. 175, § 64; 19 Appleman §§ 10481-99; Vance at 43.

192 359 U.S. 65 (1959).

193 Id at 77-78.

One of the main sources of abuse in the insurance industry at the beginning of the century was the absence of a sound actuarial basis for insurance. This problem could hardly be solved by disclosure. Good actuarial practices can be evaluated only by a highly specialized mathematician, and actuarial calculations were, and still are, considered business secrets by the insurance industry.[194] Finally, insurance has been recognized as "essentially a contractual security against anticipated loss."[195] It was traditionally sold as such, and not as an investment arrangement.[196]

The definition of a security in the securities laws, if applied literally, would be sufficiently wide to include insurance policies.[197] The cash surrender value, which was a traditional insurance feature at the time of the adoption of the securities acts, may resemble a form of investment. It should be noted that the 1933 Act is the only securities act that contains an exemption for insurance policies.[198] Nonetheless, it is clear that Congress never intended insurance policies to be included in the regulatory scheme of the federal securities laws. The exemption under the 1933 Act is, as Professor Loss expressed it, clearly "supererogation."[199] The cash surrender value neither constitutes a security in itself, nor makes the policy a security.[200] Insurance is a form of investment, said Justice Brennan in *Valic*,[201] which did not present the sort of problems that the securities acts were designed to solve, and the regulation of which Congress was willing to leave to the states.[202] This congressional policy, however, does not apply if a

194 Recently, representatives of the insurance industry negotiated with the staff on the status of variable insurance. The staff requested samples of policies and calculations. The companies involved sent the policies directly to the SEC rather than to their representatives. Gustin, Details Industry Task Force Dealings with SEC on Variable Life Product, The National Underwriter, Mar. 27, 1971, No. 13 at 6.

195 Metropolitan Police Retiring Ass'n v. Tobriner, 306 F.2d 775, 777 (D.C. Cir. 1962).

196 Comment, The Flexible Fund Annuity: VALIC Revisited, 115 U Pa. L. Rev. 600, 613 n.66 (1967); see H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

197 "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate . . . investment contract, voting-trust certificate . . . or, in general, any interest or instrument commonly known as a 'security'. . . ." Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1964). This argument was rejected in Haberman v. Equitable Life Assurance Soc'y of United States, 224 F.2d 401, 405 (5th Cir. 1955), cert. denied, 350 U.S. 948 (1956). Here is was held that the words "evidence of indebtedness" in the definition of a security in the Texas Securities Act ("any share, stock . . . note, bond, debenture . . . or other evidence of indebtedness . . . .") must be construed according to the *edjusdem Generis* rule, and that even assuming an annuity were an evidence of indebtedness, a questionable assumption in view of the aleatory and contingent nature of the amount ultimately paid, it is not like a note or a bond. Hence it is not included in this general definition. Id. at 405. Under other state Blue Sky laws annuities were held not to be securities. 1 L. Loss, Securities Regulation 497-98 n.117 (2d ed 1961).

198 Securities Act of 1933, § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1964).

199 4 L. Loss, Securities Regulation 2511 (Supp. 1969); accord, Tcherepnin v. Knight, 389 U.S. 332, 342 n.30 (1967).

200 4 L. Loss, Securities Regulation 2511 (Supp. 1969), citing 1 Mutual Fund Legislation, Hearings on S. 1659 Before the Senate Comm. on Banking & Currency, 90th Cong., 1st Sess. 122 (1967).

201 359 U.S. at 75 (Brennan, J., concurring).

202 Id. at 76.

change is effected in the very features that made state regulation appropriate and federal regulation irrelevant.

E. *When Does the Need for Investor Protection Arise?*

Under the protection criterion a variable insurance policy is a security if it has the features of an investment contract that give rise to the need for protection. However, the need for protection must be sufficiently great to offset a presumption that none is needed.

An investment contract has been defined as an arrangement by which a "person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party . . . ."[203] Accordingly, it seems that two features in the investment contract give rise to the need for protection under the federal securities acts: control and management of the investment is in the hands of someone other than the investor; the risk is borne by the investor.

1. Control of Investment

If, in an investment contract, the power to select the investment is retained by the investor, there is little need for protection under the securities acts. For example, the SEC held that the following arrangement under the Keogh Act[204] was neither a separate security, nor a separate investment company.[205] Payments are made to a trustee (for the investment companies whose securities are sold to fund the plan), and with each payment the investor specifies what amounts are to be invested in designated mutual fund shares and what amounts are to be paid for life insurance. The trustee is bound to follow the directions. He must pay the premiums, purchase the securities,[206] and render a periodic accounting to the investor. The in-

203 SEC v. W.J. Howey Co., 328 U.S. 293, 299 (1946); Continental Marketing Corp. v. SEC, 387 F.2d 466, 470 (10th Cir. 1967), cert. denied, 391 U.S. 905 (1968); Investment Co. Institute v. Camp, 274 F. Supp. 624, 642 (D.D.C. 1967), rev'd on other grounds, 420 F.2d 83 (D.C. Cir. 1969), vacated, 91 S.Ct. 1091 (1971) (aff'g 274 F. Supp. 624); Maheu v. Reynolds & Co., 282 F. Supp. 423, 426 (S.D.N.Y. 1967); Note, Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies, 82 Harv. L. Rev. 435, 455 (1968); annot., 163 A.L.R. 1050, 1055 (1946). On this basis H.R. 10 plans were also classified as securities. They involved a scheme under which a trust received contributions from an employer and his employees, and the management of the trust was committed to a third party. See Mundheim & Henderson, Applicability of the Federal Securities Laws to Pension and Profit-Sharing Plans, 29 Law & Contemp. Prob. 795, 797-802 (1964).

204 Keogh-Smathers Act, 26 U.S.C. §§ 37, 62, 72, 101, 104, 105, 172, 401, 503, 805, 1361, 2039, 2517, 3306, 3401, 6047, 7207 (1964).

205 Inv. Co. Act Release No. 5510 (Oct. 8, 1968). The life insurance certificate was sent directly to the investor; the ownership and custody of the securities were in the bank as a trustee (presumably for the investment company).

206 Id. The provisions of the Keogh-Smathers Act, supra note 204, limit insurance to 49% of the payments. The rest may be invested in securities. The investor may discontinue the insurance contract at any time by requesting a paid-up policy for the cash accumulated. He may then invest all his payments in securities. The investor may also discontinue his investment in securities but is prohibited by the Act from liquidating, borrowing, pledging or purchasing an annuity or making withdrawals, except under specified limited circumstances. The invested funds continue to draw interest, dividends and

surance company receives no additional fee, and the bank's fees are calculated according to a schedule for trust and custody services. This plan may be marketed only by members of the National Association of Securities Dealers who filed for a life insurance certificate through the insurance company and who are not employees of either the insurance company or the investment companies involved. The interested companies are permitted to advertise only in trade journals, advising duly licensed insurance and securities dealers that the arrangement is available. This arrangement is not a security because the power of investment decision-making is retained by the investor and because the interested investment and insurance companies are precluded from directly controlling the sale of the plan.[207]

If the interested insurance company does not and cannot have control of the investment performance that affects a variable annuity, the contract should not be a security even though the investor does not fully retain the power to make the investment decision. For example, a combined insurance and investment arrangement that guarantees an income according to predetermined factors is not a security, even if other earmarks of a security are present. In *Olpin v. Ideal National Insurance Co.*,[208] the defendant insurance company was obligated, through merger, to honor "Expansion and Bonus Fund Endorsements" issued by constituent companies. The bonuses provided that each year, for a twenty-year period, the company set aside in a special fund one to two dollars for each life insurance policy paid or issued and remaining in force. The bonuses further provided that the fund bear 2½ percent accumulated compound interest. After twenty years each surviving policyholder was entitled to a pro rata share of the fund. If a policyholder died before the expiration of that period, his beneficiaries obtained, in addition to the death benefits, the full proportionate share of the bonus fund of the policy. Premiums on these policies were higher than on regular policies, but they were not apportioned between the cost of insurance and the Expansion and Bonus Fund Endorsement.

After the expiration of the twenty-year period the attorney general of the state expressed doubts as to the legality of the plan, whereupon the company proposed to liquidate the fund. On a policyholder's suit opposing the plan of liquidation, the Tenth Circuit held that the policy and the Endorsement were not securities and the fund was not an investment company; rather, both were insurance. Even though benefits under the endorsement were not expressed in fixed-dollar amounts, the benefits could be

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capital gains and vest in the investor. The life insurance plans are substantially similar to ordinary life insurance, but do not include participating policies or dividend payments. The investor purchases securities at the public offering price stated in the prospectus by the investment companies. He has the right to vote the securities, to reinvest dividends, and to liquidate the securities and invest the proceeds in other securities within the limitations of the Act.

207 Gordon, Investment-Insurance Arrangements; Conference on Mutual Funds 31, 36-38 (Hodes, Geerlings & Simpson eds. CCH 1966). The author describes similar arrangements which reserve the investment decision to the investor.

208 419 F.2d 1250 (10th Cir. 1969), cert. denied, 397 U.S. 986 (1970).

calculated according to fixed factors: "Clearly, when a policyholder paid an additional premium for a policy bearing such Endorsement, he was not investing his money in a security, speculative or otherwise, from which he might receive much, little, or no benefit, depending on the wisdom and care with which Ideal [the defendant] . . . invested such extra premiums . . . ."[209]

The same principle applies to policies that provide for linkage of death benefits to some index over which the insurance company has no control, such as the cost of living or the Dow Jones Industrials Index.[210] The insurance company has no control over the performance of the index. In such policies, since there are no investments that promise yield according to these indexes, the insurance company will also bear the equity investment risk. It will have to meet an investment goal through an investment decision for which the company, not the insured, will take the risk. The risk to the insured is that his choice of an index, not the choice of an investment adviser, has proven unwise and unprofitable. Such an arrangement might, therefore, fall outside the definition of a security. However, since a choice by the investor is involved, and since, unlike the Keogh plan described above, sales efforts are presumably left with the insurance company, one could argue that even this arrangement might give rise to a need for disclosure and the protection of the securities acts. An investor cannot make an intelligent choice between this type of investment and, for example, a fixed-dollar conventional insurance policy without adequate disclosure. If the index itself is complicated or not universally known and information is required to estimate the probabilities of profit and loss, the policy should be considered a security. The answer seems to be that only investment contracts are subject to the securities acts. An instrument that is not an investment contract cannot become a security just because it gives rise to a need for disclosure. If this were so, many insurance policies would be securities. On the other hand, any indication that the insurance company, directly or indirectly, has the power to influence the performance of the index will put the policy into the security category as an investment contract.

2. Bearing the Investment Risk

The main feature of variable annuities that triggered the application of the securities acts was the shift of investment risk from the insurance company to the contractholder. The Supreme Court did not specify how much investment risk should be retained by the insurance company and what methods must be used to cover this risk in order to qualify the contract as insurance. The following discussion is addressed to these questions.

Congress did not regard every assumption of investment risk by a policy-

209 Id. at 1263. This decision has been questioned by at least one member of the staff of the Commission on the ground that the arrangement was an investment contract separate from the insurance policy.

210 See Campbell at 7-8.

holder in an insurance product as giving rise to a need for protection under the securities laws. When the securities acts were passed, insurance policies containing arrangements for participation in profits and assumption of some investment risk by the policyholders were being offered to the public. Some of these policies were amenable to misrepresentation and other abuses.[211] Nonetheless, Congress chose not to include them in the scheme regulating securities.[212] It has been held recently that the fact that policyholders in a mutual insurance company were entitled to dividends and that their interests in the insurance company were assessable did not bring the policies within the definition of a security under the 1934 Act because such policies were traditionally issued by insurance companies and historically considered insurance.[213]

A few years ago the staff of the SEC considered profit-sharing policies to be securities and the funds involved to be investment companies subject to the federal securities acts.[214] It is submitted that this classification is unfounded. Misrepresentation or the potential for abuse due to misrepresentation is not per se sufficient to classify insurance as securities. If an insurance policy that was offered when the securities laws were passed is amenable to misrepresentation that could be rectified by disclosure, it is still an insurance product, exempt from the securities acts. The test is not whether abuses arising from insurance policies require protection by disclosure, but whether these insurance products give rise to the abuses to which investors are exposed. It is only as a result of the latter that the securities acts become operative. If profit-sharing policies were sold as insurance products at the time the securities acts were passed, they are insurance today. The same argument can be applied with less force to a policy that was not sold when the securities acts were passed. If a variable insurance policy is misleading, it might become a security to which the provisions of the 1933 Act are applicable.

As mentioned, not every assumption of investment risk by a policyholder triggers the application of the securities acts, provided the insurance company retains the investment risk for a minimum amount. In *United*[215] the Supreme Court dealt primarily with the measure of this minimum amount. The problem presented two issues: what the amount should be, and, how the insurance company should cover the investment risk regarding this amount, in order to qualify the contract as insurance. United as-

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211 Kimball & Hanson at 191-95, 201-04, 211-13, 231-38, 255.

212 The exemption of insurance "makes clear . . . that insurance policies are not to be regarded as securities . . . . The insurance policy *and like contracts* are not regarded in the commercial world as securities . . . ." (emphasis added), Kimball & Hanson at 223, citing H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

213 Collins v. Baylor, 302 F. Supp. 408, 411 (N.D. Ill. 1969).

214 Life Comm. Rep. N.A.I.C. 19-31, Nov. 30, 1960, cited in Kimball & Hanson at 221-22. "*Profit-sharing policies* are participating policies promising the policyholder not only a share in the surplus created by this particular class of policies, but also in surplus generated by some other classes . . . ." Id. at 170.

215 SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

sumed the investment risk on 50 percent of the premium paid during the first year of the contract and up to 100 percent after ten years. The SEC argued that this investment risk-taking was insufficient and that nothing short of a risk-assumption covering capital and a fixed return would suffice.[216] The Supreme Court agreed that the amount over which United assumed an investment risk was "substantially less" than the fixed amount receivable under a comparable conventional annuity,[217] but it did not offer guidelines as to what a minimum sum might be, except, as we shall see, negatively, and in terms of the nature of the contract itself.

There are indications in the Court's opinion that had the investment risk assumed by United been provided in a genuine insurance contract, the assumption of this risk might have satisfied the *Valic* requirement of "some investment risk-taking." The Court treated the United contract as divisible and the pay-in period as a separate contractual arrangement. It emphasized that in the pay-in period the insurance company did not employ an insurance scheme to cover losses: "There is some shifting of risk from policyholder to insurer, but no pooling of risks among policyholders . . . . [T]he insurer is acting, in a role similar to that of a savings institution, and state regulation is adjusted to this role. . . ."[218]

The Court seemed to be saying that in the pay-in period there must be a promise of a fixed amount, partially because the contract is an annuity contract, but mainly because this portion of the contract is a pure savings device. As a part of an insurance scheme, it is classified as insurance, but only if the company retains the full extent of the equity investment risk.[219] The pay-in period of the contract, viewed separately, is not an insurance arrangement, even when all the equity investment risk is borne by the insurance company: "[W]hile the guarantee of cash value based on net premiums reduces substantially the investment risk of the contract holder, *the assumption of an investment risk cannot by itself create an insurance provision under the federal definition.*" (emphasis added).[220] In other words, standing alone, such a contract is not insurance, even if the insurance company assumes the full investment risk under it. The Court did not state the converse, that in a genuine contract of insurance the minimum assumption of investment risk provided by United might be sufficient to retain its classification. Such a statement would, in any case, have been dictum. Therefore the Court's silence should not be interpreted to negate this conclusion.

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216 Brief for Petitioner at 24, id.

217 387 U.S. at 208.

218 Id.

219 The decision in United purports not to deviate from the guidelines set forth in Valic. Counsel for United, however, asserted that the Court changed its position to require, in addition to some investment risk-taking, conventional insurance molds. Evans, Flexible Fund Annuity and the Securities Act of 1933 and Securities Exchange Act of 1934, Proceedings of the Legal Section Am. Life Convention 102, 106 (1967). See Brief for Respondent at 49-50, SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1969).

220 387 U.S. at 211.

There is no absolute measure of equity investment risk-taking by the insurance company that can determine the existence of a security. The SEC admitted as much in its brief.[221] This measure of equity investment risk-taking depends on the nature of the contract and its overall purpose. If a contract is essentially investment, the assumption of investment risk by the insurance company must be substantial, and perhaps, as the SEC argued, also cover income. But if the contract is a conventional insurance policy, the equity investment risk-taking by the insurance company may be lower. Therefore the test pertaining to annuities does not apply to conventional life insurance policies. As to annuities, it was said:

> Certainly, if the company does not guarantee adverse mortality experience, the variable "annuitant" is assuming *all* of the risks of such adverse experience, and there are not even any superficial insurance features in the program. Assuming, however, that the issuing company proposes to guarantee adverse mortality experience, this fact gives to a variable annuity only a superficial insurance feature, for the risk of investment experience, *the principal feature of a variable annuity*, is still borne by the annuitant. (emphasis added).[222]

Since the principal feature of a variable annuity is the risk of equity investment, an insignificant true insurance risk-taking is not sufficient to tilt the scales and preserve its insurance nature, once the investment risk has been shifted to the contractholder.

In determining whether a contract is essentially an insurance contract, the whole arrangement, not only the risk-taking, must be examined: "That an incidental element of risk distribution or assumption may be present should not outweigh all other factors. If attention is focused only on that feature, the line between insurance or indemnity and other types of legal arrangement and economic function becomes faint, if not extinct."[223] Thus, if the main objective of the variable annuity is investment, a mortality guarantee does not change it into insurance. Neither does a partial insignificant investment risk-taking by the insurance company. It is submitted that the converse is also true. If the main objective of an insurance policy is insurance, a shift in investment risk could be substantial without causing a change in its insurance nature.

IV. THE CHARACTERISTICS OF AN EXEMPT VARIABLE LIFE INSURANCE POLICY

Under the preceding criteria, some life insurance policies may provide for variable benefits and still retain their exempt insurance status under the securities acts. The main characteristics that these insurance policies should possess are discussed below. Variations in one characteristic, however, may require modification of others so that, on balance, the dominant

221 Brief for Petitioner at 37, id.
222 Haussermann, The Security in Variable Annuities, 1956 Ins. L.J. 382, 389.
223 Id. at 389, citing Jordan v. Group Health Ass'n, 107 F.2d 239, 247-48 (D.C. Cir. 1939).

insurance character of the policies will be retained and the need for investor protection will not arise.

A. *The Amount of Investment Risk Borne by the Insured*

1. Minimum Fixed-Dollar Amount of Death Benefits

The requirement of a minimum fixed amount of death benefits is traditional in insurance. If the insurance company carries a substantial investment risk, the protection of the federal securities acts is not needed.[224] For variable life insurance to qualify as exempt insurance the minimum amount of fixed-dollar death benefits should be the same amount obtainable at the same cost in a fixed-dollar conventional life insurance policy.

The variable life insurance policy should be exempt even if no interest is assumed. The assumption of interest in the calculation of the premium for a conventional policy is not based on the rationale that the insurance company owes the policyholder an income on monies borrowed. The explanation for the assumption of interest is rather that:

> All life insurance policies provide for the payment of the first premium before the insurance becomes effective. Since premium payments begin at the inception of the contract and benefits are payable at some future date, the element of interest must be introduced into the calculations to establish an equality between sums now due and sums to be due in the future.[225]

Variable life insurance is aimed at achieving the same result, giving the policyholder his "money's worth." Without considering the problem of protection, the income from equity investment in a variable insurance policy is balanced against the assumed interest of a fixed-dollar insurance policy. Under this arrangement the whole amount of net premiums must be invested in equity securities. This formula deviates from the formula of participating and specialty policies, in that the latter provide a fixed rate of return, usually 3½ percent to 5 percent per annum. It is submitted that this difference in the minimum fixed-dollar amount is not sufficient to convert an insurance contract into a security.[226]

2. No Minimum Fixed-Dollar Cash Surrender Value

Cash surrender value is the sum that the policyholder saves through excess premiums in earlier years in order to offset the high cost of protection in later years. State insurance laws require the insurance company to pay policyholders this cash surrender value when the policy lapses on default of payment of premiums.[227] It is submitted that no part of the cash surrender

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224 359 U.S. at 77-78.

225 Magee at 614.

226 It seems that life insurance companies are able to offer variable insurance that guarantees also assumed interest, provided they do not guarantee the cash surrender value. Walker, Variable Life Insurance—Address, delivered at the Association of the Bar of the City of New York, Apr. 28, 1971.

227 E.g., Mass. Gen. Laws Ann. ch. 175, §§ 132.6, 143 (1958), § 144 (Supp. 1970). See also 3A Appleman ch. 98.

value need be expressed in a fixed-dollar amount in order to qualify the variable insurance policy as an insurance product. Cash surrender value is an integral part of the insurance policy. It cannot be partially or fully paid to the insured without cancellation of the policy.[228] Moreover, a policyholder would never acquire a policy for its cash surrender value. By definition, this cash value is smaller than the amount of premiums paid.[229] In the earlier years of the policy, all or a substantial part of the cash surrender value may be used up to cover the load charged on the policy. Consequently, the policy may, for a period of time, have no cash surrender value at all. The investment or savings represented by cash surrender value is forced on the policyholder. He cannot obtain a policy without it. Nor does the policyholder exercise free choice when he cashes this value. The considerations under which he usually surrenders the policy are not dictated by market performance, but by personal economic stress. Therefore, information to enable the insured to evaluate the investment performance of the units representing the cash surrender value, at the issuance of the policy or at default, is not relevant either to his decision to acquire the policy or to his defaulting.

It could be argued that since the cash value is usually paid as a result of the insured's adverse economic circumstances, he might be forced to liquidate the units credited to him at a loss. Therefore, he needs the minimum fixed amount protection. The answer is that the securities acts are not designed to protect investors against adverse economic circumstances. But the policy must clearly state that cash surrender value is not guaranteed, lest the guarantee of a minimum fixed amount of death benefits may be mistaken to cover cash surrender value.

B. *The Amount of Savings That the Variable Policy May Contain*

When Congress passed the securities acts and the McCarran Act, insurance companies were issuing and selling a variety of specialty insurance policies.[230] The McCarran Act and the exemptions of insurance from the securities acts therefore apply to specialty policies that were known when the acts were passed. These policies are exempt even though the equity investment component that they contain is large, and even though they are susceptible to abuse.[231] By analogy, any variable insurance policy containing more than a proportionately similar equity investment component should not retain its insurance classification. Hence variable endowment policies should not be classified as insurance.

The use of specialty policies as a model[232] for the measure of the invest-

228 3A Appleman § 1861 at 203. Upon default the policy lapses.

229 See pp. 199-200 supra.

230 1 Appleman § 13 (tontine policies at the beginning of this century). See generally Kimball & Hanson.

231 See p. 178 supra.

232 The right to dividends depends on the terms of the policy, which vary greatly. Usually participating policies are not entitled as a matter of right to a specific amount of dividends, until declared. Vance at 550.

ment component in variable insurance can be questioned on the ground that they offer a more secure type of investment; investment in the business of the insurance company is less hazardous than an investment in a separate account. The business of insurance is fully regulated with respect to the integrity of the funds and the management of the company, as well as its business plans. The business of investment is not so regulated and supervised. Further, there is no conflict of interest between specialty policyholders and the insurance company since both desire the success of the insurance company's business. The investment business of the separate account is not so shared with the insurance company and might even give rise to a conflict of interest between the company and the contractholders.[233]

On the other hand, specialty policyholders usually have no right to dividends until declared by management, and management has wide discretion in this matter.[234] In contrast, variable insurance policyholders have a right to payments based on equity investment performance. The investment in specialty policies may therefore be less speculative than that in variable policies, but specialty policyholders must rely on the insurance company's good graces for their dividends, whereas variable insurance policyholders have an unqualified right to dividends.

There is no legal limit to the excess amount that an insurance company may collect to conduct the investment part of the specialty policy package. The market place dictates that amount. In the case of variable life insurance, the market place is not an effective regulator. The investment in the insurance company's business does not have the allure of an investment in a mutual fund; nor is it considered an independent investment tool, as are shares of a mutual fund. Therefore, a large equity investment-savings component might change a variable policy into an investment contract requiring protection by the securities laws. The equity investment-savings components in the policy ought not to exceed that which is customary in a specialty policy offering the same fixed-dollar amount. The calculation need not be, and probably cannot be, exact. It may be useful first to compare the premiums for a conventional, level-premium life policy with premiums for a specialty policy of the same amount. The difference in the premiums may indicate the acceptable ratio of investment to conventional premiums. This ratio may serve as a guide to determine the magnitude of the investment-savings component in a variable insurance policy.

C. *How Much Risk and What Type of Risk Should Be Borne by the Insurance Company?*

The variable annuity of United provided a guarantee of the value of the accumulation units in the pay-in period, a "cash value measured by a per-

233 If the insurance company sustains a loss on its mortality guarantee, the loss will be greater when the investment performance of the account is better.

234 18 J. Appleman, Insurance Law and Practice § 10017, at 72, 73 (1945) [hereinafter cited as 18 Appleman]. Vance at 550.

centage of [the] net premiums which gradually increases from 50% of that sum in the first year to 100% after 10 years."[235] This cash value was fixed by analyzing the performance of common stocks during the first half of the twentieth century and adjusting it so low that it would not have been payable under any prior condition.[236] In addition, the company charged contractholders a percentage of the value of the assets of the account to cover any possible loss. The risk of loss by the company as a result of market decline below the minimum was negligible.[237] Nonetheless, this fixed-dollar amount provided for some risk-shifting from the contractholder to the company since he could take advantage of the diversification in the fund and the assumption that the experience of the fund would follow the stock-market experience.

In *United* the SEC argued that an investment risk "in the insurance sense" means a promise to pay not only a fixed amount of capital but also income.[238] The Supreme Court did not comment on this contention. It only held that the device used by United was not sufficiently an insurance device so as to create, in and of itself, an insurance product. The Court said that "the guarantee cannot be said to *integrate the pre-maturity operation into the post-maturity benefit scheme.*" (emphasis added).[239] It is submitted that the method used by United to provide a minimum guarantee should be acceptable when used in an insurance policy. In other words, when the policy is undoubtedly insurance and provides for a minimum fixed amount, the fact that the investment risk that the insurance company is undertaking is minimal should not convert an insurance policy into a security.

In the variable annuity offered by United the "insurance" device merely made the diversification of the fund available to participants. The risk of loss below the minimum set in the guarantee was insignificant. No reserve for the guarantee was in fact needed. If an insurance company undertakes to pay a higher fixed-amount minimum, and if anticipated losses could be calculated and predicted, the company would have to establish a reserve from which investment losses would be paid. The reserve can be created by charges levied on premiums or on the assets of the investment fund. This method of providing a guarantee should be doubly acceptable since it would be a true insurance scheme. If the scheme is too costly or if it is unrealistic because statistical data is unreliable, the reserve can also be created by establishing not only a floor but also a ceiling on the investment performance of variable benefits, using gains in excess of the maximum amount to cover losses.[240] This method utilizes a hedging technique, which

235 387 U.S. at 205.
236 Id. at 209 n.12.
237 Id. at 209.
238 Brief for Petitioners at 24, id.
239 387 U.S. at 209.
240 Campbell at 43.

is a method used to insure against investment risks. Either of these methods should preserve the insurance character of the policy.

The Supreme Court in *United* also remarked, *obiter*, that a guarantee of a fixed-dollar amount through split-funding was not sufficient to convert a savings device into insurance.[241] This remark should apply to variable insurance. In split-funding a part of the premium is used to purchase a conventional annuity with a cash value at maturity equal to the minimum fixed amount, and the rest of the premium is invested in an equity account at the risk of the contractholder. This method only reduces the amounts invested in equity securities. As to these amounts, the reasons for applying the securities laws are still valid. Split-funding as applied to insurance means the purchase of an insurance policy for the minimum guaranteed amount and the investment of the rest of the premiums in equity securities. This arrangement involves, in a sense, a guarantee, that the reserves will be sufficient to pay death benefits. Nonetheless, this portion of the arrangement may be severable and does not "integrate" the investment part with the insurance portion of the policy.[242] A mutual fund is not permitted to avoid federal regulation by purchasing life insurance policies and attaching them to its shares. By the same token, an insurance company should not avoid federal regulation merely because it sells mutual fund shares in conjunction with an insurance policy. Therefore, in a variable insurance policy that is exempt from federal securities regulation, the whole amount of the premiums should be invested in equities. The profits and losses can be applied to premiums or to death benefits or both.[243] But they cannot, for the reasons mentioned in *United*, be applied to a separate fund to be invested in equity securities.

Paradoxically, such a policy may also be viewed as a security. If the insurance company is to invest all reserves in equity securities and at the same time guarantee a fixed-dollar amount of benefits, the insurance company may be taking a risk that is greater than the risk usually taken by insurance companies in conventional insurance. Had Congress in 1933 contemplated such an insurance policy, it would not have deemed this policy to be outside the reach of the federal securities acts. Therefore, the insurance exemption should not apply to variable insurance even if the company, or perhaps because the company, undertakes this greater investment risk. The reason for recognizing an exempt insurance policy becomes the reason for denying the exemption. The argument in fact questions the wisdom of permitting insurance companies to issue variable insurance policies. Implicit in this argument is the assumption that insurance companies will not be able to honor their obligations under these policies as

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241 387 U.S. at 209.

242 Cf. id. at 211.

243 The insurance industry has been preparing a variety of formulas and options to determine the use of profits and gains. See Walker, Variable Life Insurance—Address, delivered at the Association of the Bar of the City of New York, Apr. 28, 1971.

they are able to do under conventional policies, or perhaps even that these policies endanger the financial integrity of insurance companies.

This argument is misdirected. The dangers indicated stem from the insurance scheme of the policy. They can be curbed not by disclosure but by the prohibition of issuing such variable insurance policies. In the Glass-Steagall Act[244] Congress adopted this policy with respect to national banks by prohibiting them from engaging in the investment banking business. The Supreme Court recently held in *Investment Co. Institute v. Camp*[245] that participation units in commingled trust or agency funds are securities within the meaning of the Glass-Steagall Act.[246] The management of a fund that competes with mutual funds constitutes the conduct of investment banking business. The conduct of this business affects the quality of commercial banking services even when the assets of the bank are not subject to liabilities of the investment business. Promotional pressures may color judgment with respect to loans and investments that commercial banks make with other people's money.[247] Therefore, the policy of the Glass-Steagall Act forbids national banks from engaging in this business. The decision highlights the different division of regulatory powers over the banking and the insurance industry. Congress directly regulates banks. The regulation of insurance is left to the states. State regulation is not unresponsive to the dangers that activities outside the insurance sphere may produce. When life insurance companies in the late 1960's started to engage in a variety of non-insurance activities, state authorities became concerned and began investigations that culminated in "[a] flurry of legislative activity . . . aimed at providing more supervision by state insurance departments over the acquisition of insurers . . . and more disclosure and regulatory control of transactions betwen insurers and their noninsurance affiliates."[248] Whether variable insurance is sufficiently "secure" from the insurance company's point of view could be better determined by state insurance agencies. They have the expertise in evaluating statistical data and past market performance. They have the power to require safeguards and to limit investments to the less speculative equity investments. They can require, for example, that if the market price of equity securities in a portfolio falls below a certain limit, the securities should be sold and reinvested in more conservative debt securities. In fact, the substitution of state insurance agencies for the body of policyholders to safeguard the insurance company's interests and financial integrity may provide policyholders with better protection. Insurance agencies may not have today the expertise in equity investments. But they may gain expertise faster than the aggregate of policyholders.

244 Glass-Steagall Act, 12 U.S.C. § 24 (1964).
245 91 S. Ct. 1091 (1971).
246 Id. at 1101.
247 Id. at 1101-02.
248 SEC Investor Report at 518.

In order to avoid entering where only actuaries dare to tread, less emphasis should be put on the method used by the insurance company to enable it to assume its insurance and investment obligations. In evaluating a variable insurance policy the emphasis should be not so much on how much risk the company is undertaking, but on how much risk remains with the insured. Instead of examining the method, the benefits and cost of the policy should be compared with a conventional life policy to determine whether or not the variable policy is an insurance policy.

D. *Stabilizing Fluctuations in Investment Performance*

The variable insurance and the variable annuity under which benefits vary fully with investment performance of the account are not appropriate for insurance purposes without constant adjustments. The essence of insurance is stability, predictability and security. Fluctuations in the value of benefits that are too high and too frequent conflict with the very concept of insurance. The date on which benefits are due and at which investment performance is evaluated does not depend on the contractholder or the insured, but on the occurrence of retirement or death. Grave inequities might result from liquidation of accumulation units, or of death benefit units on a date dependent upon factors other than investment. The holder of a share in a mutual fund is not compelled to liquidate his holdings on a predetermined date without regard to market performance. The contractholder is compelled to liquidate at the end of the pay-in period. The life insurance policy requires liquidation upon death. A provision in the contract permitting a contractholder or beneficiary to postpone redemption or liquidation is not a satisfactory solution. The beneficiary and the contractholder count on receiving benefits promptly. This is one of the earmarks and advantages of insurance.

There are many techniques to abate fluctuation. One is the use of a moving average of market values in revaluing units. This has proved ineffective. Weighted averages tend to move in the wrong direction.[249] Another technique is the use of a more precise investment objective and diversification into equity and fixed income securities. This solution is only partial and not always satisfactory because it is also based on predictions of market performance. A further approach is to permit adjustments in the value of the units in the account. The ceiling and floor technique is one method of adjusting these values. It requires the creation of a stabilization fund and a financial backstop for early years since a succession of poor performances in those years might create a deficit.[250] When adjustments affect the value of the units, much of the resemblance to a mutual fund is lost,[251]

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249 Campbell at 43.

250 Id. This form of operation has been suggested for policies linked to the cost-of-living index.

251 A problem inherent in all suggestions is their limitation on the effectiveness of the plan. In the early development period, interest in variable annuities centered on their value as an inflation hedge; so it was more appropriate to be concerned with

especially if the adjustments are made according to predetermined factors with no reference to the investment factor or the insured's choice. The character of such a policy will be so predominantly insurance that the method of funding the policy becomes less pertinent, and the equity investment component might be higher than in other variable insurance policies.

Insurance companies use complicated formulas to calculate the application of investment appreciation either to the death benefits or to premium reductions. Paradoxically, these methods may enhance the insurance nature of the policy. As in insurance policies, a purchaser may know the results of the calculation, but he also knows that he does not and cannot understand how they were reached. He is at the mercy of the insurance company both with respect to the valuation of the assets and the computation of the sums due him. Yet, if the minimum that he receives is similar to the face amount of a conventional life insurance policy, and if he aims at obtaining only this amount, whatever he receives above this amount can be considered a windfall and should not require regulation.

E. *The Policy Must Be Sold as an Insurance Policy, Not an Investment Contract*

For the purposes of securities regulation an offering may be judged by what it represents itself to be.[252] "[T]he terms of the offer, the plan of distribution, and the economic inducements held out to the . . ."[253] prospective purchasers determine whether the contract is viewed in commerce as a security, and consequently whether the contract is a security under the federal securities acts.[254] If returns depend upon investment success and

short-term disparities between equity portfolio values and cost of living. But an investment-conscious society has developed, and the variable annuity has evolved into much more than a means of purchasing dollar-security.

Purchasers today are equally interested in investment dollar accumulation.

Id. at 43-44.

252 "And though the device be novel or uncommon, it may qualify as a security if, as a matter of fact, it has been 'widely offered or dealt in under terms or courses of dealing which established [its] character in commerce as [an] "investment contract" . . . .'" Johns Hopkins Univ. v. Hutton, 422 F.2d 1124, 1127 (4th Cir. 1970), citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 351 (1943). See also SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 90 (1959) (Brennan, J., concurring); Gordon, Investment-Insurance Arrangements; Conference on Mutual Funds 31-35 (Hodes, Geerlings & Simpson eds. CCH 1966); Recent Cases, Variable Annuity Held To Be Subject to Federal Securities Regulation, 17 Buff. L. Rev. 495, 497 (1968); Comment, The Flexible Fund Annuity: VALIC Revisited, 115 U. Pa. L. Rev. 600, 613 (1967). Note that one of the abuses of the investment companies during the 1920's and 1930's was that their sales and promotional literature created the impression that they were not unlike savings banks and insurance companies, except that they were not limited to so-called legal investments. They emphasized security for old age and for emergencies, and claimed that they could furnish security through expert management and diversification of risk. Investment Trusts and Investment Company, Hearings of the Senate Comm. on Banking & Currency, 76th Cong., 3d Sess. 164-65 (1946). Statement of M. John Boland, Attorney with the General Counsel's Office, S.E.C., Apr. 8, 1940.

253 387 U.S. at 211, citing SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344, 352-53 (1943).

254 Securities Act of 1933, § 2(1), 15 U.S.C. § 77b(1) (1964); Securities Exchange Act of

the contract is advertised to provide "growth" rather than future security, as the United Benefit Flexible Fund arrangement was,[255] the contract may be a security no matter what its strictly legal structure might be. If variable insurance advertising emphasizes its investment component, it might fall into the investment contract category by virtue of its own advertising. This element has been held to have evidentiary weight only. When an instrument is an insurance policy, even though it contains an investment element, the fact that part of the policy was described as "wise and sound investment" and a "guaranteed savings" did not create a security if other elements of a security were not present.[256]

Negotiability is not a necessary characteristic of a security. In *Tcherepnin v. Knight*,[257] the Supreme Court held that withdrawable and transferable, but non-negotiable, capital shares issued to evidence savings accounts in a savings and loan association were securities. However, a contract designated primarily for savings and not for exchange, may, probably, require more cumulative evidence to classify as a security since a non-negotiable instrument is not usually an investment medium. But the key word is and remains protection. The same was emphasized by Justice Brennan in *Valic*. In the pay-out period, when the annuitant is "locked-in" and cannot redeem his annuity, the need for protection is greater than in the pay-in period, and the annuity, though not negotiable or redeemable, is a security.[258] The same rationale applies to variable life insurance.

The preceding discussion shows how difficult it is to evaluate the chances of gain and loss to the insured in the variable life insurance policy. Whether a particular policy is a security for the purposes of the 1933 Act should also depend on whether the purchaser is able to determine the nature of the policy and its terms. If state law required such a policy to contain an accurate comparison of the cost and benefits between the policy and the conventional policy,[259] the 1933 Act protection may be unnecessary. The tests proposed above were concerned with the objective need for protection, resulting from the shift in the investment risk from the insurance company to the contractholder. There remains the subjective test—whether there is need for protection because such a policy is susceptible to misrepresentation regarding its own nature. For example, the policy may mislead a purchaser into believing that not only a minimum of death benefits but

1934, § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1964); Investment Company Act of 1940, § 2(a)(36), 15 U.S.C.A. § 80a-2(a)(36) (1971).

255 387 U.S. at 211.

256 Olpin v. Ideal Nat'l Ins. Co., 419 F.2d 1250, 1253, 1263 (10th Cir. 1969), cert. denied, 397 U.S. 1074 (1970).

257 389 U.S. 332 (1967).

258 359 U.S. at 89 (Brennan, J., concurring).

259 In the policy that the industry proposes the insured will trade a fixed-dollar guaranteed cash value for a minimum guarantee plus a hedge against inflation. The policy will not guarantee the cash surrender value. It will therefore be less useful for borrowing purposes since its cash value will depend on the market value of the equity scurities. Gustin, Details Industry Task Force Dealings with SEC on Variable Life Product, The National Underwriter, Mar. 27, 1971, no. 13 at 1, 9.

also a minimum of the cash surrender value is guaranteed, or that all of the investment appreciation will be applied to death benefits or to payment of premiums. The argument that specialty policies that were amenable to misrepresentation were nonetheless deemed insurance when the securities laws were passed does not apply to variable insurance since it did not exist then. An exempt variable policy must be truthful about itself, not only not misleading. The possibility of a test case under Rule 10b-5 under the Securities Exchange Act of 1934 might be an incentive to insurance companies and their regulators to use the Rule as a guideline on disclosure.

F. *Conclusion*

The proposed characteristics in variable insurance policies resemble those of an insurance policy because these characteristics avoid the dangers against which the securities acts afford protection. One characteristic concerns the degree and quantity of equity investment risk borne by the insured and insurance company (minimum fixed amount). In conventional insurance most of this risk is borne by the company. A second characteristic concerns the investment component. In conventional insurance it is confined to the cash surrender value. A third characteristic is the technique used to cover the promise to pay a fixed-dollar amount and the method by which the company will conduct its combined business of insurance and investment. A fourth characteristic concerns the method of sale and the character of the contract in the eyes of investors. In conventional insurance there is no doubt as to the nature of an insurance policy.

Similarity of some characteristics to those in a conventional policy may permit deviation of other characteristics from the conventional pattern. If the policy is sold as insurance, and if the policy promises not only a minimum fixed-dollar payment, but also a minimum income, and if the company adopts a true insurance scheme or establishes an adjustment fund, then, perhaps, an endowment policy might retain its insurance status, even though the investment component in such a policy is large.[260]

If, on the other hand, the quantum of equity risk borne by the insured is large, and especially if the contract is described as an alternative to a share in a mutual fund, then even the absence of any investment component in the insurance policy might not be sufficient to lift the controls that the 1933 and 1934 Acts provide. The protection that must be afforded to purchasers of variable insurance policies is twofold: the policies must be insurance policies under which the investment risk is essentially with the insurance company; and the policies must be phrased and sold so that purchasers can perceive what they are.

On October 28, 1970 the insurance industry submitted to the staff of the Commission a memorandum requesting that "the commission decide not

260 It is also assumed that the insurance company will be subject to appropriate state regulation.

to assert jurisdiction over variable life insurance policies which are so designed that their basic and predominant purpose and function is to provide protection against death."[261] The proposed policies must provide life-time insurance coverage.[262] They must be issued for an initial stated amount of death benefits and must guarantee payment of a death benefit at least equal to that amount. The amount payable upon the death of the insured in any year must be not less than a minimum multiple of the gross premium payable in that year by a person who meets standard underwriting requirements. The policy must be subject to regulation under state insurance laws. Finally, the policy should not include a provision for the accumulation in a separate equity account of policy dividends or other amounts not involving life contingencies.[263] In answer to the staff's inquiries, the industry furnished tentative and hypothetical information under which it seems that the cost of the proposed policy will be similar to the cost of an ordinary policy bearing the same face amount of death benefits. The major difference between this policy and a conventional policy is that the cash surrender value is not guaranteed. If the insured defaults in payments of his premiums and if at that time the value of the units representing the policy value is low, the insured might lose a major portion of his savings. Since the cash value of the policy depends on the value of the units, the policy is not as useful as an ordinary policy for the purpose of securing a loan. On the other hand, the policy gives beneficiaries a chance to profit from the appreciation of equity securities over a long period of time and may prove an effective device against inflation. Whether this policy should be exempt from the securities acts depends on how the policy will be written, advertised and sold.

In the last analysis the policy as a whole must be judged. The purchaser of an insurance policy that contains investment may be sufficiently protected under state insurance laws. But the purchaser of an investment containing some insurance must be afforded the protection of the 1933 and 1934 Acts.[264]

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[261] Gustin, note 259 supra, at 4.

[262] If the assumptions used by the industry are those used by United, then the company takes little risk in guaranteeing the premiums paid ten years or more before they become due. Premiums paid on a whole-life policy are kept by the company until death or default. The part of the reserves used to pay death benefits is very small, 2-3 percent of the reserve. If the company charges a percentage of the whole reserve to cover the risk entailed in guaranteeing a minimum payment on death benefits, the risk is very well covered, and might produce income. The more frequent payments that occur after a shorter period than ten years are cash surrender value payments. The proposed policy does not guarantee a minimum amount on the liquidation of units representing the surrender value.

[263] This provision excludes the creation of a fund exclusively for the purpose of investments. See p. 224 infra. The industry might also design participating and non-participating policies. The dividends under participating variable annuity policies will be lower than in ordinary participating policies because the investment income will not be available for distribution.

[264] 387 U.S. at 211: "The basic difference between a contract which to some degree is insured and a contract of insurance must be recognized."

PART II: SEPARATE ACCOUNTS

I. The Status of an Issuer of Variable Annuities Under the Investment Company Act of 1940

A. *The Separate Account as an Issuer*

The main question in *Valic*[1] was whether the company was an investment company to which the 1940 Act[2] applied. An investment company under this Act is an issuer who, among other things, invests, reinvests and trades in securities.[3] Insurance companies are excepted from the definition of an investment company.[4] They are defined as companies, organized as such, "whose primary and predominant business activity is the writing of insurance . . . ."[5] and which are subject to state regulation. Valic's predominant business was issuing variable annuities and investing and reinvesting the proceeds in securities. If these annuities were classified as securities and not as insurance within the meaning of the 1940 Act, Valic would not qualify for the insurance company exception. The Supreme Court decided that variable annuities are securities rather than insurance and, therefore, that the 1940 Act applied to the issuer, Valic.

The applicability of the Act to a company whose predominant business was the writing of conventional insurance but which proposed to sell variable annuities was not determined until 1963.[6] At that time The Prudential Insurance Company of America (Prudential) planned to sell variable annuities and requested the Commission to hold that the insurance company exception applied to it and that the exception covered its proposed variable annuity business. The Commission agreed that Prudential itself was excepted under section 3(c)(3).[7] The Commission, however, considered the pool of securities that would fund the proposed variable annuities to

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1 SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959).

2 Investment Company Act of 1940, 15 U.S.C.A. § 80a (1971) [hereinafter cited as 1940 Act].

3 § 3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (1971): "When used in this subchapter, 'investment company' means any issuer which—(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . ."

4 § 3(c)(3), 15 U.S.C.A. § 80a-3(c)(3) (1971).

5 § 2(17), 15 U.S.C.A. § 80a-2(17) (1971).

6 In re Prudential Ins. Co. of America, 41 S.E.C. 335 (1963), aff'd, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964). See Bartlett, Variable Annuities: Evolution and Analysis, 19 Stan. L. Rev. 150, 156-62 (1966); Note, Securities Regulation: SEC Reiterates Decision That Issuers of Variable Annuity Contracts Are Subject to Federal Regulation Under Investment Company Act of 1940, 1963 Duke L.J. 807; Recent Decision, 61 Mich. L. Rev. 1374, 1379 (1963).

7 41 S.E.C. at 339. Unlike the exemption of an insurance policy from the definition of a security, which was probably superfluous, an ordinary insurance company might be classified as an investment company within the meaning of sections 3(a)(1) and 3(a)(3) of the 1940 Act, were it not for the specific exemption. 359 U.S. at 74 n.4; Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., pt. 1, at 181 (1940).

be separate from the insurance company and held it to be an investment company within the meaning of the Act.[8]

An investment company is defined in section 3(a) of the Act as any "issuer" who among other things is ". . . in the business of investing, reinvesting, or trading in securities: . . . ."[9] Section 2(a)(22) defines "issuer" in terms of a "person";[10] section 2(a)(28) defines a "person" to include a "company,"[11] and the definition of a "company" includes a "trust, a fund, or any organized group of persons whether incorporated or not . . . ."[12] The Commission stated that "[t]he Act designates the relationships to which it applies—most vitally here, that of the contributor to a pool of equity capital managed and invested in securities at his risk."[13] The pool of securities—the fund—was an investment company that sold equity interests in its assets that were held by Prudential as trustee.[14] Prudential was cast in the role of a promoter of a separate "company" whose business was that of selling variable annuity contracts.[15]

In order to identify the "security" issued by the fund, the Commission viewed the variable annuity contracts as divisible into "insurance promises . . . made solely by the insurance company and supported by its assets (not including the investment fund) . . . [and] investment participations . . . measured solely by the investment fund (separate from the insurance company's assets)."[16] According to the Commission the investment business, supported by the assets in the fund, issued securities; the insurance business, supported by the general assets of the insurance company, issued insurance promises.

To Prudential's argument that the contract was "simply not divisible" the Commission answered:

> We disagree; indeed, division of its elements into investment and insurance components is essential to its performance and to its comprehension. Just as the fund has been identified as the issuer of the units sold through the medium of the contract, so Prudential should be identified as the obligor of certain promises made in the contract. In effect, Prudential's basic undertaking is that the number of annual units allocated to an annuitant (whatever their value) will not be affected by mortality experience; it will make up any inadequacies out

8 41 S.E.C. at 340-41.

9 § 3(a)(1)(3), 15 U.S.C.A. § 80a-3(a)(1)(3) (1971).

10 § 2(a)(22), 15 U.S.C.A. § 80a-2(a)(22) (1971).

11 § 2(a)(28), 15 U.S.C.A. § 80a-2(a)(28) (1971).

12 § 2(a)(8), 15 U.S.C.A. § 80a-2(a)(8) (1971); 4 L. Loss, Securities Regulation 2519 (2d ed. 1961, Supp. 1969) [hereinafter cited as Loss].

13 41 S.E.C. at 340. This theory was expounded regarding an application of Valic concerning various provisions of the Act. The Commission declared that the holders of variable annuities together with the proceeds of their payments constituted an investment company. The Commission did not require registration of that company because Valic was registered as such. In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680, 703-04 (1960).

14 41 S.E.C. at 345.

15 Id. at 346.

16 Id. at 342. See also Recent Decision, 61 Mich. L. Rev. 1374, 1379 n.22 (1963).

> of its own assets. The unit is the relevant security and must be located, despite any difficulty in the wording of a particular form of contract. This is further illustrated by the fact that during the pay-in period the contract holder may elect to redeem (in effect, sell) his individual interest in the investment fund at its then value. In this respect, the holder's position is identical to that of a mutual fund shareholder. During the pay-out period, individual interests cannot be so identified or sold. But it is clear that the investment results of the fund affect the amount of each of the payments in this period and therefore the substantive reasons for the application of the Act continue.[17]

The Commission stated that it was immaterial whether investment and insurance promises are combined in one contract.[18] An insurance company might form a mutual fund and sell shares of the fund together with its own insurance products. It might also sell variable annuity contracts, the value of each annuity payment to be measured by the value of shares of an existing and unrelated mutual fund.[19] Alternatively, an investment company might offer to its shareholders a plan for a systematic liquidation of shares on an annual or monthly basis. The insurance company in the first two examples would retain its identity as such. The mutual fund in the last example would not lose its identity, even if it made insurance promises.[20] But, the Commission reasoned, if an insurance company in effect created a mutual fund, federal law will apply to the investment promises and the assets designated to satisfy them; and if a mutual fund made insurance promises, state law will apply to the insurance promises and the assets designated to satisfy them.[21] Thus, the Commission concluded that state and federal regulation will not conflict. The Third Circuit agreed,[22] stating:

> As we have previously seen, the Investment Fund is a completely segregated account, devoted to investing in securities. The cash for 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 separable from the insurance company which, as the Supreme Court noted in *Valic,* "guarantee[s] 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."[23]

Valic spoke in terms of the annuity contract as a whole and did not separate the contract into insurance and investment components. The annuity was seen as a security notwithstanding its insurance aspects. In

17 41 S.E.C. at 347.
18 Id. at 343.
19 Id.
20 Id.
21 Id.
22 Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964).
23 Id. at 387.

Prudential the Commission isolated the investment component in the variable annuity and labeled that component an interest in a fund. *Prudential* held that this interest was a security that was issued by the fund. It then applied the Investment Company Act to the fund on the ground that the fund was an investment company.

The question that was decided in *Prudential*—whether a separate account is an investment company within the meaning of the 1940 Act—came before the Supreme Court in *SEC v. United Benefit Life Insurance Co.*[24] The Court held that the annuities issued by United Benefit Life Insurance Company (United) were securities within the meaning of the 1933 and 1940 Acts, reversing the decision of the court of appeals. The Supreme Court remanded, however, for a determination of the question whether the 1940 Act was applicable to the separate account[25] and established guidelines to be used in making that determination:

> It is clear, however, that United in the main is an insurance company exempt from the requirements of the Investment Company Act. Moreover, the provisions of that Act are substantive and go well beyond the disclosure requirements of the Securities Act. Thus the question whether the fund may be separated from United's other activities and considered an investment company is a difficult one . . . . An investigation into the relationship between the 'Flexible Fund' and United's insurance business, *as well as an investigation of the possible conflicts between state and federal regulation, is required for a proper resolution.* The SEC has requested us to remand the case for further consideration of this issue, and in view of its complexity, we deem this the wisest course. (Emphasis added.)[26]

United decided not to appeal and the Supreme Court has not resolved the question.

B. *The Investment Company Amendments Act of 1970*

In the Investment Company Amendments Act of 1970 (1970 Act) Congress for the first time referred expressly to separate accounts.[27] Separate accounts to which certain assets are allocated are exempt from coverage by the Act.[28] For an account to be exempt the assets must be derived solely

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24 387 U.S. 202 (1967), rev'g 359 F.2d 619 (D.C. Cir. 1966).

25 Id. at 212.

26 Id.

27 Investment Company Amendments Act of 1970, 84 Stat. 1413 [hereinafter cited as 1970 Act] enacting § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971).

28 1970 Act, amending § 3(c)(13), 15 U.S.C. § 80a-3(c)(13) (1964), and renumbering it § 3(c)(11), 15 U.S.C.A. § 80a-3 (c)(11) (1971). After the Prudential decision the insurance industry requested exemptions from some sections of the 1940 Act, especially with regard to formal contracts between the insurance company and the account and control of contractholders over investments. The industry also requested equal treatment with banks regarding tax qualified plans. McDougal, Variable Annuities and Separate Accounts, The Investment Company Act of 1940, Proceedings of the Legal Section, Am. Life Convention 78 (1967) [hereinafter cited as McDougal]. See also Townsend, Variable Annuity Approach, Separate Account Investments in the Company, Proceedings of the Legal Section, Am. Life Convention 21 (1968); Note, Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies, 82 Harv. L. Rev. 435, 468 (1968). Instead of exemptions by rule

from contributions under pension or profit-sharing plans that meet the requirements of section 401 or the requirements for deduction of the em-

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the Commission sought to avoid undue hardship by ad hoc exemptions. See generally 4 Loss at 2434, 2517 (Supp. 1969). Recent Decision, 13 Stan. L. Rev. 412 (1961). In re Variable Annuity Life Ins. Co., of America, Inv. Co. Act Release No. 2974 (Feb. 25, 1960), modified No. 4217 (Apr. 7, 1965); In re Equity Annuity Life Ins. Co., 39 S.E.C. 674, 677 (1960), modified Inv. Co. Act Release No. 3410 (Jan. 26, 1962). Only six years later did the Commission start to codify them. As early as 1963, however, the Commission exempted by rule from all the provisions of the Act any transaction by an insurance company involving a group annuity contract or contracts with an employer, providing for allocation of employer's contributions to a separate account if the contract:

(a) contains an undertaking by the insurance company to issue only fixed annuities. This condition was later changed as the coverage of variable annuities was allowed. Inv. Co. Act Release No. 4007 (July 2, 1964);

(b) meets the requirements of §§ 401 & 404(a)(2) of Int. Rev. Code of 1954, but does not include plans covering employees, some or all of whom are within the meaning of § 401(a)(1) of Int. Rev. Code of 1954;

(c) covers at least twenty-five employees at the time of its execution; and

(d) prohibits allocation to the separate account of any employee contribution.

17 C.F.R. § 270.3c-3 (1971).

These exempt transactions were also given, by Rule 156 pursuant to the Securities Act of 1933, the status of "transactions by an issuer not involving any public offering" under section 4(2) of the Act on the ground that the transactions do not constitute a sale of securities to the employees, since they have no choice in the matter. 17 C.F.R. § 230.156 (1971). See Blakeslee, Variable Annuities and Segregated Accounts, 14 Proceedings of the Conference of Actuaries in Public Practice 272, 280 (1964-1965). When an insurance company proposed to solicit sales of H.R. 10 plans by mail and furnish explanations of the details of the plans at meetings with prospective purchasers at which direct solicitations by the company's representatives would take place, the Commission did not exempt the transaction under Rule 156 as not involving a public offering. Sec. Exch. Act Release No. 8389 (Aug. 29, 1968).

When Rule 3c-3 was amended to permit, under the same conditions, the issuance of variable annuities to the extent of the employer's contributions, it was assumed that the transactions under the amended Rule 3c-3 were also exempt under Rule 156 even though the latter Rule was not amended. 4 Loss at 2531 (Supp. 1969). The recently amended Rule 156 expressly applies to Rule 3c-3 exemptions. 17 C.F.R. § 230.156 (1971).

In 1969, the Commission partly codified other prior ad hoc exemptions. It adopted, pursuant to the 1940 Act, Rule 6e-1 and amended Rule 156 pursuant to the 1933 Act. Rule 6e-1 granted exemptions that were more limited than those under Rule 3c-3 to a wider range of contracts than those covered by Rule 3c-3. Inv. Co. Act Release No. 5628, Sec. Act Release No. 4954 (Mar. 6, 1969), adopted, Inv. Co. Act Release No. 5741, Sec. Act Release No. 4986 (July 15, 1969). Like Rule 3c-3, Rule 6e-1 applied only to qualified pension and profit sharing plans under §§ 401 & 404(a)(2) of the Int. Rev. Code of 1954. Unlike Rule 3c-3, Rule 6e-1 applies to individual sales, H.R. 10 plans, was not limited to a minimum number of twenty-five employees, and did not require the exclusion of employees' contributions. The Commission imposed certain limitations: contractholders must be permitted to withdraw or transfer assets held in the separate account. Withdrawal rights may be limited with respect to sums allocated under the contract to provide retirement benefits to individual employees. With respect to these sums: the amount withdrawn or transferred in any month may be limited to one milion dollars or 5% of the value of the contractholder's interest at the time of request for withdrawal or transfer, whichever is greater. Further, the insurance company may impose a surrender charge of not more than 2% of the amount withdrawn, provided sales load and surrender charge on that amount do not exceed 6%. 17 C.F.R. § 270.6e-1(c)(2) (1971). On the problem of transferability and withdrawal of deposit funds see Institutional Investor Study Report of Securities and Exchange Commission, H.R. Doc. No. 64, 92d Cong., 1st Sess., pt. 2, at 577 (1971) [hereinafter cited as SEC Investor Report].

Note that in the opinion of the staff it was not possible for the same separate account to qualify under both Rules 3c-3 and 6e-1 because the exemptions under Rule 6e-1 and ployer's contribution under section 404(a)(2) of the Internal Revenue Code of 1954 (qualified plans), or from advances made by the insurance company to operate the account.[29] Therefore, if an account funds a plan that meets

Rule 156 provide "a comprehensive regulatory pattern for insurance company separate accounts used to fund pension and profit-sharing plans . . . ." Inv. Co. Act Release No. 6124, Sec. Act Release No. 5074 (July 21, 1970). On July 10, 1969, the Commission also adopted Rules 14a-2, 15a-3, 16a-1, 32a-2, 22e-1, 27c-1, 27a-1, 27a-2 and 27a-3. Proposed, Inv. Co. Act Release No. 5586 (Jan. 24, 1969), adopted, Inv. Co. Act Release No. 5738 (July 10, 1969).

As mentioned, Rule 156 was amended in 1969 to apply to transactions exempt under Rule 6e-1. This exemption required that the contract would involve at least twenty-five employees or, if H.R. 10 plans are offered, twenty-five self-employed individuals and their employees. There was a further condition that no advertising be employed except a tombstone-type advertisement to identify the insurance company, to state that it is writing such contracts, to describe the separate account and the basic provisions of the contract, and to invite inquiries. 17 C.F.R. § 230.156 (1971). The Rule further provided that, for the purpose of registration under section 5, when allocation is made to a separate account entitled to exemption under Rule 6e-1, no sale, so far as an employee is concerned, will be deemed to be involved provided that the employer does not engage any person to induce employees to participate in the plan, the solicitation by the insurance company is limited to explanation of the terms and conditions of the transaction, and the employer is expected over the anticipated life of the plan to make a contribution to the account of at least half as much as that of the employees. Id.

In the 1970 Act, the insurance industry won treatment equal to banks with regard to certain separate accounts. Comm. on Interstate & Foreign Commerce on H.R. 17333, H.R. Rep. No. 1382, 91st Cong., 2d Sess. at 18 (1970). The exception from the Act covers "any separate account the assets of which are derived solely from (A) contributions under pension or profit-sharing plans which meet the requirements of [section 401 of the Int. Rev. Code of 1954] or the requirements for deduction of the employer's contribution under section 404(a)(2) of Title 26, and (B) advances made by an insurance company in connection with the operation of such separate account." § 3(c)(11), 15 U.S.C.A. § 80a-3(c)(11) (1971). Rule 6e-1 and 3c-3 were thereby overruled, being more restrictive than section 3(c)(11). Inv. Co. Act Release No. 6430, Sec. Act Release No. 5137 (Apr. 2, 1971) effective July 1, 1971. Rule 156 was also overruled, id.

29 § 3(c)(11), 15 U.S.C.A. § 80a-3(c)(11) (1971). This provision was a latecomer. The original proposed legislation in this area, the Bill of 1967, did not mention separate accounts. The Commission preferred to deal with them administratively. 4 Loss at 2548 (Supp. 1969). The insurance industry and its separate accounts rode into the 1970 Act on the coattails of the banking industry. In 1967, it was not clear whether banks could legally engage in mutual-fund-like activities. Investment Co. Institute v. Camp, 274 F. Supp. 624 (D.D.C. 1967), rev'd National Ass'n of Securities Dealers, Inc. v. SEC, 420 F.2d 83 (D.C. Cir. 1969), rev'd 91 S. Ct. 1091 (1971) (aff'g 274 F. Supp. 624 (D.D.C. 1967)). Senator McIntyre then introduced an amendment No. 438 to the 1967 Bill reversing the decision of the district court, to permit banks to engage in the business of commingled trust and agency funds. The amendment also reiterated the exemption granted under section 3(c)(13) of the 1940 Act to employees' stock bonus, pension or profit-sharing trust that meets the conditions of section 165 of the Int. Rev. Code of 1954 as amended. 3 Mutual Fund Legislation of 1967, Hearing on Amendment No. 438 to S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess. 1209-23 (1967). See also 4 Loss at 2547 (Supp. 1969). At that time separate accounts that funded such plans received only a partial exemption under Rule 6e-1. See note 28 supra. The insurance industry demanded equal treatment with banks with respect to employees' pension or profit-sharing plans—a full and unconditional exemption. 4 Loss at 2548 (Supp. 1969). The final Bill reflects both House and Senate agreement with this demand. The stated purpose of subsection (11) of section 3(c) of the Act, replacing subsection (13) is "to give life insurance companies the same treatment with respect to employees' pensions and profit-sharing plans . . . as is provided for banks." House Comm. on Interstate and Foreign Commerce, 1970 Act, H.R. Rep. No. 1382, 91st Cong., 2d Sess. 18 (1970). The final version of the Act did not include the McIntyre amendment. The question of whether banks could engage in investment business through commingled trust funds was left to

the requirements of Section 403(b) of the Code, or also funds non-tax exempt plans, the account does not fall within the definition of section 3(c)(11) of the 1940 Act.[30]

Section 2(a)(37) of the 1940 Act contains a definition of separate accounts. That section was added "to provide a definitional base for the exclusion from the Act of certain separate accounts . . . ."[31] and presumably, does not describe accounts that are subject to the 1940 Act. The 1970 Act did not declare that a separate account is a "company" or an "issuer" or an "investment company." Arguably, the status of separate accounts not exempt under the 1970 Act is still in doubt. Nonetheless, implicit in the industry's arguments for equal treatment with banks is an acceptance of the principle that a separate account can be an investment company.[32] The reason why most of the accounts funding variable annuities were not registered as investment companies under the 1940 Act was that the sponsoring insurance companies believed that these accounts enjoyed an exempt status under Rule 3c-3 or Rule 6e-1 pursuant to the 1940 Act.[33] Even though the exemptive provisions of section 3(c)(11) do not apply the 1940 Act expressly to separate accounts,[34] these provisions may be evidence that Congress considered these accounts to be investment business, not insurance business, and, but for the exemption, subject to the Act. Were the question ever to reach the Supreme Court, chances are slim indeed that the Court would overrule *Prudential.*

C. *Second Thoughts and Some Later Adjustments*

Prudential[35] was based on the assumption that the separate account, the fund which invested in equity securities at the risk of the contractholders,

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the Supreme Court. House-Senate Conference Comm. Report on S. 2224, H.R. Rep. No. 1631, 91st Cong., 2d Sess. 29 (1970). On April 5, 1971, the Supreme Court decided that participation units in a bank investment fund are securities within the meaning of the Glass-Steagal Act and that this Act prohibits banks from underwriting the issuance of securities because Congress acted to keep commercial banks out of the investment banking business. Investment Co. Institute v. Camp, 91 S. Ct. 1091, 1100 (1971). At present the banking industry cannot carry on the business of commingled trust funds without express federal legislation.

30 This was emphasized by the Commission in the notice of proposed Rules implementing the amendments to section 27 of the Investment Company Act, Inv. Co. Act Release No. 6493 (Apr. 29, 1971). The notice stated that the 1940 Act and the proposed Rules apply to plans that qualify under section 401 of the Int. Rev. Code of 1954 and to plans that meet the requirements of section 402(a)(2), if they are funded by accounts that are not excluded from the definition of an investment company under section 3(c)(11).

31 House Comm. on Interstate and Foreign Commerce, 1970 Act, H.R. Rep. No. 1382, 91st Cong., 2d Sess. 15 (1970). See also Senate Comm. on Banking and Currency, Inv. Co. Amendments Act of 1969, S. Rep. No. 184, 91st Cong., 1st Sess. 22 (1969).

32 Hearing on Amendment No. 438 to S. 1659 Before the Senate Comm. on Banking and Currency, 90th Cong., 1st Sess., pt. 3, at 1350-51 (1967). See generally id. at 1347-53.

33 SEC Investor Report, note 28 supra, at 643-46.

34 Therefore, arguably these provisions may not satisfy the requirement in the McCarran-Ferguson Act that a federal statute shall not supersede state law regarding the business of insurance except by an express provision. See McCarran-Ferguson Act, 15 U.S.C. § 1012(b) (1964).

35 41 S.E.C. 335 (1963).

could be clearly and easily distinguished from the insurance company and that the fund could be treated as an investment company. This assumption was based on another assumption that the distinction between investment and insurance promises is followed by a distinction between the assets that fund these promises. The investment promises were the promises to invest in securities and to pay annuities. The insurance promises were the mortality and expense guarantees.

It has been shown that in reality the assets of the account support both insurance and investment promises. In addition to being invested in equity securities, the assets constitute the reserves supporting the insurance promises. *Prudential* did not spell out how insurance promises were to be satisfied by the insurance company. It was uncertain whether the company should wait until one of the contractholders outlived his expected mortality age and then pay his annuity until death,[36] or whether the insurance company should wait until all funds in the account were exhausted, and then assume the liability for paying the annuities to those who have outlived the available funds in the account.[37] This area was considered to be within the domain of state insurance authorities. It seems that the Commission expected that the assets in the separate account would be equal to the total reserve liability. However, an account containing additional funds to back up the reserves was not required to register as an investment company.[38]

"The term 'reserve' . . . has a special meaning in the law of insurance. While its scope varies under different laws, in general it means a sum of money, variously computed or estimated, which with accretions from interest, is set aside, 'reserved,' as a fund with which to mature or liquidate, either by payment or reinsurance with other companies, future unaccrued and contingent claims, and claims accrued, but contingent and indefinite as to amount or time of payment."[39]

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36 As was envisaged by one author, "if he [the annuitant] does not outlive the actuarial prediction, [he] has no claim against the assets of the company . . . ." Comment, The Expanding Jurisdiction of the Securities and Exchange Commission: Variable Annuities and Bank Collective Investment Funds, 62 Mich. L. Rev. 1398, 1402 (1964).

37 This second situation is unlikely to occur. Annuity payments are calculated according to tables that in all probability ensure that the funds in the account will never be exhausted.

38 Prudential planned to allocate payments by contractholders to two accounts. Charges for "sales and administrative expenses and the insurance surplus," as well as charges for the mortality and expense guarantees, were to be placed in an "other assets account." 41 S.E.C. at 348 n.30. Net payments by contractholders, after deduction of sales and administrative charges, were to be allocated to the separate account and invested in equity securities, to serve as the source of payment of annuity obligations. The National Ass'n of Securities Dealers argued before the Commission that the "other assets account" was as much an investment company as the separate account. The Commission held that the "other assets account" need not register under the Act. Id. "In one sense it is clear that the contract holders have an interest in the Other Assets account; it is funds from this account which must be transferred to the Investment Fund to assure that the assets of the Fund shall be equal to Prudential's total reserve—annuity—liabilities under the variable contracts. Presumably state insurance authorities will continuously assure that this equality is maintained. Aside from the reserve liability, any excess in this account over liabilities belongs to the contract holders only in their capacity as policy holders of a mutual company and not as investors in an investment company." Id.

39 Maryland Cas. Co. v. United States, 251 U.S. 342, 350 (1920). See also J. Maclean,

Reserves are calculated pursuant to state statutes on a fixed valuation date. Typically, the valuation is made annually.[40] In the time between two valuation dates, reserves may be either more or less than the amount set aside under the law to fund insurance obligations. Usually, under state laws the assets in the separate account cover at least reserve liabilities on valuation dates.[41] If state law requires no more, these assets are the only reserves. Sometimes an additional fund is set up. This fund represents a reserve over and above that contained in the separate account, to be used should the separate account reserve be inadequate. The decision to establish an additional reserve fund depends upon an evaluation of the risk involved in the mortality guarantee. New York seems to consider the risk to be high probably because the magnitude of the loss is unpredictable,[42] though the probability of occurrence may be predictably small, and so requires an additional reserve fund.[43] Most states do not require an additional reserve. They usually provide for an adjustment of the separate account on valuation dates, presumably to and from the general account of the insurance company.[44] According to experience, however, adjustments result in a flow of assets to the general account of the insurance company.

By now it should be clear that the promise to pay variable annuities is not a pure investment promise. The calculation of the premiums of the

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Life Insurance 111-40 (9th ed. 1962). Variable annuities do not contain assumed or promised interest. Instead, they are affected by the performance of an equity fund. Therefore, the reserves must be invested in this fund, or else the insurance company might not be able to honor its liabilities.

40 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 9 (Supp. 1971); N. J. Stat. Ann. § 17:34-22 (1963); N.Y. Ins. Law § 205.1 (McKinney 1966).

41 Colo. Rev. Stat. Ann § 72-2-12 (1963); D.C. Code Encycl. Ann. § 35-541(a) (1968); Fla. Stat. Ann. § 627.0976 (Supp. 1971); Hawaii Rev. Stat. § 431-563(a)(2) (Supp. 1970); Ind. Ann. Stat. § 39-3501 (Class I(c)) (1965); Kan. Stat. Ann. § 40-436(f) (Supp. 1970); Ky. Rev. Stat. Ann. § 304.834(3) (1970); La. Rev. Stat. Ann. § 22:1500G (Supp. 1971); Mich. Comp. Laws Ann. § 500.925(4) (Supp. 1971); Minn. Stat. Ann. § 61A.145 (Supp. 1971); Nev. Rev. Stat. § 690.460.2 (1967); N.H. Rev. Stat. Ann. § 408:30 (1968); Okla. Stat. Ann. tit. 36, § 6061(h) (Supp. 1971); S.C. Code Ann. § 37-333(i) (Supp. 1970); S.D. Comp. Law Ann. § 58-28-22 (Supp. 1971); Va. Code Ann. § 38.1-443(a) (1970). See also Model Variable Annuity Contract Regulation art. IV, § 6, reproduced in Warchall, State Variable Annuity Laws and Regulations Contracts and Companies, App. B., Proceedings of the Legal Section, Am. Life Convention, 163, 197 (1968) [hereinafter cited as Model Variable Annuity Contract Regulation]. The Commission indicated approval of this insurance practice. Qualifications of separate accounts for exemption under Rule 6e-1 included a requirement that the value of the assets in the account be at least equal to the reserves and other contract liabilities with respect to such account. The definition under Rule 0-1(e) of a separate account qualifying for other exemptions describes the insurance practices even more accurately: "[T]he assets of the separate account shall, at the time during the year that adjustments in the reserves are made, have a value at least equal to the reserves and other contract liabilities with respect to such account, and, at all other times, shall have a value approximately equal to or in excess of such reserve liabilities."

42 For example, the probability that a full cure for cancer will be found in the next five years might be low, but if it materializes the insurance company will incur great losses on its annuity contracts. The unknown factor that creates the great risk is the magnitude of the loss, not the probability of its occurrence.

43 N.Y. Ins. Law § 227(1)(k) (McKinney Supp. 1970). Reg. No. 47 § 50.6(a)(3), 11 N.Y. Codes Rules & Regulations (1971).

44 See note 41 supra.

annuities to be paid and of the amounts that should be placed in the separate account to meet reserve requirements, are all insurance matters. These calculations not only involve the relationship between the contractholder and the insurance company, but also govern the separate account and its assets. Variable annuities are not periodic liquidations of capital, but periodic payments based on an insurance scheme. In the pay-out period, which involves both insurance and investment promises, the assets of the account support both promises. As a result, the assets are subject to concurrent and sometimes conflicting regulation by state and federal legislation. The Commission has attempted to solve the problem of conflicting regulation by exemptions.

The application of both federal and state law to the same assets also results in a conflict over the management of the assets. The separate account presents a novel division of the investment and insurance risks between contractholders and the insurer. In an ordinary stock insurance company, policyholders bear no risk; the corporation, and indirectly its shareholders, take all the insurance and investment risks in the conduct of the business.[45] Since investment risk is usually accompanied by the power to manage,[46] shareholders usually have a voice in the management and policyholders usually do not.[47] In an ordinary mutual insurance company, policyholders bear both investment and insurance risks since they are both insurers and insureds.[48] Therefore, members in a mutual insurance company are accorded rights similar to those of shareholders,—a voice in management.[49]

Occasionally insurance companies conduct insurance business both as mutual and as stock companies. The following is a description of a company's business in the 1880's:

> . . . the company has kept separate accounts of the business carried on in the stock and mutual departments, and of the receipts and expenditures in each. None of the assets and earnings of one department have been applied to payment of losses or dividends of the other. The dividends to shareholders have been paid from the earnings of the stock department. None of the earnings of this department have been paid as dividends to the holders of policies issued by the mutual department. The salaries, rents, and other general expenses of the company were divided between and borne by the two departments in proportion to the amount of cash premiums received by them respectively. The tax assessed on account of the guaranty capital was paid by the company, and charged to the stock department. Practically, the company considered that, under a common board of directors, there were two sep-

[45] 18 J. Appleman, Insurance Law and Practice § 10001, at 2 (1945) [hereinafter cited as 18 Appleman].

[46] See p. 326 infra.

[47] See pp. 326-27 infra.

[48] 18 Appleman §§ 10046-47. College Retirement Equities Fund (CREF) is conducted on these terms. If mortality experience is lower than the assumptions made in the mortality tables, the contractholders will bear the loss.

[49] See p. 328 infra.

> arate and distinct organizations,—one governed by the laws relating to stock companies, and the other by those relating to mutual. Two branches of business were conducted, each independent of the other, with distinct interests, but under a common head.[50]

Another example of a division of risks between shareholders of the insurer and its policyholders are charter companies. Under their charter holders of policies on a mutual plan are entitled to a percentage in the profits. Subject to rights of shareholders, the surplus of the company belongs to the holders of the policies on the mutual plan.[51] Even in these cases the insurance company had one management.

In the separate account, the division of risk follows the different businesses carried through the account. Payment of annuities according to insurance principles is an insurance business. Profits and losses from this business belong to, and are borne by, the insurance company, and therefore the company ought to have the right to manage the account's insurance business. The assets of the account are also invested in securities, an investment business. Profits and losses from this business belong to, and are borne by, the contractholders, and therefore the contractholders ought to have the right to manage the account's investment business.

In the separate account the same assets support two types of risks, each borne by a different group, and are subject to two regulatory schemes. The division of the account's activities into different promises is not helpful since the underlying assets supporting the promises and businesses are, for all practical purposes, the same. Conflicts arising from competing claims to management and control have usually been resolved in favor of contractholders on the basis of their rights under the 1940 Act. But many unresolved questions remain.

Compounding these conflicts is the fact that there are two conceptual approaches to the separate account. The conventional investment-company-oriented approach is to view the account as a company established for the purpose of doing investment business and to view the 1940 Act as superimposing upon this company requirements concerning the conduct of its business and its internal organization. The insurance-oriented approach is to view the account as a department of the insurance company, recognized as an entity for the sole purpose of applying the 1940 Act to it. The account is not a regulated investment company in the usual sense, but rather an entity existing for the purposes of the 1940 Act only,[52] a regulated department of an insurance company. Both approaches raise difficulties.[53]

Another troublesome aspect of *Prudential* is the characterization of the account together with the contractholders as "any organized group of per-

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[50] Traders' & Mechanics' Ins. Co. v. Brown, 142 Mass. 403, 8 N.E. 134 (1886).
[51] Ohio State Life Ins. Co. v. Clark, 274 F.2d 771 (6th Cir. 1960).
[52] 4 Loss at 2519 (Supp. 1969).
[53] See, e.g., pp. 253, 268, 281 infra.

sons whether incorporated or not."[54] It was first held that the account was a "fund," an entity that can be separated from the other business of the insurance company and subjected to the 1940 Act. But the nature and structure of this entity were left undefined. The Commission reasoned that contractholders must be organized[55] in order to exercise their voting rights and other rights under the 1940 Act and that they are also a "company" under the definition of the 1940 Act, being "any organized group of persons whether incorporated or not." The Commission concluded that the account is absorbed in the same organization and becomes, with the contractholders, an "organized group of persons."

Usually a promoter of an investment company determines its organization under state law. In *Prudential* the promoter, the insurance company, denied its role as a promoter and argued that it did not provide any organizational form either for the account or for the contractholders. The Commission held that the insurance company was a promoter but left the task of organizing the account to the company. In addition, the insurance company was allowed to provide for a form of organization for the account without having to recognize the account's separate existence. The Commission permitted the insurance company to organize the contractholders and declared in advance that this organization was also the organization of the account. Under this arrangement the account could be a department of the insurance company with no organizational structure of its own, existing only for the purposes of applying the 1940 Act to its investment business. The contractholders are organized, presumably as an unincorporated association, to enable them to exercise their rights under the 1940 Act. It is doubtful whether this result had been intended in *Prudential* since this approach is not fully accepted by the staff even today.[56]

Under the conventional investment-company approach, the account could be considered a corporate entity. A "fund," an inanimate pool of securities, is usually a part of the organization of its owner. In the case of separate accounts the owner is, in over half of the states, the insurance company[57] from which the account must remain separate. On the other

54 41 S.E.C. at 345. 1940 Act, § 2(a)(8), 15 U.S.C.A. § 80a-2(a)(8) (1971).

55 Id. The difference between an "unincorporated association" and an "organized group of persons" that is unincorporated, is that the latter includes a group that is "organized" by one other than members of the association. The term "organized" connotes having a formal organization to coordinate or carry out joint activities. Webster's Third New International Dictionary (15th ed. 1966). The term has also been loosely construed to mean the recruitment of members to a cause for a purpose. See Wellman v. United States, 227 F.2d 757, 765 (6th Cir. 1955). The accused were held to have attempted to organize the overthrow of the United States by recruiting members into the Communist Party. In this sense, perhaps, the insurance company is organizing the contractholders for the purpose of exercising their rights under the 1940 Act.

56 See p. 253 infra.

57 Ala. Code tit. 28, § 4(5)(1)(e) (Supp. 1969); Alas. Stat. § 21.21.320(f) (1966); Ariz. Rev. Stat. Ann. § 20-6510 (Supp. 1970); Ark. Stat. Ann. § 66-3523(e) (Supp. 1969); Cal. Ins. Code § 10506(A) (West Supp. 1971); Conn. Gen. Stat. Ann. § 38-33(a) (Supp. 1971); Ga. Code Ann. §§ 56-1038(e), -1040(k) (1971); Hawaii Rev. Stat. § 431-563(a)(4) (Supp. 1970); Idaho Code Ann. § 41-1936(5) (Supp. 1969); Ill. Ann. Stat. ch. 73, § 857.54 (Smith-Hurd Supp. 1971);

hand there is no reason to submerge the account with the group of its issuees. The organization of the contractholders was not voluntary. *Prudential* held that the insurance company was obliged to organize contractholders in order to enable them to exercise their rights under the 1940 Act. The Act does not require the organization of contractholders for the purposes of carrying on an investment company business, and neither the insurance company nor its contractholders showed that they desired such an organization. An organizational structure that may be appropriate for the purpose of enabling contractholders to exercise their rights under the 1940 Act, divorced from the conduct of the investment business, is not necessarily appropriate for the conduct of the business.

Usually the assets of unincorporated associations are owned and managed by their members. In the case at hand the assets in the separate account may be owned by one entity, the insurance company, and managed by others, the contractholders.[58] If the fund itself is not a corporate entity, the split between ownership and management will make it impossible to identify the investment company to which the 1940 Act applies; the insurance company cannot, and contractholders should not be deemed to substitute for it.[59]

It has been said that a corporation is characterized by the powers to sue and be sued in the corporate name, to acquire and transfer property, to purchase and hold real estate, to have a common seal, to make by-laws for the internal government of the corporation and to have perpetual succession.[60] One of the great advantages of incorporation is limited liability of the shareholders, yet this is not considered essential to the existence of a

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Ind. Ann. Stat. § 39.3501 (Class I(c)) (1965); La. Rev. Stat. Ann. § 22:1500F (Supp. 1971); Md. Ann. Code art. 48A, § 96A(f) (1968); Minn. Stat. Ann. § 61A.145 (Supp. 1971); Miss. Code Ann. § 5649.35 (Supp. 1970); Neb. Rev. Stat. § 44.310.06 (Supp. 1967); N.Y. Ins. Law § 227.1(j) (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(1) (Supp. 1969); N.D. Cent. Code § 26-11.1-01.5 (Supp. 1971); Laws of Ohio bk. I, § 3907.15 (1969-1970); Ore. Rev. Stat. § 733.180(5) (1969); S.C. Code Ann. § 37-333(i) (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-17 (Supp. 1971); Tenn. Code Ann. § 56-316 (1968); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971); Utah Code Ann. § 31-13-31(7) (Supp. 1967); Vt. Stat. Ann. § 3855(a)(5) (Supp. 1971); Wash. Rev. Code Ann. § 48.18A.020(4) (Supp. 1970); Wis. Stat. Ann. §§ 206.385(5) (Supp. 1971).

58 For the state law requirement that the insurance company own the assets see note 57 supra. For control of management by contractholders see pp. 345-50 infra.

59 Federal courts have accorded the status of an independent entity to an aggregate of individuals in order to effectuate the purposes of federal statutes. A partnership has been held to be an entity capable of being a director for the purposes of section 16(b) of the Securities and Exchange Act of 1934, Blau v. Lehman, 368 U.S. 403, 409-10 (1962), and capable of committing a crime, United States v. A & P Trucking Co., 358 U.S. 121 (1958). This case held that 49 U.S.C. § 322(a) (1964) imposing criminal sanctions on any person knowingly and willfully violating the provisions of Part II, applied to partnerships. These decisions were based on congressional power to change the common law rule that partnerships were not entities. They held that by defining a partnership as a "person" Congress had changed the common law for the purposes of the federal act.

60 1 W. Fletcher, Cyclopaedia of the Law of Private Corporations § 5, at 22-23, § 6, at 24 (perm. ed. rev. 1963) [hereinafter cited as 1 Fletcher]. 1 G. Hornstein, Corporation Law & Practice §§ 15, 16 (1959).

corporate entity.[61] Neither is a corporate seal[62] or the power to make by-laws an essential feature of a corporation.[63] But the existence of a corporate name is essential.[64]

Under these criteria the separate account has the main characteristics of a corporation. It has a special name and the capacity to sue and be sued,[65] to hold property, and to enter into contracts.[66] It has an indefinite existence.[67] It does not have a corporate seal, does not grant its contractholders limited liability,[68] and cannot provide for its internal organization.[69] Yet these traits, as mentioned, are not essential to the existence of a corporate entity.

An aspect peculiar to the separate account is that it must be established by, and cannot exist apart from, an insurance company.[70] This characteristic does not negate the existence of a corporate entity. To be sure, it is unusual, but there is at least one precedent for such a relationship between two corporate entities.[71] A corporation must be comprised of persons as members or shareholders, the persons being either natural or artificial.[72] Masses of property can also be artificial persons[73] so long as they are provided with persons through whom they can function.[74] Finally, even though an account is "established" under state law, not "incorporated" by a grant from the legislature,[75] it may be considered to have been incorporated by implication. Entities created by statute in order to effectuate some public or semi-public functions were recognized by the courts as corporations even

61 1 Fletcher § 14, at 45.

62 Id. § 9, at 41.

63 Id. § 10, at 41.

64 Id. § 8, at 40.

65 See p. 264 n.180, 282 infra.

66 See p. 281 infra.

67 On dissolution of the account see p. 373 infra. The existence of an account will also terminate if it ceases to be an investment company. If the account is an unincorporated association and if it is classified as a partnership, an extremely remote possibility, the account would dissolve upon the death of any one of its members. A more likely classifiication is to treat the account as a joint stock company, in which case it would retain its status, notwithstanding the death of any of its members. See 1 Fletcher § 21, at 72.

68 See p. 273 infra.

69 See p. 264 infra.

70 See p. 247 infra for the definition of an account.

71 In Massachusetts, the deacons of a church were a corporate entity that existed apart and separate from the church. This entity's existence, however, depended on its association with the church. If the deacons seceded from the church, their corporate existence would be terminated. Stebbins v. Jennings, 27 Mass. (10 Pick.) 171 (1830). By analogy, since the security offered by a separate account is a component of an insurance product, the account must be connected with an insurance company in order to retain its identity.

72 1 Fletcher § 27, at 119. A person is any entity to which the law attributes a capacity for legal relations. J. Hall, Readings in Jurisprudence 444-45 n.1 (1938); Hogan v. Greenfield, 58 Wyo. 13, 22, 122 P.2d 850, 853 (1942).

73 T. Holland, Jurisprudence 97-98 (13th ed. 1924).

74 1 Fletcher § 27, at 119-20 n.2.

75 Id. at § 113.

though they received no express statutory grant of the privilege of incorporation.[76]

Under this construction the law applicable to the account will be the law governing its sponsoring insurance company, and superimposed on that law is the 1940 Act.[77] The regulated-department approach leads to the same results with respect to the investment business of the account. Since the business is conducted by the insurance company it is governed by the state insurance and corporate laws. Presumably the 1940 Act will also apply. The organization of the contractholders, however, is established only for the purposes of affording them, as a special class of policyholders, voting rights and a voice in the management of the account in order to satisfy the requirements of the 1940 Act.[78] It is not clear what law applies to this special organization. If the account is deemed to be an unincorporated group of persons then, presumably, the law of unincorporated associations would apply to it. This law is inappropriate to the operations of an investment company or even for the purposes of governing the group of contractholders in the exercise of their rights under the 1940 Act.[79]

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[76] If powers and privileges that have been bestowed by legislation cannot be exercised or enjoyed without a corporate status, or if the purposes of the statute cannot be effectuated without the recognition of a corporate existence, the courts will interpret the statute as creating a corporation for the purposes of that statute and to the exent necessary to effectuate these purposes. A levee district which was given by statute the attributes of a corporation, to make contracts, incur debts, employ agents, and have perpetual succession, was held to be a corporate entity. Board of Levee Inspectors v. Crittenden, 94 F. 613, 615-16 (8th Cir. 1899). Dean v. Davis, 51 Cal. 406, 410-11 (1876). Accord, Sels v. Greene, 81 F. 555 (C.C.N.D. Cal. 1897); Vincent v. Lincoln Co., 30 F. 749, 750-51 (C.C.D. Nev. 1887). These semi-public bodies are sui generis. They were classified as corporations because many of the rules governing corporate entities applied to them. But they would cease to exist if the policy of the state changed and there were no further functions for them to perform. Reclamation Dist. No. 70 v. Sherman, 11 Cal. App. 399, 105 P. 277 (1909); see also Blair v. West Point Precinct, 5 F. 265, 267-68 (C.C.D. Neb. 1881); Anaheim Sugar Co. v. County of Orange, 181 Cal. 212, 218-19, 183 P. 809, 812 (1919); Packard v. First Congregational Parish, 256 Mass. 550, 553-54, 152 N.E. 921, 922-23 (1926). When the purpose of the legislature could be effected without the existence of a corporate entity, none would be implied: "The doctrine is thus a remedial doctrine in that it is invoked to give effect and force to statutory provisions which would otherwise fail of accomplishing their purpose." Anaheim Sugar Co. v. County of Orange, 181 Cal. 212, 218, 183 P. 809, 812 (1919).

The similarity of separate accounts to these sui generis corporations is striking. Accounts are also created by law. They are created for the purpose of facilitating federal securities regulation, and, as such, they perform a public function. Like the old levee districts, they will cease to exist when regulation is no longer necessary. It may well be that this dormant doctrine should be revived whenever state law does not provide an appropriate organizational structure for accounts.

[77] The account must be viewed from its inception and not from the moment it becomes an investment company—just as corporate law applies to a corporation before it issues securities. The account is established under state law. Because it is a part of the insurance company, state corporate laws also apply to it. When the account becomes an investment company, the 1940 Act is superimposed on the state laws already governing it. The result is the law of separate accounts.

[78] This seems to be the present attitude of the insurance industry.

[79] See, e.g., pp. 265, 273 infra.

The application of the 1940 Act to a business based on an insurance scheme also raised conceptual difficulties. The operation and structure of an insurance account is not compatible with the model to which the Investment Company Act applies. Measures of investment performance and reserves cannot fit into the molds of shares and corporate-like capital structures.[80]

Finally, a difficulty that could be expected was the natural resistance of the insurance industry to the limitations on what, in effect, are its business activities and to changes in its mode and pace of operations.

The separate account will be examined as an investment company established to conduct an investment business. Its nature, powers, establishment and dissolution will be discussed. Parallel to this, the account will be examined as a regulated department of an insurance company established and existing only for the purpose of applying to it the 1940 Act.

The organization of this discussion will follow the separate account as an institution rather than as a regulated department. It was felt that this framework might highlight the differences and similarities between the separate account and a conventional investment company. It will be assumed that the 1940 Act applies to separate accounts. At the conclusion of this article this premise will be re-examined. Whether the 1940 Act applies to separate accounts has not been decided by the Supreme Court. As was emphasized in the Supreme Court's decision in *SEC v. United Benefit Life Insurance Co.*,[81] the application of the 1933 Act to variable annuities does not result in automatic application of the 1940 Act to separate accounts. The two Acts differ greatly as to their objectives: whereas the 1933 Act essentially requires disclosure, the 1940 Act regulates the business of the investment company, affects its organizational structure, and, in addition, dictates some of the most important contractual provisions of the securities issued by the investment company, such as the amount of load and redeemability.

The provisions of the Investment Company Act and of state insurance laws are similar in that both regulate the business of the issuer. The 1933 Act, on the other hand, only regulates the issuance of securities. Therefore, the likelihood that insurance laws and the company's smooth business operation will conflict with the 1940 Act is greater than the likelihood that they will conflict with the 1933 Act. Following the guidelines set forth in *United*,[82] this article will analyze the conflicts between state laws and the Investment Company Act for the purpose of re-examining the applicability of the 1940 Act to separate accounts. Eight years have passed since the *Prudential*[83] decision. A re-evaluation is in order.

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80 See p. 293-95 infra.
81 387 U.S. 202 (1967).
82 "[A]n investigation of the possible conflicts between state and federal regulation, is required for a proper resolution." Id. at 212.
83 41 S.E.C. 335 (1963).

II. The Nature of a Separate Account

A. *Definitions*

The separate account, like the variable annuity, is subject to a wide variety of definitions, conceptual approaches and theoretical frameworks.[84] Section 2(a)(37) of the 1940 Act defines a separate account as:

> an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.[85]

Originally, the Commission's definition of a separate account, under proposed Rule 0-1(e),[86] was as follows:

> [t]he term 'separate account' shall mean 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 has 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.

The final definition under Rule 0-1(e)[87] reads as follows:

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84 For example, the separate account has been defined as "assets set aside in a separate account by [the insurance company] with respect to payments received under the variable annuity contracts offered by this prospectus . . . and designated as the Lincoln National Variable Annuity Fund A." Prospectus, Lincoln National Variable Annuity Fund A at 2 (Sept. 14, 1967). The following definition was contained in a variable annuity contract: "[t]he total of all assets, less liabilities for obligations chargeable to the Accumulation Fund . . . held by . . . [the insurance company] to the credit of all variable annuity contracts issued by . . . [the insurance company] which provide for the contract values or dollar amounts of payments to vary to reflect the investment results of the Accumulation Fund." Specimen, The Paul Revere Terminal Funding Group Variable Annuity Contract, Non-Participating No. TF, TF-2, 68-5, at 1. The same company, in its prospectus, defined the Accumulation Fund as "the facility through which the Insurance Company sets aside assets attributable to its variable annuity contracts." Prospectus, The Paul Revere Variable Annuity Contract Accumulation Fund, Group Variable Annuity Contracts at 2 (May 1, 1968). The prospectus of another company defined a separate account as "an investment account established by . . . [the insurance company] in which the payments made under variable annuity contracts and the assets held under such contracts are kept separate and apart from the rest of . . . [the insurance company's] assets." Prospectus, Naitonal Variable Annuity Co. of Florida Separate Account at 2 (Apr. 30, 1968).

85 § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971).

86 Inv. Co. Act Release No. 5586 (Jan. 24, 1969).

87 17 C.F.R. § 270.0-1(e) (1971).

> [t]he term 'separate account' shall mean an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains or losses of the insurance company.

The other part of the definition was relegated to a condition:

> As conditions to the availability of [exemptive Rules 14a-2, 15a-3, 16a-1, 22e-1, 27a-1, 27a-2, 27a-3, 27c-1, and 32a-2,] the separate account shall be legally segregated, the assets of the separate account shall, at the time during the year that adjustments in the reserves are made, have a value at least equal to the reserves and other contract liabilities with respect to such account, and, at all other times, shall have a value approximately equal to or in excess of such reserves and liabilities; and that portion of such assets having a value equal to, or approximately equal to, such reserves and contract liabilities shall not be chargeable with liabilities arising out of any other business which the insurance company may conduct.[88]

This last definition corresponds to the definition in the 1970 Act. The additional conditions are obviously desirable in the Commission's opinion and become mandatory to some degree when the Commission exercises its power of exemption.

B. *The Definition of an Account*

The Investment Company Act of 1970 does not define an account. "Account" is an insurance term describing a well-established device used by insurance companies. Accounts have been used to facilitate the issuance of insurance policies in foreign currencies,[89] to trace the investment experience of certain premium payments of participating policies (in order to credit policyholders with their part of investment or insurance income) and, in group contracts, to calculate investment income resulting from contributions of an employer in order to credit him with a portion of this income.[90] Some of these accounts are conducted as independent businesses, but legally they are an integral part of the insurance company's general insurance business.[91] State laws sometimes require insurance companies to keep

[88] 17 C.F.R. § 270.0-1(e) (1971); Inv. Co. Act Release No. 5738 (July 10, 1969). The definition of an account under Rule 6e-1 is somewhat different. It refers to a "fund" rather than to the account and the condition refers to a "legally segregated asset account." The differences are probably not substantive. 17 C.F.R. § 270.6e-1(d) (1971). The conditions for exemption are enumerated in subsection (c).

[89] Johnson, The Separate Account: A New Phenomenon in Life Insurance, 2 The Forum 248, 254-55 (1967) [hereinafter cited as Johnson].

[90] G. Johnson & D. Grubbs, The Variable Annuity 89 (1968) [hereinafter cited as Johnson & Grubbs]. For a description of separate accounts in the insurance industry see Finnegan & Garner, The Separate Account as an Investment Company: Structural Problems of the "Ectoplasmic Theory," 3 Conn. L. Rev. 106, 107-09 (1970) [hereinafter cited as Finnegan & Garner].

[91] Finnegan & Garner, note 90 supra, at 107-09.

separate accounts for various purposes, such as accounting for dividends that accrue to policyholders from a specific fund or segregating various businesses of the insurance company.[92]

Common to all these separate accounts is the provision for separate accounting, similar to bank accounts. Whether assets must be physically segregated and what rights insureds have in the assets may differ greatly from one type of account to another.[93]

Before 1960 all moneys allocated to accounts were subject to the investment restrictions governing the insurance company's assets in general. During the early sixties, pension funds and other group savings devices presented a growing, lucrative business for which mutual funds, banks and insurance companies were competing. In 1961, public school employees became eligible for tax-sheltered annuities under section 403(b) of the Internal Revenue Code, and a year later, a similar plan was made available to self-employed individuals.[94] These events created a potential market of approximately two million additional customers.[95] Assets funding such pension plans typically contain employers' contributions, which are available to purchase annuities for retiring employees. Before retirement time, however, these assets are invested, and profits or losses credited or debited to the employer. Since insurance companies were restricted by law to making conservative investments, employers found it more profitable to take

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92 See, e.g., N.J. Stat. Ann. § 17:34-10 (1963): "The amount of the apportioned surplus . . . shall be carried as a distinct and separate liability to the class of policies on or for which the same was accumulated. No company or any of its officers shall use any part of the apportioned surplus fund for any other purpose than the express purpose for which it was accumulated." See also Mayor of City of Newark v. Board of Equalization of Taxes, 80 N.J. 258, 77 A. 795 (1910), in which the Supreme Court of New Jersey gave the following explanation of a statute requiring separate accounts: The Act ". . . was intended to effect an apportionment and segregation of the fund in which deferred dividend policy holders as a class were entitled to participate under the terms of their policies." (syllabus by the court no. 2). See also a California provision enacted in 1935 but now repealed that provided that an "insurer . . . shall keep separate accounts of its life insurance business and shall segregate the assets relating to that business such assets and the interest thereon together with all premiums . . . shall be held for the sole benefit of such business . . . . It is the intention of this provision that the life insurance business and the disability insurance business of an insurer . . . shall each be self-sustaining and not dependent one upon the other." Law of 1935, ch. 282, § 2 [1935], Cal. Ins. Law (repealed 1957) [previously Cal. Ins. Code § 10890 (West 1955)].

93 For example, the holders of conventional non-participating life policies payable in foreign currency do not have rights in the assets of the account from which their policies are paid. See p. 327 infra. But see Dresser v. Hartford Life Ins. Co., 80 Conn. 681, 70 A. 39 (1908) which held that policyholders were beneficial owners of the assets of a special fund to which they annually paid specified sums. By the terms of the policies the fund belonged, and had to be distributed, to the surviving policyholders when the aggregate amount of the outstanding policies was reduced below a specified minimum by death or discontinuance of membership and under other specified conditions. The policyholders were held to be entitled to an accounting.

94 Crapo, The Variable Annuity, The Middle Atlantic Actuarial Club Meeting (Wash., D.C. 1967).

95 Id. See also Dorsey, The Place of "Variable Annuities" in Law and Economics, 34 Notre Dame Lawyer 489 (1959); Frei & Archer, Taxation and Regulation of Pension Plans Under the Internal Revenue Code, 1967 U. Ill. L. Forum 691.

their contributions to banks, which were free to invest this money in equity securities.[96] Even conservative insurance companies, which opposed the business of individual variable annuities, sought legislative authority permitting insurance companies to invest employers' contributions in equity securities[97]—to make equity investments at the employers' risk through the use of a separate account.[98] Under the first authorizing statutes, an account could only be used to fund pension and profit-sharing plans that qualified under the Internal Revenue Code. Only employers' contributions could be invested in equity securities and only at the employers' risk. Employees' contributions could only be invested conservatively, at the risk of the insurance company.[99] This type of account was considered an administrative arrangement for an activity of the insurance company.[100] Members of the insurance industry assumed that separate accounts funding variable contracts would fall under the same category.[101]

An insurance account is distinguishable from an incorporated or unincorporated organization in that it operates with few pre-determined rules. There are no pre-arranged and fixed conditions to the operation of the account and the number and terms of contracts to be issued in connection with it. These are business decisions left to the insurance company, subject only to the special purpose of the account (e.g., foreign currency), the specific conditions in the contracts and state statutes. In contrast, an incorporated entity is not only established under statutory grant, but also operates according to pre-determined rules, specified in the statute, charter and by-laws, which can be changed only pursuant to statute and by amendment of charter and by-laws. This characteristic is also present in unincorporated associations, even though the rules under which they operate are contractual rather than statutory.[102] The difference between an account and an incorporated or unincorporated association stems from an insurance law principle that the rights of policyholders are several and depend on their contracts with the insurance company. No contractual arrangements among policyholders are needed to form and operate an account and no joint rights in the assets of the account are assumed to exist.[103]

96 Finnegan & Garner, note 90 supra, at 107. As for the competitive disadvantages of life insurance companies during the 1950's and early 1960's, see Part I n.22 supra.

97 McDougal, note 28 supra, at 81.

98 Finnegan & Garner, note 90 supra, at 109. See, e.g., 1968 Mass. Acts & Resolves ch. 391, § 21 (1968), as amended, now Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.Y. Laws 1962 ch. 680, § 2, as amended, now N.Y. Ins. Law § 227 (McKinney Supp. 1971).

99 Id.

100 In re Prudential Ins. Co. of America, 41 S.E.C. 335, 346 (1963).

101 These contracts "would have a relationship to the rest of the company's business very similar to that of contracts in a foreign currency. The company's obligations under the contracts in any such currency are not limited to the company's resources in that currency, but the payments made under such contracts are nevertheless payable only in the currency specified in the contract." Day, A Variable Annuity Is Not a "Security," 32 Notre Dame Lawyer 642, 653 (1957).

102 1 G. Hornstein, Corporation Law and Practice § 13 (1959).

103 Eberhard v. Northwestern Mut. Life Ins. Co., 241 F. 353 (6th Cir. 1917). For the purpose of aggregating claims to achieve the jurisdictional amount, tontine policyholders'

A separate account subject to the Investment Company Act is similar to other insurance accounts. Within the account there can be separate accounting arrangements for pay-in and pay-out periods, for proceeds of life insurance policies that insurance companies hold for beneficiaries[104] and for participating group policies, unless accounting convenience dictates use of different accounts. The insurance company determines who will participate in the account and the amount and type of contracts to be issued. Contractholders do not have a say in these matters. These characteristics may arguably conflict with the philosophy and scheme of the 1940 Act.

The account has only two pre-determined features. First, there must be compliance with the requirements of the 1940 Act. Second, the bulk of the assets of the account are invested in equity securities.[105] Even this generalization should be qualified. When fixed-dollar amounts are promised under the contracts, state laws require that the reserves supporting these promises be conservatively invested. Yet in most states these reserves may continue to remain in the account.[106]

It is submitted that the 1970 Act definition uses the term "account" in the sense usually used in the insurance industry, but not necessarily in the sense of an account funding foreign currency, often referred to as a model for separate accounts.[107] The term ought to be interpreted as embracing the type of insurance accounts whose terms are more receptive to the requirements of the 1940 Act, such as accounts established for the exclusive benefit of participants.[108]

C. *Separate Balance Sheet*

A separate account means an account established and maintained by an insurance company pursuant to state laws "under which income, gains and

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claims were several, each depending upon his contract with the company, even though there was some relation between the total number of qualified policyholders and the amount that each would eventually receive. Policyholders' rights stem from their policies.

104 See, e.g., Cal. Ins. Code § 10506(C) (West Supp. 1971):

> In addition to the allocations to separate accounts provided for in subdivision (A) of this section, a domestic insurer may, at the request of a policyholder or contractholder or the beneficiary of a policy or contract, allocate to any such separate account or accounts death payments, proceeds of matured endowments, dividends, or surrender values.

See also: Ariz. Rev. Stat. Ann. § 20-651A (Supp. 1970); Ore. Rev. Stat. § 733.180(a) (1969); S.D. Comp. Laws Ann. § 58-28-13 (Supp. 1971); Tenn. Code Ann. § 56-312 (Supp. 1970).

105 SEC Investor Report, note 28 supra, at 658-66.

106 See, e.g., Miss. Code Ann. § 5649-32 (Supp. 1970):

> [P]rovided, that to the extent that the company's reserve liability with regard to (1) benefits guaranteed as to amount and duration, and (2) funds guaranteed as to principal amount or stated rate of interest is maintained in any separate account, a portion of the assets of such separate account at least equal to such reserve liability shall be invested in accordance with the laws of this state governing the investments of life insurance.

107 Johnson, note 89 supra, at 254-55; Johnson & Grubbs, note 90 supra, at 89.

108 See p. 336 supra. Dresser v. Hartford Life Ins. Co., 80 Conn. 681, 70 A. 39 (1908). See also Texas Rev. Civ. Stat. art. 3.72, § 7 (Supp. 1971).

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.[109] This requirement is the essence of a separate account. It is, in effect, what makes an account "separate" in insurance law. The words "under which" refer not to the account, but to the state laws pursuant to which the account is established. An account established pursuant to state law that does not contain the above provision would, therefore, not fall under the definition.

State laws usually contain, almost verbatim, the same requirement for a separate balance sheet.[110] The language of state statutes differs from the language of the 1970 Act in two significant respects. First, whereas state laws speak of *allocation of amounts* in accordance with contractual provisions, the Act speaks of *credit or charge* in accordance with the applicable contract. The language in the state laws is more reasonable. Contracts may specify the amounts to be allocated to two or more separate accounts or to a separate account and the general account of the insurance company. Only amounts so specified may be allocated to the account. The language of the Act is difficult to understand. If it means that the requirement of a separate balance sheet is subject to contractual arrangements, the result might be contrary to the policy underlying the Act. The Act may require that the contracts contain the same provisions for separate accounting in order to facilitate private enforcement of this provision based on a breach of contract. Or perhaps the Act has the same meaning as state law, and a literal reading should be disregarded.

Second, state laws speak of credit or charge against *amounts* placed in the account. The 1970 Act speaks of credit or charge against the *account.* Under state laws this provision is essentially the codification of an accounting rule. The definition of the Act could arguably involve a recognition of the account as an entity. If we assume that the difference in language is

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109 § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971).

110 See, e.g., Ala. Code tit. 28, § 4(5)(1)(c) (Supp. 1969); Alas. Stat. § 21.42.370(d) (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651B (Supp. 1970); Cal. Ins. Code § 10506(A) (West Supp. 1971); Ga. Code Ann. §§ 56-1038(c), -1040(g) (1971); Idaho Code Ann. § 41-1936(3) (Supp. 1969); Ill. Ann. Stat. ch. 73, § 857.52 (Smith-Hurd 1965); Kan. Stat. Ann. § 40-436(c) (Supp. 1970); La. Rev. Stat. Ann. § 22:1500D (Supp. 1971); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Mich. Comp. Laws Ann. § 500-925(4) (Supp. 1971); Minn. Stat. Ann. § 61A.14.2 (1968); Miss. Code Ann. § 5649-33 (Supp. 1970); Mo. Stat. Ann. § 376.309.1 (Supp. 1971); Neb. Rev. Stat. § 44.310.06 (Supp. 1967); N.M. Stat. Ann. § 58-4-6.1(c) (Supp. 1969); N.Y. Ins. Law § 227-1(a) (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(h) (Supp. 1969); Okla. Stat. Ann. tit. 36, § 6061(f) (Supp. 1971); Ore. Rev. Stat. § 733.180(3) (1969); Pa. Stat. Ann. tit. 40, § 506.2(b) (Supp. 1971); R.I. Gen. Laws Ann. § 27-32-3 (1968); S.C. Code Ann. § 37-333(b) (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-16 (Supp. 1971); Tenn. Code Ann. § 56-314 (1968); Tex. Ins. Code art. 3.39, pt. III(b) (Supp. 1971); Utah Code Ann. § 31-13-31(3) (Supp. 1967); Wash. Rev. Code Ann. § 48.18A.020(1) (Supp. 1970); Wis. Stat. Ann. § 206.385(3) (Supp. 1971). For somewhat different language but the same result see N.J. Stat. Ann. § 17:35A-7 (Supp. 1971): "Except as may be otherwise specifically provided by the contract, all amounts received in connection with any contract on a variable basis shall be placed in the variable contract account designated in such contract, and all liabilities on any such contract shall be set up in said account."

important, few accounts could qualify under the 1970 Act. To avert this undesirable result we might assume that the difference between "*amounts*" and "*account*" is not significant. Or we might assume that the initial approach was erroneous, that the words "under which" pertain to the account, or at least do not pertain to state law. In the latter case a separate account would fall within the definition of the Act if losses and gains were charged and credited against the account, regardless of state law provisions.

The difference in attitudes of the insurance companies and the Commission toward separate accounting has led to disagreement about the income-tax treatment to be afforded gains and losses of the account's investment business. The insurance industry treats the insurance and investment business of the account as part of its business for income tax purposes, as it is permitted to do under the Internal Revenue Code.[111] The Commission is of the opinion that the balance sheet of the account regarding its investment business (not insurance) must be carried separately by the account and that losses of the account cannot be offset against gains of the insurance company's business.

This disagreement pertains to the cut-off date of the separate accounting. It pertains to the difference between the investment-company approach and the regulated-department approach. Under the Commission's view, accounting never ceases to be separate. Under the industry's view, the separate acounting only serves the purpose of tracing investment performance of the assets in the account, as in foreign currency accounts. Since the 1940 Act does not expressly require that an investment company be a separate entity for the income tax purposes, the account need not be one.

It is submitted that the Commission's view should prevail here. Since the contractholders bear the tax liabilities of the investment business, tax benefits ought to inure to them. In practice, the account is charged with tax on income and capital gains. These tax payments are reflected in the net assets affecting the value of the units in the account. For the purpose of the Internal Revenue Code, however, the business of the account is the business of the insurance company. All gains and losses of the investment business of the account and all tax payments made by the account's separate accounting are credited and debited to the insurance company. In 1969 many separate accounts had capital losses that were debited to the insurance company, reducing its tax burden. This did not result in immediate loss to the contractholders. However, if the account were separate for tax purposes, it could have taken advantage of the loss to offset gains in later years.[112] Under the present system, it could not.

The solution to this problem depends, in part, on the attitude of the Internal Revenue Service. At least in one instance it permitted a separate account to be taxed as a mutual fund under Subchapter M.[113] This

111 Int. Rev. Code of 1954, § 801(g); 26 C.F.R. § 1.801-7(1) (1971).

112 Int. Rev. Code of 1954, § 1212.

113 Prospectus, Prudential's Investment Plan Account at SP 10-11 (Apr. 30, 1970). Int. Rev. Code of 1954, §§ 851-55.

separate account, however, only holds amounts funding variable annuities in the pay-in period and does not fund any insurance arrangements. The account, therefore, is identical to an investment company. Theoretically, one can pass to annuitants the dividends and profits on the reserves backing the annuities. But this has never been permitted by the Internal Revenue Service.

If an insurance company uses the investment losses of an account to reduce its tax payments to the detriment of the account or the contractholders, at that time or in the future, contractholders may seek relief in court on several grounds. First, contractholders may bring a derivative suit or a class action against the directors of the account under section 37 of the 1940 Act.[114] *Brown v. Bullock*[115] held that when directors authorize payment for services that they know have not been rendered, the directors are liable under section 37 for embezzlement and that a private right of action can be based on this section. By analogy, directors of an investment company might be liable to the company for damages caused by permitting the insurance company to enjoy a tax advantage at the account's expense.

Further, the directors of the account, as well as the directors of the insurance company and perhaps the insurance company as an investment adviser, may be liable under section 36(a) of the 1940 Act[116] provided the facts give rise to an allegation of a breach of fiduciary duty coupled with personal misconduct. A private right of action under this subsection might be recognized or the Commission might bring the action. It may well be that the directors of the account will have no choice but to take the necessary steps to reduce the fees of the insurance company by the amounts by which the company had benefited.[117]

Moreover, there may be grounds for arguing that this accounting arrangement in fact provides additional compensation to the insurance company as an adviser. The directors of the account and the insurance company may then be liable under section 36(b) of the Act[118] for breach of their fiduciary duty to the account. This arrangement may also constitute a violation of section 15(a)(1)[119] of the Act, if the advisory contract between the account and the insurance company does not specify the benefits to the insurance company from the arrangement.[120] In answer it may be argued that the benefits to the insurance company are not in consideration of its advisory

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114 § 37, 15 U.S.C.A. § 80a-36 (1971).

115 294 F.2d 415 (2d Cir. 1961).

116 § 36, 15 U.S.C.A. § 80a-35 (1971).

117 See p. 369 infra. Moses v. Burgin, 39 U.S.L.W. 2714 (1st Cir. June 4, 1971). If an investment company could recapture give-ups, the board of directors of the investment company did not have discretion to waive recapture on the ground that payment of give-ups to broker-dealers enhanced the sales of the fund shares for the benefit of the shareholders. As to the duties of directors and investment advisers under section 36, see p. 363 infra.

118 § 36, 15 U.S.C.A. § 80a-35 (1971).

119 Id. § 15(a)(1), 15 U.S.C.A. § 80a-15(a)(1) (1971).

120 See, e.g., In re Managed Funds, Inc., 39 S.E.C. 313 (1959).

services but stem from its status as the insurance company that had established the account and issued insurance obligations to contractholders.

If the Rules of the account contain a provision that the account must obtain for its units a price based on the current net asset value of the units, there is authority for the proposition that permitting the insurance company to benefit at the expense of the account may be a violation of the Rules if the result will affect the value of the units.[121] Finally, contractholders might have a cause of action analogous to that of minority shareholders against a majority shareholder or interlocking directors who unfairly reap tax advantages from a consolidated balance sheet.[122]

As against all these arguments stands an express and special provision of the Internal Revenue Code that treats the account as an integral part of the insurance company for tax purposes.[123] It might outweigh all other arguments if it is interpreted to preclude the insurance company from paying its tax savings to the account.

III. Creation and Organization of Accounts

A. *Applicable Law*

The definition of a separate account requires that it be "established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, or of Canada or any province thereof . . . ."[124]

State insurance laws authorize an insurance company to establish and maintain a separate account, but under these laws it is not certain that an account is a separate legal entity. It is one of many activities of an insurance company; it does not possess rights and is not subject to obligations. Duties arising from the business of an account are imposed by state laws on the insurance company.[125] Under all state laws, it is the insurance company or

121 Moses v. Burgin, 39 U.S.L.W. 2714 (1st Cir. June 4, 1971). Note that the receipt of excessive fees does not seem to be a direct violation of Rule 22c-1 under the 1940 Act that requires the unit price to be based on the current net asset value, since excessive fees do not affect this value. Yet the decision might suggest the contrary. Receipt of excessive fees could violate charter provisions that are similar to the provisions of the Rule.

122 Alliegro v. Pan American Bank, 136 So. 2d 656 (Fla. 1962), cert. denied, 149 So. 2d 45 (1963); contra, Western Pac. R.R. v. Western Pac. R.R., 197 F.2d 994 (9th Cir. 1951), vacated, 345 U.S. 247, rehearing denied, 206 F.2d 495 (9th Cir.), cert. denied, 346 U.S. 910 (1953); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967); Case v. New York Cent. R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965).

123 Int. Rev. Code of 1954, § 801(g).

124 § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971).

125 E.g., "Any domestic life company may invest and reinvest the amounts allocated to such separate accounts, and the accumulation thereon, if any, in any class of investments as the company may determine or as may be specified in a written agreement without regard to any restrictions . . . ." Ill. Ann. Stat. ch. 73, § 857.53 (Supp. 1971). See also Ala. Code tit. 28, § 4(5)(1)(b) (Supp. 1969); Alas. Stat. § 21.42.370(c) (Supp. 1970); Ark. Stat. Ann. § 66-3523(b) (Supp. 1969); Cal. Ins. Code § 10506(A) (West Supp. 1971); Colo. Rev. Stat. Ann. § 72-2-15(1) (1963); D.C. Code Encycl. Ann. § 35-541(g) (1968); Fla. Stat. Ann. § 627.0978 (Supp. 1971); Ga. Code Ann. §§ 56-1038(b), -1040(c) (1971); Hawaii Rev. Stat. § 431-563(a)(2) (Supp. 1970); Idaho Code Ann. §§ 41-734, -1936 (2) (Supp. 1969); Kan. Stat. Ann. § 40-436(b) (Supp. 1970); Ky. Rev. Stat. Ann. § 304.837

its subsidiary, but not the account, that must qualify to issue variable annuities.[126]

The Commission is of the opinion that a fund may be an investment company even though it is not recognized as "an independent legal entity" under state law.[127] A "fund which is neither a corporation nor an association or trust, given to a common agent for the purpose of investment, is nonetheless an investment company for the purposes of the 1940 Act."[128]

(1969); La. Rev. Stat. Ann. § 22:1500C (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 1128 (1969); Md. Ann. Code art. 48A, § 362(b) (Supp. 1970); Mich. Comp. Laws Ann. § 500.925(1) (Supp. 1971); Minn. Stat. Ann. § 61A.14.3 (Supp. 1971); Miss. Code Ann. § 5649-32 (Supp. 1970); Mo. Ann. Stat. § 376.309.4 (Supp. 1971); Neb. Rev. Stat. § 44-310.06 (1967); Nev. Rev. Stat. tit. 57, § 690.490 (1967); N.H. Rev. Stat. Ann. § 408:32 (1968); N.J. Stat. Ann. § 17:35A-9(a) (Supp. 1971); N.M. Stat. Ann. § 58-4-6.1(b) (Supp. 1969); N.Y. Ins. Law § 227.1(b) (McKinney Supp. 1971); N.C. Gen. Stat. §§ 58-79.2(d)-(g) (Supp. 1969); N.D. Cent. Code § 26-11.1-01.2(a) (Supp. 1971); Laws of Ohio bk. I, § 3907.15 (1969-1970); Okla. Stat. Ann. tit. 36, §§ 6061(b)-(e) (Supp. 1971); Ore. Rev. Stat. § 733.180(4) (1969); Pa. Stat. Ann. tit. 40, §§ 506.2(c)-(d) (Supp. 1971); R.I. Gen. Laws Ann. § 27-32-2 (1968); S.C. Code Ann. § 37-333(a) (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-15 (Supp. 1971); Tenn. Code Ann. § 56-313 (1968); Tex. Ins. Code art. 3.72, § 8 (Supp. 1971); Utah Code Ann. § 31-13-31(2) (Supp. 1967); Vt. Stat. Ann. § 3855(a)(2)(A) (Supp. 1971); Wash. Rev. Code Ann. § 48.18A.020(2) (Supp. 1970); Wis. Stat. Ann. § 206.385(2) (Supp. 1971); Wyo. Stat. Ann. §§ 26.1.136, 26.1.367(b) (1967).

126 Alas. Stat. § 21.42.370(g) (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651H (Supp. 1970); Ark. Stat. Ann. § 66-3525 (Supp. 1969); Cal. Ins. Code § 10506(E) (West Supp. 1971); Colo. Rev. Stat. Ann. § 72-2-13 (1963); D.C. Code Encycl. Ann. § 35-541(c) (1968); Fla. Stat. Ann. § 627.0979 (Supp. 1971); Ga. Code Ann. §§ 56-1038(g), -1040(m) (1971); Hawaii Rev. Stat. § 431-563(c) (Supp. 1970); Idaho Code Ann. § 41-1938 (Supp. 1969); Ill. Ann. Stat. ch. 73, 857.51(d) (Smith-Hurd Supp. 1971); Iowa Code Ann. § 508.35 (Supp. 1971); Kan. Stat. Ann. § 40-436(i) (Supp. 1970); Ky. Rev. Stat. Ann. § 304.834(1) (1969); La. Rev. Stat. Ann. § 22: 1500I (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537(6) (1969); Md. Ann. Code art. 48A, § 362(a) (Supp. 1970); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Minn. Stat. Ann. § 61A.19 (Supp. 1971); Miss. Code Ann. § 5649-39 (Supp. 1970); Mo. Ann. Stat. § 376.309.7 (Supp. 1971); Neb. Rev. Stat. § 44-310.06 (Supp. 1967); Nev. Rev. Stat. tit. 57, § 690.470 (1967); N.H. Rev. Stat. Ann. §§ 408:35-.41 (1968); N.J. Stat. Ann. § 17:35A-2 (Supp. 1971); N.M. Stat. Ann. § 58-4-6.1(f) (Supp. 1969); N.Y. Ins. Law § 227.5 (1966); N.C. Gen. Stat. § 58-79.2(9) (Supp. 1969); N.D. Cent. Code § 26-11.1-03 (Supp. 1971); Laws of Ohio bk. I, § 3911.011(A) (1969-1970); Okla. Stat. Ann. tit. 36, § 6061(k) (Supp. 1971); Ore. Rev. Stat. § 733.190(2) (1969); R.I. Gen. Laws Ann. § 27-32-6 (1968); S.C. Code Ann. § 37-322(d) (Supp. 1969); S.D. Comp. Laws Ann. § 58-28-26 (Supp. 1971); Tenn. Code Ann. § 56-318 (1968); Tex. Ins. Code art. 3.72, § 2 (Supp. 1971); Vt. Stat. Ann. § 3857 (Supp. 1971); Va. Code Ann. §§ 38.1-443(b)-(c) (1970); Wash. Rev. Code Ann. § 48.18A.040 (Supp. 1970); Wis. Stat. Ann. § 206.385(9) (Supp. 1971); Wyo. Stat. Ann. § 26.1-367(f) (1967). Once the qualifications are met the insurance company can start business immediately. Some states now permit a subsidiary of the insurance company to establish an account if the insurance company or the subsidiary qualifies. See, e.g., Iowa Code Ann. § 508.33 (Supp. 1971); La. Rev. Stat. Ann. § 22:1500I(3) (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537(6) (1969); Mo. Ann. Stat. § 376.309.8 (Supp. 1971); Laws of Ohio bk. I, § 3911.011(A) (1969-1970); Wash. Rev. Code Ann. § 48.18A.040 (Supp. 1970); Wis. Stat. Ann. § 206.386 (1967). See note 205 infra.

127 House Comm. on Interstate and Foreign Commerce, Report of the SEC on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 34 n.5 (1966) [hereinafter cited as SEC Investment Co. Growth Report]. The Commission was discussing the Alexander Fund, which was named after its first entrepreneur Wallace W. Alexander. See also SEC v. W. J. Howey Co., 328 U.S. 293 (1946). For a description of the Alexander Fund see Survey, The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Lawyer 736, 770-72 (1969).

128 SEC Investment Co. Growth Report, note 127 supra, at 34 n.5.

The fund "must be *given* the capacity for certain actions . . . quite irrespective of state legislative action segregating the investment fund. . . ."[129]

The Commission did not go so far as to assert that state law will not be controlling if that law specifically prohibits separation of the account from the insurance company, or prohibits the creation of something that "must be *given* the capacity for certain actions."[130] It is arguable that the policy of the Act supports even this extreme construction. When the need for protection of investors under the 1940 Act arises, the Act may apply to any investment company business, state law notwithstanding.

The legitimacy of recognizing an entity, regardless of state laws, must also be tested under the McCarran-Ferguson Act.[131] If the investment business of the account is so intertwined with the insurance business as to be inseparable, the application of the 1940 Act to the investment business will result in the application of the 1940 Act to insurance business as well. Section 3(c)(11), which implicitly exempts specially qualified separate accounts, may furnish proof of congressional recognition that, but for the exemption, these accounts would in fact be regulated by the 1940 Act. The exemption may also show that Congress deemed the business of a separate account to be investment; rather than insurance business.[132]

It should be noted that a separate account is not always deemed to be separate from the insurance company, even by the Commission. The account is treated as a part of the insurance company for the purpose of allocating to the insurance company liabilities for the account's activities.[133] In practice there is very little to separate the account from its creator.

The Commission has also taken the view that requirements of the 1940 Act essential for the protection of investors, such as the requirement that each security must have a vote,[134] take precedence over state insurance laws providing for another voting formula and that if an insurance company desires to establish a variable annuity separate account it can seek an appropriate amendment of state law.[135]

In apparent contradiction, it seems that under the Commission's rules the establishment of an account, apart from the question of whether it constitutes a separate entity, must conform to state laws. This requirement has

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129 41 S.E.C. at 345 (emphasis in original). The Commission stated, however, that state legislation did recognize the separateness of the fund and the exclusive rights of the contractholders in the fund. Id. at 342.

130 Id. at 345 (emphasis in original).

131 15 U.S.C. §§ 1011, 1012(b) (1964).

132 For a discussion of the McCarran-Ferguson Act see p. 209-11 supra.

133 "Under Wisconsin insurance laws Account B [the separate account] is an integral part of [the insurance company]." Inv. Co. Act Release No. 5528, at 1 (Oct. 31, 1968), granted, Inv. Co. Act Release No. 5659 (Apr. 22, 1969). See also p. 273 infra.

134 See p. 298 infra.

135 41 S.E.C. at 353. The Commission felt confident that the insurance industry could bring about these changes, and it was right. However, it took longer than anticipated (almost four years) to change the laws of New Jersey, the home state of Prudential. McDougal, note 28 supra, at 83.

been incorporated in the 1970 Act definition. If an insurance company establishes an account in violation of state insurance laws, it appears that the account cannot register under the Investment Company Act.[136]

The contradiction may be explained by recognizing that the establishment of an account is an act of the insurance company and a part of its insurance business. Since state law regulates insurance companies, a company must derive its power to create a separate account from that law.[137] An ultra vires registration of an investment company was held voidable under section 7(a) of the 1940 Act, though a subsequent ratification by the shareholders validated the registration.[138]

When an account proposes to offer and sell investment contracts and engages in the investment business, it becomes an investment company[139] subject to the 1940 Act. The fact that the provisions of the 1940 Act are in conflict with state laws classifying the activities of the account as those of the insurance company is irrelevant. The characteristics of the account may be dictated by state law, at least under the definition in the 1940 Act, section 2(a)(37). But whether or not it is an investment company is a question of federal law.[140] This does not mean that the Commission does not recognize the integrated nature of the activities of the insurance company and the account. It has systematically granted exemptions to avoid inconvenience, or conflict with state law, when some means other than the 1940 Act afford protection for investors.[141] These exemptions and the form in which accounts have been organized did not help to clarify the question of accounts' separate existence. If accounts are viewed as conventional investment companies, problems arise with respect to their dissolution and the transfer of the advisory and underwriting contracts between the account and the insurance company. If accounts are viewed as separate entities only for the purposes of the 1940 Act, other problems arise. One result of this theory is that the identity of a party to a transaction

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136 The registration forms for separate accounts (Form N-8B-1(1) for open-end management companies and N-8B-2(5) for unit investment trusts), under section 8 of the 1940 Act, contain information concerning the "name of state or other sovereign power, the laws of which govern with respect to the organization of the registrant." Exemptive Rule 6e-1 applies only to separate accounts "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 . . . ." Rule 0-1(e) contains the same definition except that the account might also be established and maintained pursuant to the laws of Canada or any province thereof as in the 1970 Act definition.

137 § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971). See also Tcherepnin v. Knight, 389 U.S. 332, 336-37 (1967). The Commission also took pains to emphasize that it was not regulating insurance companies (in contravention of the exception under the 1940 Act) 41 S.E.C. at 339, or the business of insurance (in contravention of the McCarran-Ferguson Act) 41 S.E.C. at 342.

138 Koos v. Ludwig, [1961-1964 Transfer Binder] CCH Fed. Sec. Rep. ¶ 91,177 (N.Y. Sup. Ct. 1962).

139 § 3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (1971).

140 The term "security" is a federal term to be determined by federal law. Cf. Tcherepnin v. Knight, 389 U.S. 332, 337-38 (1967); accord, 359 U.S. at 69.

141 41 S.E.C. at 353. "This Commission is not doctrinaire in providing some flexibility through exemptions."

depends on whether state law or federal law is invoked. For example, in litigation involving sale of securities by the insurance company for the account, the insurance company will be deemed to be a principal if the cause of action is based on state law. If the cause of the action is based on federal law, if the sale is alleged to have been in violation of the 1940 Act and therefore void under section 47(b)[142] of the Act, the insurance company will be deemed to be an investment adviser, and the independent existence of the account will have to be recognized, both in state and federal courts. Presumably the account may intervene in such a proceeding to declare the transaction void. Again, if payments under annuity contracts were not allocated to the account in violation of state insurance law requiring all net payment by contractholders to be allocated to the account, the defendant will be the insurance company. The same facts may give rise to a cause of action under the 1940 Act. The account will be a party, in state as well as federal courts, with respect to the federal cause of action but not with respect to the state cause of action in state courts. The theory that a separate account exists for the purposes of the 1940 Act only, raises difficulties unless under this theory a separate account has a separate existence with respect to all actions that the 1940 Act might regulate. In the case of the account that is registered as a management company, the account must exist with respect to all its investment business activities, under state as well as under federal law. In the case of an account that is registered as a unit investment trust, however, the theory might raise fewer problems. The range of activities that are governed by federal law is more limited, since the investment business of the account is carried on by a conventional investment company.

In conclusion, a separate account can be established only by an insurance company. The capacity of the insurance company to establish an account is governed by applicable state or Canadian law. At this point the account is neither an investment company nor a separate entity. Once established and proposing to engage in the activities enumerated in section 3(a) of the 1940 Act, the account becomes an investment company. The Act requires that an account be an entity separate from the insurance company, at least in the context of the activities that the account must or is presumed to perform as an investment company.

B. *Method of Establishment*

1. State Law

All states and the District of Columbia permit insurance companies to establish separate accounts, usually by statute.[143] These statutes differ as to

142 § 47(b), 15 U.S.C.A. § 80a-46(b) (1971).

143 Ala. Code tit. 28, § 4(5)(1)(a) (Supp. 1969); Alas. Stat. § 21.42.370 (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651A (Supp. 1970); Ark. Stat. Ann. § 66-3523(a) (Supp. 1969); Cal. Ins. Code § 10506(A) (West Supp. 1971); Colo. Rev. Stat. Ann. § 72-2-12 (1963); Conn. Gen. Stat. Ann. § 38-154 (1969); Del. Code Ann. tit. 18, § 2933 (1968); D.C. Code Encycl. Ann. § 35-541 (1968); Fla. Stat. Ann. § 627.0976 (Supp. 1971); Ga. Code Ann. §§ 56-1038(a),

the form of establishment of separate accounts. Some statutes simply state that an insurance company may establish or organize an account.[144] Some require it to do so upon issuing variable annuities.[145] Some require the adoption of a resolution of the board of directors.[146] And others require an additional certification by state insurance authorities.[147] These variations are not significant since the company conducts business through its board of directors and the directors usually conduct business pursuant to resolution.

The decision to establish a separate account is presumably considered in most states a business decision within the authority in the insurance companies' charters. Vermont, however, provides that the corporate charter be deemed amended to authorize the activities mentioned in the statute.[148] With respect to granting voting rights to contractholders in the management of the account, a few state statutes either require by-law[149] or charter amendment,[150] or amend the charter by operation of law,[151] but most do

-1040(b) (1971); Hawaii Rev. Stat. § 431-563(a) (Supp. 1970); Idaho Code Ann. § 41-1936(1) (Supp. 1969); Ill. Ann. Stat. ch. 73, § 857.51(b) (Smith-Hurd Supp. 1971); Ind. Ann. Stat. § 39-3501 (Class I(c)) (Supp. 1970); Iowa Code Ann. § 508.32 (Supp. 1971); Kan. Stat. Ann. § 40-436(a) (Supp. 1970); Ky. Rev. Stat. Ann. § 304.834(3) (1969); La. Rev. Stat. Ann. § 22:1500A (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537 (1969); Md. Ann. Code. art. 48A, § 362(a) (Supp. 1970); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Mich. Comp. Laws Ann. § 500.925(1) (Supp. 1971); Minn. Stat. Ann. § 61A.14 (Supp. 1971); Miss. Code Ann. § 5649-31 (Supp. 1970); Mo. Ann. Stat. § 376.309.2 (Supp. 1971); Neb. Rev. Stat. § 44-310.06 (Supp. 1967); Nev. Rev. Stat. tit. 57, § 690.460.1 (1967); N.H. Rev. Stat. Ann. § 408:30 (1968); N.J. Stat. Ann. § 17:35A-6 (Supp. 1971); N.M. Stat. Ann. § 58-4-6.1(a) (Supp. 1969); N.Y. Ins. Law § 227.1 (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(b) (Supp. 1969); N.D. Cent. Code § 26-11.1-01 (Supp. 1971); Laws of Ohio bk. I, § 3907.15 (1969-1970); Okla. Stat. Ann. tit. 36, § 6061(a) (Supp. 1971); Ore. Rev. Stat. § 733.180(1) (1969); Pa. Stat. Ann. tit. 40, § 506.2(a) (Supp. 1971); R.I. Gen. Laws Ann. § 27-32-1(a) (Supp. 1970); S.C. Code Ann. § 37-331 (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-13 (Supp. 1971); Tenn. Code Ann. § 56-312 (Supp. 1970); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971); Utah Code Ann. § 31-13-31(1) (Supp. 1967); Vt. Stat. Ann. § 3855(a) (Supp. 1971); Va. Code Ann. § 38.1-443(a) (1970); Wash. Rev. Code Ann. § 48.18A.020 (Supp. 1970); Wis. Stat. Ann. § 206.385(1) (Supp. 1971); Wyo. Stat. Ann. § 26.1-367(a) (1967).

144 E.g., Del. Code Ann. tit. 18, § 2933(a) (1968): "A domestic life insurer may establish one or more separate accounts . . . to provide benefits payable in fixed or in variable dollar amounts or in both."

145 E.g., Fla. Stat. Ann. § 627.0976 (Supp. 1971): "Every domestic life insurance company which issues annuity contracts providing for payments . . . which vary directly according to investment experience shall establish one or more separate accounts . . . ."

146 E.g., Cal. Ins. Code § 10506(A) (West Supp. 1971): ". . . may, after adoption of a resolution by its board of directors, allocate to one or more separate accounts . . . ." Alas. Stat. § 21.42.370 (Supp. 1970); Ill. Ann. Stat. ch. 73, § 857.51(b) (Smith-Hurd Supp. 1971); Kan. Stat. Ann. § 40-436(a) (Supp. 1970); Mich. Comp. Laws Ann. § 500.925(1) (Supp. 1971); Mo. Ann. Stat. § 376.309.2 (Supp. 1971); Neb. Rev. Stat. § 44-310.06 (Supp. 1967); N.C. Gen. Stat. § 58-79.2(b) (Supp. 1969); Ore. Rev. Stat. § 733.180(2) (1969); Vt. Stat. Ann. § 3842 (1970); Wash. Rev. Code Ann. § 48.18A.020 (Supp. 1970).

147 Conn. Gen. Stat. Ann. § 38-33a(a) (Supp. 1971): ". . . may, after adoption of a resolution by its board of directors and certification thereof to the insurance commissioner, allocate . . . ."

148 Vt. Stat. Ann. § 3855(b) (Supp. 1971).

149 E.g., Kan. Stat. Ann. § 40-436(k) (Supp. 1970) permits either charter or by-law amendment.

150 E.g., Del. Code Ann. tit. 18, § 2933(g) (1968).

151 E.g., Ill. Ann. Stat. ch. 73, § 857.51 (Smith-Hurd Supp. 1971).

not. This minority apparently views the establishment of the account or the grant of voting rights as causing a change in the corporate structure of the insurance company. Contractholders' voting rights in these states are based on the company's constitutional documents as well as on their contracts and the 1940 Act.

2. 1940 Act

(a) *Form of Organization.* The Investment Company Act does not require an investment company to be organized in any particular way. The Act divides investment companies into face-amount certificate companies, unit investment trusts and management companies. Face-amount certificate companies issue debt obligations to be paid for on an installment basis. Unit investment trusts are organized under a trust indenture contract, or a contract of custodianship or agency, or a similar instrument. They do not have a board of directors, and issue only redeemable securities. Each of these securities represents an undivided interest in a unit of specified securities. All investment companies other than face-amount certificate companies and unit investment trusts are management companies.[152]

Valic was described by Justice Brennan as being, during the pay-in period, "something quite similar to a conventional" open-end investment company, under a periodic payment plan[153] and as being during the pay-out period "something equivalent to an investment trust."[154] The contracts, he said, "contain to a very substantial degree elements of investment contracts as administered by equity investment trusts."[155] The Commission's position, as indicated by a member of its staff, is that companies are entitled to organize their business in any way that conforms to the requirements and policies of the Act. Hence, even though it might have preferred the establishment of a separate corporation,[156] the Commission has accepted all forms of organization except the Valic model.[157] The split in voting rights between variable annuity contractholders and shareholders permitted shareholders to outvote contractholders in matters concerning the separate account.[158] This result runs counter to the policy of the Act.

152 § 4, 15. U.S.C.A. § 80a-4 (1971).

153 SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 85 (1959).

154 Id. at 88.

155 Id. at 91.

156 4 Loss 2519 (Supp. 1969); Inv. Co. Act Release No. 4798 (Dec. 21, 1966).

157 Townsend, Variable Annuity Approach, Separate Account Investments in the Company, Proceedings of the Legal Section, Am. Life Convention 21, 22 (1968); McDougal, note 28 supra, at 83-84. In order to make the exemptions under § 3(a)(8) of the 1933 Act available to Valic's conventional policies, the Commission gave Valic an exemption from § 24(d) of the 1940 Act (which specifically applies the Securities Act of 1933 to insurance products issued by investment companies). The Commission assumed that these insurance contracts were also securities. See 4 Loss at 2517 (Supp. 1969); 39 S.E.C. at 699-700, modified, Inv. Co. Act Release No. 4217 (Apr. 7, 1965).

158 Votes for directors were split between contractholders and shareholders "on the basis of a formula that gave each contract holder that number of votes obtained through dividing the redemption value of his contract (or, during the annuity or 'pay-out' period, the value of the valuation reserves applicable to the contract) by the net asset value of a share of stock . . . ." 4 Loss at 2520-21 (Supp. 1969).

The structural model that the Commission first contemplated was the separate incorporation of an investment fund, which would be subject to the 1940 Act. The insurance company would hold all the shares and control the company, but there would be a "pass-through" of the voting power of the shares to the annuitants. The insurance company would become the underwriter and investment adviser for the investment company.[159] This model resembles a unit investment trust. Its advantages are that it separates the investment business from the business of the account. In a unit investment trust form, the insurance company organizes a conventional investment company whose shares are purchased by the insurance company and held in the separate account. The unit investment trust does not have a board of directors and need not enter into advisory and underwriting contracts with the insurance company, a requirement that raises difficulties.[160] This requirement is not eliminated altogether. It is relegated to the level of the underlying mutual fund.[161] Further, this approach requires two registration statements and two prospectuses. One for the underlying fund and one for the account. This approach also makes it more difficult to create funds with different investment policies. Moreover, problems may be raised in some states with respect to the extent of permitted investments in the fund and the power of insurance companies to create it,[162] as well as with respect to the qualification of the salesmen of the insurance company to sell the contract.[163] This structure is more in accord with traditional insurance philosophy. Nonetheless, up to October 1968 most insurance companies entering the variable annuities field chose to register their accounts as diversified open-end management companies.[164] On the other hand, Prudential created a complex of separate accounts registered as unit investment trusts.[165] Insurance companies also create a wholly owned subsidiary to establish separate accounts. The accounts register under the 1940 Act and the subsidiary acts as an investment adviser.[166] This form insulates the insurance company from the requirement to register as a broker dealer under the 1934 Act.[167] The same result can be achieved by registering a subsidiary to act as an investment adviser for accounts established by the insurance company.[168]

159 Id. at 2518-19. See also Polikoff, The Unit Investment Trust Approach to Variable Annuities, Proceedings of the Legal Section, Am. Life Convention 28-29 (1968).

160 Polikoff, note 159 supra, at 32-33; 4 Loss at 2523 (Supp. 1969).

161 Polikoff, note 159 supra, at 33.

162 For an express authority see, e.g., Iowa Code Ann. § 508.33 (Supp. 1971).

163 Polikoff, note 159 supra, at 34.

164 Id. at 30; 4 Loss at 2519-20 (Supp. 1969).

165 Prudential established one conventional investment company and three accounts. For other unit investment trusts see 4 Loss at 2522-23 (Supp. 1969); see also New York Life Separate Accounts N and Q established by New York Life Ins. Co. to fund individual variable annuities. Inv. Co. Act Release No. 6495 (Apr. 30, 1971). A wholly owned subsidiary serves as the investment adviser of New York Life Fund, Inc. See Inv. Co. Act Release No. 6499 (Apr. 30, 1971), granting the fund exemption from sections 15(a)(b), 16(a), 17(f) and 32(a) of the 1940 Act.

166 4 Loss at 2521 (Supp. 1969).

167 Id.

168 Id.

(b) *Registration.* An account acquires a separate existence with the filing of a notification under section 8 of the 1940 Act. Following the disclosure approach of the 1933 Act, section 7 of the 1940 Act prohibits an investment company from engaging in interstate commerce and from using the mails unless the company is registered with the Commission.[169] Willful violation of this provision is a federal crime.[170] The account should file with the Commission a notification of an intent to register,[171] followed within three months by a full registration statement.[172] The statement must include information as to whether the company is an open-end or closed-end investment company, whether it is diversified or not diversified, and a detailed statement as to its future investment policies.[173] Full information must be given concerning officers, directors and affiliated persons. A new special form has recently been devised for unincorporated investment companies issuing periodic payment plans.[174] But separate accounts are required to use the form for open-end management companies or unit investment trusts.[175]

Even though the insurance company is not an investment company for the purposes of the 1940 Act, the Commission requires that it execute the registration form[176] on the ground that for the protection of investors the insurance company should be responsible in the event that the separate existence of the account is questioned.[177]

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169 § 7, 15 U.S.C.A. § 80a-7; § 8, 15 U.S.C.A. § 80a-8 (1971).

170 § 49, 15 U.S.C.A. § 80a-48 (1971).

171 Form N-8A, 17 C.F.R. §§ 270.8b-1 to -32 (1971).

172 Form N-8B-1, 17 C.F.R. §§ 270.8b-1 to -32 (1971). For the Commission's guidelines see Inv. Co. Act Release No. 5632, Sec. Act Release No. 4955 (Mar. 12, 1969). See also the proposed guidelines for the preparation of Form N-8B-1, Inv. Co. Act Release No. 5633 (Mar. 11, 1969).

173 See p. 352 infra. Mostoff, The Federal Securities and Their New Applicability to Insurance Companies, 15 Corporate Law and Practice, The Insurance Industry Today 143, 152-53 (Practising Law Institute 1969).

174 Form N-8B-3, 17 C.F.R. §§ 270.8b-1 to -32 (1971).

175 Form N-8B-1; N-8B-2. Rule 6e-1, 17 C.F.R. § 270.6e-1 (1971), exempted accounts, now fully exempt under section 3(c)(11), from the provisions of §§ 7 and 8 of the 1940 Act. See Nelson, Problems Raised by Investment Company Act of 1940, Including Proposals for Revised Rules, Proceedings of the Legal Section, Am. Life Convention 77, 81-84 (1968). In lieu of registration under § 8, the account had to file a notification pursuant to subsection (b) of the Rule (see proposal to adopt Forms N-6e-1 and N-6e-2, Inv. Co. Act Release No. 5996A (Mar. 6, 1970)) or file a report within three months after the fiscal year of the account. Reports under §§ 30 and 31 also had to be filed. When a group contract provided for variable annuities, the insurance company had to deliver to every employer a copy of a statement (a) that the benefits were varied, not fixed; (b) that the contributions could be invested in equity securities and such investments might change; (c) a description of the essential procedure of the insurance company in determining the dollar amount of variable benefits. The insurance company had to recommend to the employer that this statement be submitted to covered employees, and to file with the Commission this, as well as any other, statement concerning the account, that was delivered by the insurance company to the employer for transmittal to employees, within ten days of delivery.

176 McDougal, note 28 supra.

177 See p. 273 infra.

C. *Institutionalization of the Account: The Rules and Regulations*

The establishment of an account merely requires an act by the insurance company.[178] Yet, since the 1940 Act grants certain powers to the contractholders of an account registered as a management company, relations among the contractholders, inter se, and between each contractholder and the aggregate had to be established. True to the characterization of the contractholders as an "organized group of persons," the Commission required insurance companies to provide some organizational document partially modeled upon by-laws and articles of association of corporations and unincorporated associations.[179] The Rules provided by insurance companies for their accounts contain the following provisions. The account is described, including its name,[180] purpose,[181] office and fiscal year. The voting rights of contractholders are set forth, the annual meeting and who may convene it, special meetings, notice, quorum, record dates, and the procedure at the meetings.[182] The purposes of the committee,[183] its powers[184] and proceedings in its meetings are regulated. Filling of vacancies is provided for. Sometimes the structure of the committee is

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178 McDougal, note 28 supra, at 86.

179 These by-laws are attached as an exhibit to the registration statement of the separate account under the Securities Act of 1933, Form S-5.

180 The Rules of three accounts are used for comparison: The Paul Revere Variable Annuity Accumulation Fund (Paul Revere) established in 1968, the Metropolitan Variable Account B (Metropolitan) established in 1970 and the John Hancock Variable Account A (Hancock), which is now being processed. In addition to the statement of the Account's name, Metropolitan specifically reserves its rights to the name and its service marks, art. I, § 1.1. As to property rights in the name see Inv. Co. Act Release No. 5510 (Oct. 8, 1968).

181 The purpose of the account is to provide funding for the variable annuity contracts. Hancock cites the state law provision permitting the establishment of the account and states that amounts held in the account shall be invested, reinvested and distributed in accordance with the provisions of the variable annuity contracts, the Rules, and state and federal law, art. I, § 1.02. See Paul Revere art. I, § 3; Metropolitan art. I, § 1.1.

182 These provisions are similar to the provisions regulating meetings of shareholders of a corporation.

183 Only Metropolitan contains a provision with respect to the purposes of the committee. "The operations of the Account will be supervised by the Metropolitan Variable Account B Committee ('Committee') with the powers provided in Section 3.2 hereof . . . ." art. I, § 1.4.

184 The Rules list the powers that the directors of an account are expressly required to exercise under the 1940 Act such as: approval and selection of an independent public accountant; execution and approval of advisory and underwriting contracts; annual recommendations for a change in fundamental policies and their submission to contractholders' vote. Paul Revere adds the authorization of all investments in accordance with the fundamental policies of the account, and the submissions of a semi-annual report to contractholders. In addition, the board is required to transmit to the Board of Directors of Paul Revere Variable Insurance Company, the sponsoring insurance company, a record of all meetings of the contractholders, art. IV. Metropolitan adds the authorization of all filing by an account of registration statements and a catchall provision authorizing performance of such additional acts as may be required to comply with the 1940 Act, art. III, § 3.2. The Committee under Metropolitan and Paul Revere has the power to amend the Rules in order to carry out the purposes of the account. Metropolitan art. V, § 5.1; Paul Revere art. XIV. Under Hancock, the insurance company, with the Committee's approval, may amend the Rules, art. X.

described. Compensation of members and their indemnification are treated. Amendments of the account's Rules and a change of its status is discussed. At least in one case the Rules provide for investment policies, valuation of assets and calculation of liabilities.[185] A comparison between these Rules and a constitution of an unincorporated association or the articles of association and by-laws of a corporation reveal the nature of the "organized group of persons."

Unincorporated associations represent a form of organization that is basically free of statutory interference and depends almost entirely on the will of the members. Under the common law, associations are created and governed by an agreement among their members, evidenced by the signing of a constitution.[186] This constitution is binding on members who signed it and on future members who consent to be bound by it.[187] The constitution is the law of the association and usually contains a detailed description of the powers, purposes and structure of the organization. The constitution may be amended either in accordance with its own provisions or, absent such provisions, by a majority vote at a valid meeting.[188]

Corporations, on the other hand, cannot be created except under statutory authority.[189] Their constitution is deemed for many purposes a contract among the members. Within the statutory constraints, members, alone or with their board of directors, have a great deal of freedom to change the powers, capital structure and internal organization of their corporation by amending their constitution.

The organized group of contractholders does not resemble, in these respects, either an unincorporated association or a corporation. Its creation and its purposes are derived not from contract or from Rules, but impliedly from the provisions of the Investment Company Act of 1940. The organization as understood in *Prudential*, comes into being even in absence of any arrangement among the members.[190] The organization is closely related to

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185 Hancock art. VI.

186 1 Fletcher § 21, at 71.

187 Talton v. Behncke, 199 F.2d 471 (7th Cir. 1952); Stoica v. International Alliance of Theatrical Stage Employees & Moving Picture Mach. Operators, 78 Cal. App. 2d 533, 178 P.2d 21 (1947), member must exhaust remedies afforded by the constitution before seeking redress through the courts; Nilan v. Colleran, 283 N.Y. 84, 27 N.E.2d 511 (1940); Maria Konopnicka Soc'y of Holy Trinity Polish Roman Catholic Church v. Maria Konopnicka Soc'y, 331 Mass. 565, 120 N.E.2d 769 (1954); Logan v. Group Health Ass'n, Inc., 173 A.2d 717 (D.C. Mun. Ct. App. 1961).

188 In re Osteopathic Hosp. Ass'n, 41 Del. Ch. 369, 195 A.2d 759 (1963), on remand, 41 Del. Ch. 424, 197 A.2d 630 (1964); Ace Bus Transp. Co. v. South Hudson County Blvd. Bus Owners' Ass'n, 118 N.J. Eq. 31, 177 A. 360 (1935), aff'd, 119 N.J. Eq. 37, 180 A. 835 (1935). An amendment of the by-laws must be consistent with the fundamental scheme of the association. Marshall v. Pilots' Ass'n, 18 Pa. Super. 644 (1902), rev'd on other grounds, 206 Pa. 182, 55 A. 916 (1903). The amendment may not destroy the vested rights. Id; Board of School Comm'rs v. Hudgens, 274 Ala. 647, 151 So. 2d 247 (1963).

189 1 Fletcher §§ 113, 114.

190 41 S.E.C. at 345: "It is a principal purpose of the Act to require that a group such as this *have* a certain role and take part in certain responsibilities; it does not leave these matters to contractual whim." (emphasis in original).

another entity, the insurance company, which ought to be given power to protect its interests in the account.

The characteristics of the Rules may be summarized as follows: Rules are not necessary for the establishment of the account under state law, nor for the creation of the account as a separate entity pursuant to the 1940 Act. They are not a source of the powers of the account since state laws do not recognize the account as capable of having powers. The insurance company that initially writes the Rules has no authority to grant in them powers to the account. Under state laws, insurance companies are authorized, but not required, to grant, presumably by delegation, specified powers to the board of the account or the contractholders. The Rules may contain this grant of powers.

Only the insurance company has authority to write Rules for the organization of contractholders so that they can become an "organized group of persons," presumably unincorporated, under the 1940 Act. Insurance companies are sometimes given statutory authority, expressly or by implication, to provide for compliance with any applicable state or federal laws in order that variable annuities may be lawfully sold.[191] Writing Rules is one of these provisions. The 1940 Act does not require that contractholders have the power either to establish or to change the organization of the investment company, as long as the powers enumerated in the 1940 Act are granted to them. It can therefore be argued that, subject to the 1940 Act's specific provisions and to state insurance laws, only the insurance company may in its discretion write Rules.

Finally, the Rules are a contract designed to implement the 1940 Act. The Rules are a contract among the contractholders and between the contractholders individually and the aggregate.[192] Contractholders become a party to the contract by purchasing the annuity, like member-policyholders of a mutual insurance company. They cannot acquire a policy without becoming members and they cannot become members without acquiring a policy.[193] Yet there must be consent to becoming a member, express or by implication.[194] When a prospectus that contains a description of voting rights is given to a prospective purchaser, the purchase of an annuity might be proof of consent to membership. When the Rules contain provisions as to matters of investments, valuation of assets and calculation of liabilities, contractholders may have a joint cause of action against the insurance company on the basis of these Rules as well as on federal law. This is a basic deviation from traditional insurance concepts.[195]

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191 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.J. Stat. Ann. § 17:35A-9(b) (Supp. 1971); N.Y. Ins. Law § 227.6 (McKinney Supp. 1971); Tex. Ins. Code art. 3.72, § 12 (Supp. 1971).

192 1 A. Corbin, Contracts § 55, at 234 (2d ed. 1963) [hereinafter cited as 1 Corbin].

193 18 Appleman § 10046, at 97: "Membership in a mutual insurance company must be accompanied by insurance; conversely, one insuring in a mutual company automatically becomes a member thereof." Wisconsin Town Mut. Reinsurance Co. v. Calumet County Mut. Fire Ins. Co., 224 Wis. 109, 271 N.W. 51 (1937).

194 18 Appleman § 10046, at 99.

195 See notes 498, 499 & 500 infra.

As to the insurance company, if the Rules are incorporated in the variable annuity contracts, as they sometimes are,[196] the Rules might form a part of the annuity, and the insurance company will be bound by the Rules, as against each contractholder.[197] If the insurance company has invested in the account, it will be a member of the account by virtue of its investment. If the Rules grant the insurance company rights,[198] the company might be deemed to have indicated its consent to be bound by them, or it may be deemed a party to the Rules by having only an enforceable right, without a corresponding duty,[199] or it may be deemed to be a third party beneficiary without being a party to the contract at all,[200] depending on the interpretation of the Rules and the circumstances of their adoption.

Contractholders may not amend the Rules except within the terms of the Rules themselves. The staff did not object to a provision that the Rules could be amended, altered or repealed by a vote of the Executive Committee of the insurance company, with the approval of the majority of the Board of Managers of the account who were not affiliated with the insurance company.[201] Perhaps a provision that permits the insurance company to amend the Rules without the Board's approval would also be permitted. Such an attitude results in acceptance of the account as a regulated department of the insurance company. It might be based on the principle that state insurance laws govern the preparation of the Rules. It is also consonant with the characterization of the account as an organized group of persons, since the powers of members of such a group may be dictated by an outsider. This attitude might also be based on the argument that since the insurance company is conducting an insurance business through the account, a change in the Rules may affect its interests and, more importantly, its obligations under the variable annuity contracts and other contracts funded through the account. Pursuant to this reasoning contractholders have only those rights that are specifically granted them by the 1940 Act. All residual rights in the account including the rights to prepare and amend Rules, continue to vest in the insurance company.[202]

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196 See, e.g., Prospectus, American Republic Assurance Co. Separate Account B (Sept. 20, 1968); Preliminary Prospectus, ISL Variable Annuity Fund B at 1 (June, 1968).

197 1 Corbin § 3.

198 See, e.g., Rules and Regulations of John Hancock Variable Account A, §§ 6.01-10.01 (Sept. 16, 1970). Rules and Regulations of Metropolitan Variable Account A art. I, § 1.1, reserving for Metropolitan the rights in the Account's name.

199 1 Corbin § 55, at 234.

200 4 A. Corbin, Contracts § 782, at 83, 86-87 (1951).

201 Rules and Regulations of John Hancock Variable Account A art. X, § 10.01 (Sept. 16, 1970).

202 The only check on the insurance company's exercise of these decisions is the Commission's authority with respect to the registration statement. The Commission's authority in regard to disclosure has been used to effect changes in the Rules for the purpose of protecting investors. See 1 Loss at 265-71. The Commission has used its authority to effect changes in other areas as well. For example, it does not permit registration of the insurance company itself as an investment company, even if the insurance company issues only variable annuities. McDougal, note 28 supra, at 83-84. The Commission also has an "unwritten rule which requires that employees who make 'not insignificant' or 'substantial' contributions to variable annuity contracts . . . be

If the conventional investment-company approach is taken it could be argued that the power of contractholders to initiate and amend Rules must be determined by the law applicable to shareholders of the insurance company—the law of its incorporation. Contractholders are "stockholders" of the insurance company with respect to the investment business of the account, having undertaken the investment risk. It is precisely for the purpose of putting contractholders in this position that the account is separated from the insurance company. The contractholders should have inherent power as stockholders to initiate Rules, subject to any express authority state insurance laws grant to the insurance company to write the Rules. Once enacted, however, these Rules may be amended by contractholders, as the by-laws of the insurance company may be amended by its shareholders.[203] If the insurance company is a mutual insurance company, the amendment powers of the contractholders would presumably be similar to those of the members of the company.

With respect to Rules the account is at present treated as a regulated department of the insurance company, rather than as an investment company. Control is with the insurance company, and the contractholders are afforded exactly the rights that are expressly required by the 1940 Act, but no more. Since the interests of the insurance company and contractholders might conflict, neither should be given full control. The organization of the contractholders should be set forth in law, not left to the insurance company. The company may have a legitimate claim to a say in some of the amendments to the Rules. Therefore, legislation should spell out the matters that contractholders may decide, and allocate the decision power among the insurance company, the contractholders and the board.

D. *Qualifications of Issuers Under the 1940 Act and State Laws*

The Investment Company Act prohibits a registered investment company and its principal underwriter from making a public offering of securities unless the investment company has a net worth of $100,000, or unless it has raised this amount in the past, or provisions are being made for escrow and repayment of funds to be raised should the minimum $100,000 not be obtained at the public offering.[204]

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accorded the right to instruct the contract owner how to exercise the votes attributable to their contributions." Finnegan & Garner, note 90 supra, at 131. Some insurance counsel are of the opinion that this requirement has no legal basis. Id. at 132. The United States Court of Appeals for the District of Columbia Circuit has recognized that "directions" from the Commission could amount to orders subject to court review. See Independent Broker-Dealers' Trade Ass'n v. SEC, 442 F.2d 132 (D.C. Cir. 1971).

[203] Often in large corporations only the directors may amend the by-laws. However, shareholders have exclusive power to amend the articles of association which govern the organization of the company. Separate accounts do not have articles of association and the only document concerning their internal governance is the Rules.

[204] § 14(a), 15 U.S.C.A. § 80a-14(a) (1971). This section was enacted to ensure financial responsibility of investment companies. "What this provision really states is: You ought to have initially a pool of at least $100,000 before you go around asking the public to turn over their money to you for your management. Also you ought to have a pool of

money with which you can at least get some research facilities to make adequate analysis of the securities that you intend to buy." Hearings on H.R. 10065 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 117 (1940) (statement of David Shanker). In July, 1968, the industry proposed a draft of an exemption from this section to cover separate accounts used solely in connection with qualified plans under sections 401 and 403(b) of the Internal Revenue Code. The request was based on the ground that it is impossible in practice to meet the $100,000 requirement through a private offering of such contracts; these contracts involve small payments by a large number of employees who do not become beneficiaries or contractholders until a later date. The insurance industry proposed to exempt an account if its insurance company sponsor had combined capital and surplus (if a stock company), and unassigned surplus (if a mutual company) of not less than $500,000. Nelson, Problems Raised by Investment Company Act of 1940, Including Proposals for Revised Rules, Proceedings of the Legal Section, Am. Life Convention 77, 85 (1968).

The Commission responded with an alternative solution. In one instance it permitted the insurance company to contribute $100,000 to the account, and in another instance is permitted the trustees of a qualified pension plan with fixed-dollar benefits to place in the account $200,000 of plan assets not involving contract reserves and not attributable to employee contributions. The Commission also required that the contribution to the account be made for investment and not with the intention of assigning or redeeming it. Id. The requirement of contribution was later reversed, at least with respect to contracts regarding profit-sharing plans which qualified under sections 401(a) or 403(a) of the Internal Revenue Code, and tax deferred annuities under section 403(b) of the Code. With respect to these plans, ad hoc exemptions were granted on the grounds that under state law the account "is an integral part" of the insurance company and that the latter holds all the assets of the account and is "responsible for the performance of the obligations" of the account under the contracts. The notice of application for exemption mentioned that under state laws the income and losses are credited only to the account and that there is no risk that the account will be unable to meet its obligations or continue in existence because (1) the insurance company has assets of billions, (2) the company is responsible for the performance of the obligations under the contracts, and both the insurance company and the account are bound under the state insurance laws to perform their contractual obligations. The Northwestern Mut. Life Ins. Co. and NML Variable Annuity Account B, Inv. Co. Act Release No. 5528 (Oct. 31, 1968), granted, Inv. Co. Act Release No. 5569 (Apr. 22, 1969). See also Great-West Variable Annuity Account A and the Great-West Life Assurance Co., Inv. Co. Act Release No. 5516 (Oct. 16, 1968), granted, Inv. Co. Act Release No. 5547 (Nov. 25, 1968). On July 10, 1969, the Commission promulgated Rule 14a-2 exempting from the $100,000 contribution requirement accounts established to sell variable annuities, which meet the requirements of sections 401, 403(b) and 404(a)(2) of the Internal Revenue Code. Inv. Co. Act Release No. 5738 (July 10, 1969). The Commission explained that the tax treatment of assets arising from such contributions varies from the tax treatment of payments made under the variable annuity contracts. A privately contributed $100,000, therefore, requires separate accounting; it also entails problems concerning investment objectives. The exemption is subject to the conditions that the account will not contain non-tax exempt funds, and that the establishing insurance company will have a combined capital and surplus (if a stock company) or an unassigned surplus (if a mutual company) of one million dollars, as per the balance sheet of the company contained in the registration statement filed under the 1933 Act. This Rule is the codification of ad hoc decisions to the same effect. See Continental Assurance Co. Separate Account (B), Inv. Co. Act Release No. 4798 (Dec. 21, 1966).

On July 15, 1969, the Commission also granted an exemption from section 14(a) of the Act under Rule 6e-1 which applies to plans involving accounts qualified under sections 401 or 404(a)(2) of the Internal Revenue Code, provided that the sponsoring insurance company has a combined capital and surplus (if a stock company) and an unassigned surplus (if a mutual company) of not less than one million dollars at the time of filing with the Commission notification in lieu of registration. The exemption is offered in order to treat equally accounts exempt under Rule 6e-1 and accounts exempt under Rule 14a-2 promulgated on July 10, 1969. Inv. Co. Act Release No. 5741 (July 15, 1969). Rule 6e-1 is now superseded by section 3(c)(11), which exempts similar accounts fully.

Most state laws impose special qualification requirements on insurance companies proposing to issue or deliver variable annuities.[205] The companies must satisfy insurance authorities that their methods of issuance will not be hazardous to the public or to its policyholders. State authorities are usually required to consider the company's history and financial condition, the fitness of its officers and directors, and, in the case of a foreign company, the regulation by the company's domiciliary state.[206] In California the company is also required to maintain a minimum combined capital and surplus of two million dollars,[207] in Illinois, five million dollars,[208] and in Indiana, two and a half million dollars.[209] In addition, insurance companies do not qualify in many states unless they have been conducting insurance business for a specified number of years.[210] Some jurisdictions have amended their laws to permit insurance companies to conduct the variable annuity business through subsidiaries, provided either the company or the subsidiary qualifies.[211] Subsidiaries are helpful because they partially insulate the insurance company from application of the federal securities laws.[212]

It is submitted that the requirements of section 14(a) should not apply to accounts because insurance statutes and the supervision of state agencies provide an effective regulatory substitute to ensure the financial integrity of insurance companies.

E. *Which Is the Investment Company?*

Under *Prudential* the "fund" constitutes the investment company: "[T]he investment fund, the 'company' to which the investment interests (in the annuity contracts) relate, is the 'issuer' of those interests."[213] The question, however, remains, what is the nature of this fund? *Prudential* suggests that the fund should be identified with the contractholders: "[T]he variable annuity contract holders together with the proceeds of their payments . . . constitute a 'trust,' a 'fund' and 'an organized group of persons' "[214] namely a "company" or companies under the 1940 Act. The characterization of the account is important even when the account exists only for the purposes of federal law. For example, the rights and liabilities of contractholders, such as their right to sue derivatively or as a class, may be determined by the

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205 For a short description of qualification requirements for entry into the insurance business see SEC Investor Report, note 28 supra, at 508-09. See note 126 supra.

206 See note 126 supra.

207 Cal. Ins. Code § 10506(E) (West Supp. 1971).

208 Ill. Ins. Dep't Regs., art. XIV½, Rule No. 14½.03(1) (Feb. 15, 1968).

209 Ind. Ann. Stat. § 39-4225 (1965).

210 E.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Nev. Rev. Stat. § 690.470 (1967); N.J. Stat. Ann. § 17:35A-2 (Supp. 1971) (the requirement was left in force by the 1968 amendment to this section).

211 N.J. Stat. Ann. § 17:35A-2 (Supp. 1971). See also note 126 supra.

212 4 Loss at 2521 (Supp. 1969).

213 41 S.E.C. at 345.

214 In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680, 703 (1960).

characterization of the account. If the account is a corporation, neither its contractholders nor its assets are the issuer. But if the separate account is an unincorporated group of persons subject to the laws of unincorporated associations, more than one possibility exists. The unincorporated association may be an issuer and its members may be issuers individually.[215] Alternatively, the association may be an issuer, but not its members.[216] Or the fund, apart from the association or the members may be the issuer. The choice of the theory affects the rights and liabilities of the parties involved. It is submitted that the third theory leads to the most reasonable results.

F. *Who Is an Issuer Under the Securities Acts?*

The 1933, 1934 and 1940 Acts define an issuer as every or any "person who issues or proposes to issue any security . . . ."[217] The identity of an issuer might depend on the circumstances of the transaction and the nature of the document treated as a security. The Commission has held that an arrangement concerning a security that significantly alters the terms and conditions of that security may result in the issuance of an additional security by a different issuer, a new investment company. The following plan was held to be a security: sums were accumulated by a broker-dealer over a period of time and invested in equity securities, the broker-dealer was paid special fees and limitations were placed on participants' rights as shareholders and their rights to withdraw the securities. This arrangement was held to be a security and the broker-dealer was held to be an issuer.[218]

Prudential reversed this analysis, finding a security within a security. The variable annuity contracts, themselves securities, were found to contain investment promises that were also securities of another issuer, the separate account.[219]

Under *Prudential*[220] the account is the obligor of the variable annuity contracts, undertaking to manage the investment business of the account, redeem interests and pay annuities. The account may also own the assets in the account from which such obligations will be paid. But before the account is an entity, an investment company, it must be an issuer. Prior to its being an investment company the account is not separate from the insurance company and is not an entity. Further, under many state laws the legal and beneficial ownership in assets of the account is vested in the insurance company. Can the account be an issuer without being a separate entity and can it issue a security without being the owner of the assets?

A security must create some claim or right as against the issuer. Generally, the issuer and the obligor of a security are one. If an obligor (the insurance

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215 See note 246 infra.

216 See p. 278 supra.

217 Securities Act of 1933, 15 U.S.C. § 77b(4) (1964); Securities Exchange Act of 1934, 15 U.S.C. § 78c(8) (1964); Investment Company Act of 1940, § 2(a)(22), 15 U.S.C..A. § 80a-2(a)(22) (1971).

218 Sec. Act Release No. 4491, Inv. Co. Act Release No. 3480 (May 22, 1962).

219 41 S.E.C. at 342.

220 Id. at 347.

company) issues a security that is to be primarily satisfied from a designated pool of securities, then that pool, itself, may become an issuer together with the insurance company for the purposes of the 1940 Act. It is submitted that under the 1940 Act, passive assets can be an issuer, whereas under the 1933 and 1934 Acts passive assets cannot be an issuer.[221] The 1970 Act excepts certain qualified separate accounts from the definition of an investment company. Presumably these accounts can issue securities under the 1940 Act. On the other hand, the 1934 Act[222] and the 1933 Act[223] include in their definition of an exempt security, interests or participations in separate accounts. Yet neither of the latter Acts mentions the identity of the issuer of these exempt securities. The exemptions do not, therefore, indicate whether the account can be an issuer under these Acts.

The definition of a "person" under the 1933 Act[224] is different from its equivalent under the 1940 Act.[225] Both Acts contain the words an association, a joint-stock company, and a trust. The 1933 Act, however, does not include the words "a fund, or any organized group of persons whether incorporated or not" as does the 1940 Act; instead it contains the words "unincorporated organization," which the 1940 Act does not. The words "unincorporated organization" do not include a "fund." The first term speaks of an organization of persons, regardless of what it owns, the latter term speaks of a pool of money and securities, regardless of who owns it.

The two Acts have different objectives. The 1933 Act regulates the issuance of securities and places responsibilities on those who control and profit from the issuance of securities.[226] For this reason the issuer of interests or shares in an unincorporated trust not having a board of directors, is the person assuming the duties of a depositor or a manager, not the person who physically issues the certificates.[227] If an account is an inanimate

221 Although there is an instance in which no one is liable as an issuer under the 1933 Act, at least for the purposes of section 11 of the Act, so far as Form S-12 is concerned. 1 Loss at 465.

222 Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C.A. § 78c(a)(12) (1971).

223 Securities Act of 1933, § 3(a)(2), 15 U.S.C.A. § 77c(a)(2) (1971).

224 15 U.S.C. § 77b(2) (1964).

225 §§ 2(a)(28), 2(a)(8), 15 U.S.C.A. §§ 80a-2(a)(28), 80a-2(a)(8) (defining "company").

226 See, e.g., Securities Act of 1933, § 2(4), 15 U.S.C. § 77b(4) (1964). In "the case of an uninicorporated association which provides by its articles for limited liability of any or all of its members" the association, but not the members, is the issuer. This sentence was introduced as an amendment by Act of June 6, 1934, ch. 404, § 201, 48 Stat. 905. Legislative history explains that the principle of absolute liability imposed in section 11 of the Act to the issuer of securities is the principle that one should not retain the fruits of an unfair bargain. In the case of trusts or committees it is the trust or committee rather than the trustees or members who profit from the transaction. The Commission's interpretation is that the trust or unincorporated association is recognized as an entity for the purposes of the definition of a "person" under the 1933 Act and is itself the issuer. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 39 (1934).

227 1 Loss at 462-63, 465, 3 id. at 1724 n.130 (Supp. 1969). See, e.g., Northwestern Mut. Life Ins. Co. application for exemption: "Under Wisconsin Insurance Laws Account B is an integral part of Northwestern Mutual. The latter holds all the assets of Account B and is responsible for the performance of the obligations of Account B under the contracts." Inv. Co. Act Release No. 5528, at 1 (Oct. 31, 1968), granted, Inv. Co. Act Release No. 5659 (Apr. 22, 1969).

fund, the issuer of the securities for the purpose of the 1933 Act should be the insurance company or the investment adviser that benefits and stands to profit from the sale of the securities.

On the other hand, the 1940 Act regulates the conduct of investment business as it affects investors, regardless of who owns or controls the assets or the business. The Act also regulates the rights of issuees in the management of the assets, which rights, again, do not depend on the identity of the obligors under the security. A fund that is an artificial legal person and can be an obligor might be an issuer under both the 1933 and the 1940 Acts. A fund that is a mere pool of securities might be an issuer under the 1940 Act and subject to its requirements. But being a pool of securities without capacity to incur legal obligations, it should not be deemed an issuer under the 1933 Act.

G. *Allocation of Liabilities for the Business of the Account*

It is submitted that the insurance company should be responsible to the contractholders and to third parties for all the liabilities and losses of the business carried on by the separate account, except losses resulting from investments and from investment business decisions that were not made by the insurance company. These losses should be limited to the assets in the account, and the account should be charged with their payment. The contractholders are not personally liable for the obligations and losses of the business of the account, except in the sense that amounts due to them under the variable annuity contracts will vary with the investment performance and investment business of the account. If the contractholders are classified as an unincorporated association, they may become liable personally for the account's obligations.

1. Liability of the Insurance Company

The liability of the insurance company rests on the variable annuity contracts and on state laws. Under the contracts, the insurance company is the obligor of all the promises, including the promise to conduct an investment business. The issuance of an additional security by the account does not change or abrogate these obligations. Here the regulated-department approach should govern. State laws consider the accounts to be one of the activities of the insurance company. Implicit in all their provisions is the assumption that the insurance company is liable for the obligations and losses of the business carried on by the account, but that the insurance company's obligations to the contractholders will follow the investment performance of the assets in the account. The 1970 Act and the Commission's exemptive rules existing prior to the Act define a separate account as an account established and "maintained" by an insurance company.[228] "Maintain" means to continue the existence of, and to support finan-

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228 § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971); 17 C.F.R. § 270.0-1(e) (1971).

cially.[229] This expression might connote an obligation on the part of the company to protect contractholders against all losses, except those arising from investments.

There is no doubt that the amounts due to the contractholders under the contracts are affected by investment performance. But are they also affected by losses resulting from the conduct of the investment business, such as failure of the depositary? It is submitted that under state laws the insurance company will always be liable to third parties.

As to chargeability of the account, under state laws the account has a balance sheet that is separate from the insurance company's business.[230] Many state laws provide that the account will not be chargeable with liabilities arising from other business activities of the insurance company.[231] The negative implication of these laws is that the account is chargeable with liabilities arising from the business that it conducts. There is no doubt that fees and other expenses connected with the investment business as well as expenses specified in the variable annuity contracts, such as charges for the mortality guarantee, are liabilities to be paid from the assets of the account. It is not clear whether the insurance company may charge the account for payments by it in connection with the business of the account, such as losses due to failure of the depositary, or payments for torts committed in connection with the business of the account. These payments will be rare, but they may be high. Whether or not the insurance company may charge these payments to the account depends on the interpretation of the phrase "another business of the insurance company" in state statutes and may vary in different jurisdictions. The 1940 Act does not give the answer. Although Rule 22c-1 under the 1940 Act [232] provides that the value of units in the account must be based on the net assets value, this does not preclude payment for torts committed in connection with the business of the account.[233] It is submitted that if the insurance company did not, as an adviser or in any other capacity, make a decision that resulted in payment, payment must be charged to the account. When the advisory contract is with an adviser chosen by the insurance company, the insurance company should not be chargeable unless it was negligent in the choice of adviser and the negligence resulted in losses.

Will contractholders be personally liable for the liabilities of the account? The probability that contractholders will be sued personally is

229 Webster's Third New International Dictionary (15th ed. 1966). See also George Moore Ice Cream Co. v. Rose, 289 U.S. 373 (1933) (definition with respect to maintenance of a suit); Stanley v. City of Macon, 95 Ga. 108, 97 S.E.2d 330 (1957) (definition with respect to physical maintenance).

230 See p. 251 supra.

231 See p. 334 infra.

232 17 C.F.R. § 270.22c-1 (1971).

233 The Rules and Regulations of John Hancock Variable Account A, for example, contain an express provision that "all other liabilities of whatever kind and nature" will be deducted from the value of the assets, thus arriving at the net assets value. John Hancock Variable Account A, Registration Statement Under the 1933 Act at 20 (1970).

minute. If state law governs, the insurance company will be responsible to third parties and the contractholders will occupy the position of policyholders. The problem may still arise in connection with the advisory and underwriting contracts between the account and the insurance company. Unlimited personal liability of investors is not repugnant to the provisions and the policy of the 1940 Act. The Act itself includes associations in the definition of a company.[234] Thus, if an investment company is organized as a partnership, or as an unincorporated association, as investment clubs usually are, the partners or members will be personally liable for the obligations of the investment business, in accordance with the applicable state law.[235]

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234 § 2(a)(8), 15 U.S.C.A. § 80a-2(a)(8) (1971).

235 The common law distinguishes between associations organized for profit, whose members, as in partnerships, are individually responsible for contracts of the association made in the course of its business activities, Goodwin v. United States Annuity & Life Ins. Co., 24 Conn. 591 (1856); Wilcox v. Arnold, 162 Mass. 577, 39 N.E. 414 (1895), and associations not organized for profit whose members are not liable merely upon membership or participation, but only if they caused or authorized the contract. Feldman v. North British & Mercantile Ins. Co., 137 F.2d 266 (4th Cir. 1943); Stone v. Guth, 232 Mo. App. 217, 102 S.W.2d 738 (1937); Bloom v. Vauclain, 329 Pa. 460, 198 A. 78 (1938); Note, Unincorporated Associations in New England, 37 B.U.L. Rev. 336 (1957); Note, Legal Problems Created by the Formation and Operation of Investment Clubs, 106 U. Pa. L. Rev. 832, 887 n.368 (1958) citing cases in which members of a non-profit association were held liable on the theory of implied authorization; Comment, Enforcing a Contractual Claim Against an Unincorporated Association in Wisconsin, 1960 Wis. L. Rev. 444, 445-48.

If separate accounts are unincopórated associations engaged, through their representatives, in the busines of investing in securities, then contractholders will bear unlimited liability for contracts of the business. And this is true even under the liability rule of charitable associations when they ratify the contracts, e.g., advisory and underwriting contracts with the insurance company. S. Wrightington, Unincorporated Associations and Business Trusts § 64 (2d ed. 1923); Comment, Enforcing a Contractual Claim Against an Unincoproated Association in Wisconsin, 1960 Wis. L. Rev. 444, 447-48.

Under the common law, there are circumstances under which members of an association are held liable for torts committed by the agents of the aggregate of members within the scope of their employment. Elder & O'Rorke, Representative Suits in Tort in Ontario: Unincorporated Associations and the "Trust Fund" Doctrine, 18 Fac. L. Rev. 128 (1960); Note, Legal Problems Created by the Formation and Operation of Investment Clubs, 106 U. Pa. L. Rev. 832, 890-91 (1958). Liability depends upon the rules of agency governing liability of a principal for the torts of his agent. See Note, Unincorporated Associations: Legal Liabilities of Agents and Members, 42 Dick. L. Rev. 154 (1938). The tort liability of members of an unincorporated association is based essentially on the same principles that govern their contract liability. The full burden is placed upon members of an association organized for profit. Cox v. Government Employees Ins. Co., 126 F.2d 254 (6th Cir. 1942).

Members of an unincorporated association that issues securities may be issuers under the 1933 and 1934 Acts, responsible, for example, for violations in connection with the sale of securities under sections 11 and 12 of the 1933 Act, and Rule 10b-5 under the 1934 Act. Members might also become personally liable under the 1940 Act for the liabilities of the association in its capacity as an investment company, e.g., inaccurate reporting under section 29 of the 1940 Act. Section 2(4) of the 1933 Act excepts members of an unincorporated association from the definition of an issuer if the constitution of the association provides for limited liability of its members. There is no corresponding provision in the 1934 or 1940 Acts. Under state law concerning unincorporated associations engaged in business, whether partnerships or joint stock companies or business trusts, it is difficult to see how members could acquire limited liability for the conduct

Even if the account is deemed to be a corporation for some purposes, it should not be assumed that it has the corporate characteristic of limited liability. However, there must be a legal basis for imposing upon contractholders liabilities for losses of the account, and it is doubtful whether this basis exists. Generally, the personal liability of an individual who carries on a business alone is predicated on obligations that he undertakes, or on actions that he performs directly or through agents. The liability of a partner for the obligations of the partnership is predicated on an extension of this theory. Each partner is deemed to be an agent of the partnership, the aggregate of all partners.[236] Members of a joint stock company are personally liable as partners for transactions in the ordinary course of business of the association, whether or not they have specifically authorized them.[237] Members of an association who have joined in a profit-making business venture through their elected representatives ought to be responsible for the liabilities of their business incurred by their elected representatives.[238] Further, those who have control over the business as co-owners also bear the risk of loss.[239]

The factors that indicate the existence of a partnership are an agreement,[240] community interest in the sense that the parties' position is that of principals conducting a business jointly for profit (which excludes employees), and, barring an agreement to the contrary, control of management.[241] Both partnerships and joint stock companies are, in fact, groups of persons associated by agreement for the purpose of conducting a business for profit.[242] The old English common-law rule was that those who shared in the profits were personally liable for the losses of the business. This rule

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of the investment business of the association. If the business is not an entity, only its members can be held liable, except that contractual arrangements and insurance might limit the creditors to reaching only the assets of the enterprise. For contractual arrangements to limit liability of members of a joint stock company, see E. Warren, Corporate Advantages Without Incorporation 355-69 (1929); as for members of a trust, see id. at 384-404.

236 J. Crane & A. Bromberg, Law of Partnership 272-74 (1968).

237 Brown v. Bedell, 263 N.Y. 177, 188 N.E. 641 (1934). See also J. Crane & A. Bromberg, note 236 supra, at 273; R. Sugarman, Partnership § 7, at 19 (4th ed. 1966). Joint stock companies differ from partnerships in that they issue transferable shares, whereas partnerships do not. See also 1 Fletcher § 21. Joint stock companies are not dissolved upon changes in the membership, and are managed by an elected board rather than by the members themselves. But these differences do not affect members' liability. Liability is based on the theory that the members are principals conducting a business through their agents.

238 1 Fletcher § 21. See also 1 J. Barrett & E. Seago, Partners and Partnerships 237 (1956); E. Warren, Corporate Advantages Without Incorporation 355 (1929).

239 For example, beneficiaries under a common law trust are not personally liable for the obligations of the trust. They lose immunity from liability when they gain control over the trustees. 16A W. Fletcher, Cyclopaedia of the Law of Private Corporations § 8230, at 552 (perm. ed. rev. 1962).

240 J. Crane & A. Bromberg, note 236 supra, at 39.

241 J. Barrett & E. Seago, note 238 supra, ch. 2, §§ 2.3, 2.4. See also R. Sugarman, note 237 supra, § 3.

242 J. Barrett & E. Seago, note 238 supra, ch. 2, § 1, at 19.

has been modified by case law and statute.[243] Under the Uniform Partnership Act the sharing of profits only creates a presumption that a partnership exists.[244] Arrangements the main objective of which is not the joint conduct of business for profit for the benefit of the partners are not presumed to give rise to a partnership.[245]

At first blush contractholders of a separate account resemble shareholders of a joint stock company. They own units that resemble shares. They elect representatives who manage the business, and they continue the business even though members have died or transferred their shares. They might, therefore, be liable, like partners, for the account's obligations. Closer scrutiny compels a different conclusion.

First, the right to net profits, or the right to payment varying with investment performance is ancillary to the payment of annuities. Just as no partnership results from the payment of compensation, even if compensation is affected by the investment performance of the business, so no partnership results from payment of an annuity, even if the index to the amounts payable is investment performance. In over half of the states that permit the establishment of separate accounts, contractholders are creditors, not owners. Therefore, the presumption that they are partners does not exist. The right of control that contractholders have is not as extensive as that of partners or even as that of shareholders of joint stock companies. The right of control, per se, cannot be interpreted as giving contractholders the status of principals so as to impose on them personal liability, especially when control stems from the 1940 Act. A provision in the 1940 Act designed to protect investors cannot be interpreted to provide the legal basis for unlimited liability of those investors. Under state insurance laws too, voting rights to elect the management, per se, do not result in liability. Although participating policyholders have voting rights under state laws, these rights do not result in liabilities. In short, unless contractholders and the account together are an unincorporated association, a partnership, or a joint stock company, there is no legal basis for imposing upon contractholders individual liability for the obligations of the investment business.

The distance between the positions of the contractholders and of a sole proprietor has become so great that none of the elements upon which the

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243 J. Crane & A. Bromberg, note 236 supra, at 67.

244 Uniform Partnership Act § 7(4); Martin v. Peyton, 219 App. Div. 297, 220 N.Y.S. 29 (1927), aff'd 246 N.Y. 213, 158 N.E. 77 (1929).

245 Therefore, there is no partnership when directors jointly manage a corporation. Cohen v. Mahoney, 160 Misc. 196, 197, 289 N.Y.S. 802, 803 (Sup. Ct. 1936). No partnership relation among corporate directors can be implied from their activities in carrying on the corporate business. Manacher v. Central Coal Co., 125 N.Y.S.2d 260 (Sup. Ct. 1953); Berger v. Eichler, 211 App. Div. 479, 207 N.Y.S. 147 (1924). The two forms of organization are mutually exclusive. Bing v. Morgan Guarantee Trust Co., 17 App. Div. 2d 132, 232 N.Y.S.2d 832 (1962). A creditor is not a partner even when he is given substantial powers of management. See note 244 supra. Payment of profits as compensation does not give rise to a presumption of partnership. See, e.g., Drummy v. Stearn, 269 S.W.2d 198 (Ky. 1954); Kent v. Universal Film Mfg. Co., 200 App Div. 539, 193 N.Y.S. 838 (1922); Sheldon v. Little, 111 Vt. 301, 15 A.2d 574 (1940).

sole proprietor's liability is based are present. Ownership of assets is not necessarily present. Control is limited and granted under federal law for the purpose of protecting investors. Profit-sharing is ancillary to the main purpose of securing annuity payment. Above all, it may be safely stated that neither the insurance company, nor contractholders, nor outsiders, expect contractholders to be personally liable for the obligations of the account. There is no express liability under state or federal law. It is submitted that none can be presumed.

2. Liability Under the Securities Acts

If the account is an unincorporated group or persons, there exists the theoretical possibility that the contractholders may be liable under the 1933 Act as issuers,[246] under the 1934 Act as issuers or sellers of securities, or under the 1940 Act for violation of duties imposed on the investment company. This might be the reason why the staff of the Commission insists that the insurance company is responsible as guarantor or co-issuer together with the account for the performance of all the account's obligations. Presumably these are the obligations under the securities acts, rather than obligations of the investment business of the account.

It has been suggested that the insurance company in addition to being the issuer of the variable annuity is a co-issuer of the security issued by the account or a guarantor of the investment and other promises of the account.[247] This suggestion is based on several grounds. First, the mortality and expense guarantees given by the insurance company make it a co-issuer, together with the account, of the security issued by the account. Second, the issuance of a variable annuity, ipso facto, makes the insurance company an issuer of a separate security, a guarantee of the obligations of the separate account. Third, perhaps the insurance company must be directly liable for the obligations of the separate account in jurisdictions that declare the insurance company the owner of the assets in the account.[248] As to the first theory the mortality and expense guarantees have been classified by the Commission as insurance promises, at least for the purposes of the 1940 Act.[249] They are not the guarantees that are included in the definition of a security under the 1933 Act. They are assumptions of risk. When issued by an insurance company, these promises, standing alone, are exempt from the securities acts. The fact that the insurance company "writes and sells a contract purporting to combine"[250] its exempt insurance obligations

246 Under section 2(4) of the 1933 Act, members of an unincorporated association that established in its constitution a limited liability for them are not deemed issuers for the purposes of the Act. See Note, Legal Problems Created by the Formation and Operation of Investment Clubs, 106 U. Pa. L. Rev. 832 (1958). The Rules that this writer has examined do not contain a limitation-on-liability provision.

247 4 Loss at 2522 (Supp. 1969).

248 Id.

249 41 S.E.C. 335 (1963).

250 Id. at 343.

with investment obligations ought not to create, for the purposes of the securities acts, an additional obligation.

The second theory is that by issuing its insurance promises together with the investment promises of the account, the insurance company, by implication, has also issued a guarantee. A guarantee to pay a sum of money, if the account fails to pay, is a security under the 1933 Act.[251] The rationale of the implied guarantee is that the account cannot conduct a business independently of the insurance company, and that purchasers of annuities are relying on the insurance company to fulfill the obligations of the account; hence the guarantor is the co-issuer of the securities issued by the account. The assumption that an account cannot conduct an independent insurance and investment business is open to question. In fact the account would then resemble a mutual insurance company. The theory perhaps may not be sufficient to impose liability on the insurance company for other purposes but may suffice to create liability for the purposes of the securities acts to protect investors.

The third theory seems to assume that the obligations of the account as an issuer under the securities laws will run with its assets. Therefore, whoever owns the assets is bound to honor the obligations attached to them under the securities acts. This theory takes cognizance of the provisions of state laws that vest ownership of the assets of an account in the insurance company.[252] It is submitted that this approach is more compatible with the legal framework of insurance laws.

All the described theories are, in fact, attempts to impose upon the insurance company the obligations of the account as an issuer for the purposes of the securities acts. In *Prudential* the account was separated from the insurance company in order to apply the 1940 Act to some of its assets and activities. The above theories are inconsistent with *Prudential* in that they impose on the insurance company, through securities concepts, liabilities under the securities acts for these assets and activities.

Theories aside, this subject requires legislative treatment. Even though the probability that contractholders will be personally liable for the debts of the business of the account is theoretical and very small, such possibility is disturbing. It is also disturbing that prospectuses regarding variable annuities do not contain any indication or warning of this possibility. The allocation of liabilities between the investment business of the account and the insurance company's business in the account ought to be made clear.

IV. Purposes and Powers of the Account

A. *Purposes*

Under state law separate accounts are established "in connection" with the sale and issuance of variable annuity contracts, for the following pur-

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251 Securities Act of 1933, 15 U.S.C. § 77b(1) (1964); 1 Loss at 466.
252 See note 57 supra.

poses: to receive net payments (after deduction of expenses) under the contracts, to invest and reinvest the assets of the account in equity securities without regard to restrictions on investments of insurance companies' assets, and to provide the source of payment of variable benefits. The latter purpose is not explicit, but may be implied from the provisions regarding reserves funding variable annuity contracts.[253] The type of contracts that accounts may fund vary from state to state and each state at different times has permitted different contracts. The first enabling statutes permitted only tax-deferred qualified pension and profit-sharing plans.[254] Later, other variable annuity contracts were authorized. Recently, other insurance equity contracts have been authorized.[255]

Under the Investment Company Act the purpose of a separate account is somewhat narrower, namely, to engage or to hold itself out as being primarily engaged, or to propose to engage primarily, in the business of investing, reinvesting or trading in securities,[256] or to engage or to propose to engage in the business of investing, reinvesting, holding or trading in securities having a value exceeding 40 percent of the value of the fund's total assets on an unconsolidated basis.[257]

The account's purpose must be investment in order to sustain the definition of a security and an investment company. Other purposes, such as paying annuities or death benefits, may vary with the terms and conditions of the contracts constituting the "security," without affecting the status of the account as an investment company.

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253 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971). The purposes stated in the Rules and Regulations of Metropolitan Variable Account B art. I, § 1.1 are: "to provide a separate investment account for such contracts issued . . . by Metropolitan as Metropolitan may designate from time to time for such purposes."

254 See Johnson & Grubbs, note 90 supra, at 15-19; note 98 supra.

255 See: Ala. Code tit. 28, § 4(5)(1)(a) (Supp. 1969); Ariz. Rev. Stat. Ann. § 20-651A (Supp. 1970); D.C. Code Encycl. Ann. § 35-541(a) (1968); Fla. Stat. Ann. § 627.0975 (Supp. 1971); Ind. Ann. Stat. § 39-3501 (Class I(c)) (1965); Kan. Stat. Ann. § 40-436(a) (Supp. 1970); Ky. Rev. Stat. Ann. § 304.833(1) (1969); Md. Ann. Code art. 48A, § 362(a) (Supp. 1970); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Minn. Stat. Ann. § 61A.13 (Supp. 1971); Mo. Ann. Stat. § 376.309.2 (Supp. 1971); Nev. Rev. Stat. § 690.460.1 (1967); N.H. Rev. Stat. Ann. § 408:28 (1968); N.J. Stat. Ann. § 17-35A-1 (1963); N.Y. Ins. Law § 227.1 (McKinney Supp. 1971); N.D. Cent. Code § 26-11.1-01 (Supp. 1971); S.D. Comp. Laws Ann. § 58-28-13 (Supp. 1971); Tenn. Code Ann. § 56-312 (Supp. 1970); Wash. Rev. Code Ann. § 48.18A.020 (Supp. 1970); Wis. Stat. Ann. § 206.385(1) (Supp. 1971).

256 §3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (1971): An investment company is an "issuer which—(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities . . . ."

257 § 3(a)(3), 15 U.S.C.A. § 80a-3(a)(3) (1971): An investment company is an "issuer which—(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . on an unconsolidated basis." An additional purpose listed under the Act is to engage or propose to engage in the business of issuing face-amount certificates of the installment type. § 3(a)(2), 15 U.S.C.A. § 80a-3(a)(2) (1971). See also Model Variable Contract Regulation, note 41 supra, at 190.

B. *Powers: To Contract and Conduct an Investment Business*

An account that is registered as a management company must have power to perform these acts. If these powers are presumed only for the purposes of the 1940 Act, then sale of securities for the account will be effected by the insurance company as a principal under state law. If a violation of the 1940 Act is alleged, the sale will be deemed to have been effected by the insurance company as an investment adviser, whose powers are derived from the investment advisory contract. Since the 1940 Act requires that the insurance company enter into an advisory agreement with the account,[258] the account must be recognized as a party and have capacity to enter into the contract. If capacity is assumed for purposes of federal law only, the applicable law might change as a result of the fact that the insurance company is acting as a principal rather than an investment adviser. Thus, in an action between the insurance company and a third party regarding the purchase and sale of securities, state law will govern, and the insurance company can be sued as a principal. If one of the parties to the suit, or the board of the account, or perhaps the contractholders derivatively, alleged that the sale was void as a result of a violation of the 1940 Act,[259] the insurance company will be deemed an investment adviser. In such a case the insurance company's powers will have derived from the account through the advisory contract. The result will also be that state law will deem the sale binding on the insurance company and federal law will void the sale against the account. If the theory is that the insurance company as such must abide by federal law with respect to its own assets and its own transactions, then the theory violates section 3(c)(3) of the 1940 Act, which excepts insurance companies from the definition of an investment company. In conclusion, it seems that the separate existence of the account must be recognized by state law in connection with the exercise of these powers.

An account that is registered as a management company must have power to issue securities and trade in securities,[260] to issue redeemable securities,[261] to enter into contracts with an investment adviser and an underwriter,[262] to hire an accountant[263] and, probably, to do all acts necessary to carry out these activities.[264] The 1940 Act is not the source of any implied powers of the account to issue securities and engage in investment business because capacity to do these acts is a condition precedent to the application of the 1940 Act to any company. Since in the period before ap-

258 § 15(a), 15 U.S.C.A. § 80a-15(a) (1971).
259 § 47(b), 15 U.S.C.A. § 80a-46(b) (1971).
260 § 3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (1971).
261 § 27(c), 15 U.S.C.A. § 80a-27(c) (1971).
262 § 15, 15 U.S.C.A. § 80a-15 (1971).
263 § 32(a), 15 U.S.C.A § 80a-32(a) (1971).
264 Perhaps the account must also have power to pay dividends. Investment Company Act of 1940, § 19, 15 U.S.C. § 80a-19 (1964).

plication of the 1940 Act to it, the account as a part of the insurance company may exercise all the powers of the insurance company, after the 1940 Act's application, state laws continue to apply to the account as a separate entity, even if only for the purposes of federal law. Therefore, the scope of these powers and the rules applicable to their use are to be determined by state insurance and corporation laws governing the activities of the insurance company. If we view the account as a regulated department of the insurance company the same law is applicable. On the other hand, if the organizational structure of the account is that of its contractholders, the scope of the account's powers may be governed by the law of unincorporated associations, which is inappropriate. Unincorporated associations have powers as specified in their constitutions and determined by their members, whereas the powers of the account are determined by the insurance company and by implication from the law. The Rules of accounts do not specify the account's powers.[265] The contractholders cannot determine the powers of the account as members of an association do. The insurance company may be prohibited by state law from delegating such powers to the account.

The present state of the law is unsatisfactory. The insurance company operates the account as a principal pursuant to its own powers under state law. Under federal law it operates the account under a contract pursuant to powers derived from the account. So long as the 1940 Act applies to the account it is desirable that state legislation recognize its existence and specify its powers, at least when the application of federal law is involved. Whether state courts will feel compelled to recognize the account's existence under the constraints of federal law remains to be seen. Legislative clarification is preferable. If the account is registered as a unit investment trust its powers are restricted to the holding of shares and the passive receipt of income.[266] In addition such an account must have the power to issue securities. The problems discussed in this section also arise in the context of a unit investment trust but to a more limited extent because they do not involve investment business. This business is carried on by a corporate entity, the fund whose shares are held in the account.

C. *Capacity to Sue and Be Sued*

The insurance industry posed the question of whether the account has capacity to sue and be sued in connection with a possible breach by the account of its contractual obligations to the insurance company under an

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[265] See, e.g., The Rules and Regulations of John Hancock Variable Account A; Rules and Regulations of Metropolitan Variable Account A; Rules and Regulations of Paul Revere Accumulation Fund.

[266] A unit investment trust is defined by section 4(2) as an investment company "which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities . . . ." 1940 Act § 2(4), 15 U.S.C.A. § 80a-2(4) (1971).

investment advisory or an underwriting contract.[267] Annuity contract-holders might ask the same question regarding the insurance company's obligations to them under these same contracts. The following discussion focuses on hypothetical litigation with respect to an investment advisory contract between an account and an insurance company since the question of capacity of the account is most likely to arise in connection with these contracts.

1. The Contract May Raise Federal and State Causes of Action

At the outset it should be noted that disputes under advisory contracts may give rise to a cause of action under the 1940 Act, such as disputes over the assignment of the contract by the insurance company.[268] Other disputes may raise questions not directly related to federal law, such as whether the insurance company fulfilled its obligation under the contract to pay all the account's expenses. It is not clear whether this dispute gives rise to a federal question or to a cause of action under state law. In *Acampora v. Birkland*[269] for example, the validity of the advisory contract under federal law was attacked. In addition it was alleged that the investment adviser breached its obligations under the contract and that it did not pay all the expenses of the investment company.[270] The court resorted to federal case-law dealing with the interpretation of government contracts in order to determine the correct interpretation of the advisory contract.[271] It is not clear from the decision whether this cause of action, termed, "[A]lternative requests for relief,"[272] was considered to be based on state law. Nor is it clear whether the court's jurisdiction was based on diversity, or federal question and pendent jurisdiction. Whether a breach of an advisory contract that is not predicated on an express provision in the 1940 Act gives rise to a federal cause of action depends on the interpretation of the federal statute. When federal law required a railroad to quote rates to shippers and the railroad quoted the wrong rates, which quote caused injury to the plaintiff, it was held that there may be a cause of action in negligence and

267 McDougal, supra note 28, at 94. Note that if the account is organized as a unit investment trust there is no requirement for an advisory and underwriting contract between the account and the insurance company. The advisory and underwriting contracts are between the insurance company or its designate and the fund.

268 § 15(a), 15 U.S.C.A. § 80a-15(a); § 2(a)(4), 15 U.S.C.A. § 80a-2(a)(4) (1971). See also Willheim v. Murchinson, 342 F.2d 33 (2d Cir. 1965): change of control in the publicly held investment adviser, as a result of proxy solicitation, was not an assignment.

269 220 F. Supp. 527 (D. Colo. 1963).

270 Id. at 532. Relief was granted on the basis of these allegations. Id. at 550-51. For another example of allegations based on breach of contract see Arnold Berenhand & Co. v. Keystone Custodian Funds, Inc., 92 Sec. Reg. L. Rep. at I-1 (BNA Mar. 10, 1971).

271 Id. at 545. The court cited United States v. Essely, 284 F.2d 518 (10th Cir. 1960); Roosevelt Materials Co. v. Nolan Bros. Inc., 264 F.2d 807 (10th Cir. 1959). The court does not seem to be concerned with the question as to diversity jurisdiction. It apparently is of the opinion that all the issues, including the contract issue, are federal questions.

272 Id. at 532. State courts dealing with advisory contracts applied the 1940 Act. E.g., Coran v. Thorpe, 42 Del. Ch. 67, 203 A.2d 620 (1964); Kleinman v. Sauminsky, 41 Del. Ch. 572, 200 A.2d 572 (1964); Rome v. Archer, 41 Del. Ch. 404, 197 A.2d 49 (1964). However, the cause of action in these cases was based on the 1940 Act.

breach of contract under state law, but that no substantive right was created under federal law, since the injury was the result of negligence and breach of contract and not of the quote per se.[273] So also, it was held that an express congressional policy against racial discrimination was not sufficient to create a federal cause of action when a union interfered with a government contract in order to induce discrimination against the plaintiff. Congress has chosen a comprehensive scheme of regulation in this area but did not declare such an activity to be actionable.[274] On the other hand certain types of contracts have been held to be governed by federal law, such as contracts to which the United States was a party,[275] or contracts regarding which uniformity of treatment was peculiarly needed, such as labor contracts.[276] Although an investment advisory contract is required under the 1940 Act, the interests of the United States are not as vitally involved as in contracts to which the government is a party. The advisory contracts resemble contracts of national banks, which are governed by state law, subject only to an overriding federal policy.[277] Furthermore, no uniform law applies at present to advisory contracts of all other investment companies. The application of a uniform law to contracts of separate accounts will not achieve uniformity throughout the industry since separate accounts constitute only a small fraction of all investment companies. It may, therefore, be forcefully argued that the 1940 Act requires the writing of an advisory contract, but does not prohibit its breach except with respect to the mandatory conditions required by federal law. For the purposes of this discussion it will be assumed that the breach of an advisory contract may give rise to federal as well as state causes of action.

2. Prevailing Federal Law

As a matter of interpretation of the 1940 Act it may be argued that for the purposes of regulating and effectuating the policies of the Act, a separate account (i) will be deemed separate from the insurance company, (ii) will have capacity and power to enter into legally binding contracts and (iii) will have capacity to sue and be sued on the contracts. In other words, neither a federal nor a state claim on an advisory contract may be defeated because of lack of capacity of the account, or of the aggregate of contractholders, to sue and be sued on the contract.

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273 Eickhof Constr. Co. v. Great N. Ry. Co., 291 F. Supp. 44, 48 (D. Minn. 1968).

274 United States v. Building and Constr. Trades Council, 271 F. Supp. 447, 451-52 (E.D. Mo. 1966). This case dealt with the interpretation of the term substantive federal right under Rule 17(b) of the Federal Rules of Civil Procedure for the purpose of determining under this Rule a union's capacity to sue and be sued.

275 Clearfield Trust Co. v. United States, 318 U.S. 363, 366-67 (1943).

276 Textile Workers Union v. Lincoln Mills, 353 U.S. 448 (1957); H. Wellington, Labor and the Legal Process 98-100, 123-25 (1968). Uniformity is an implicit ground of the decision in Lincoln Mills. The decision has been criticized as "theoretically unsound." H. Wellington at 123-25.

277 See p. 288 infra, cf. litigation with respect to the Trust Indenture Act, regulating the provisions of certain trust indentures, 2 Loss at 740-42 n.63.

3. Cause of Action Based on a Federal Statute

When the cause of action is based on the 1940 Act, a federal court may seek to characterize the account, and through this characterization reach the question of capacity. It has been held than an account is a "fund," a "company," and therefore a "person" for the purposes of the 1940 Act. Whether this person is a corporate entity, or synonymous with the aggregate of the contractholders, or an unincorporated association, is a matter of substantive federal law. It was held that the Commission had power under section 25(a) of the 1934 Act to require, as one of the conditions for a permit to delist shares, that the shareholders approve the decision to delist, notwithstanding the fact that under the applicable state law the shareholders did not have voting rights. These rights were necessary in order to give effect to the policies of the 1934 Act.[278] By the same token the Commission, or perhaps the courts, may use state law to define "fund" under the 1940 Act[279] or may themselves provide an account with an organizational structure, especially when the provisions of state law are inadequate to give effect to the federal statute or are repugnant to federal law or policy.[280]

A federal court may be reluctant to take the characterization route. The 1940 Act, as was emphasized before, is not designed to provide a comprehensive structure for investment companies. Note also that the 1970 Act defines an account as established under state law. A federal court will therefore, in all probability, look directly at the question of capacity.

Capacity may be implied as a matter of federal law. Thus, in *Davis* v. *SEC* an unincorporated association was held amenable to process in a crimial contempt proceeding under the Securities Act of 1933 on the ground that associations are included in the definition of a "person" under the Act and therefore "amenable to the provisions of the Act the same as though incorporated."[281]

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278 Shawmut Ass'n v. SEC, 146 F.2d 791 (1st Cir. 1945).

279 See generally Note, Interaction of National and State-Created Interests in Non-Diversity Fields, 47 Colum. L. Rev. 629 (1947): "[S]o long as the federal statute provides no national definitions, or does not obviously require that a national definition be adopted to effectuate the national legislative purpose, the state-created interests which form the foundation upon which the federal rights act should be applied as state law has defined them." Id. at 632.

280 See generally 1A J. Moore, Federal Practice ¶ 0.325 (2d ed. 1965).

281 109 F.2d 6 (7th Cir.), cert. denied, 309 U.S. 687 (1940). See also SEC v. Universal Serv. Ass'n, 106 F.2d 232 (7th Cir.), cert. denied, 308 U.S. 622 (1940). In this earlier case which dealt with the same defendant, the court declined to rule on this point in connection with the responsibility of fraudulent promoters of an unincorporated association to their investors. A year later the court made such a ruling in connection with the question of ownership of books and records of the association. See also Ripply v. Denver United States Nat'l Bank, 260 F. Supp. 704, 714-15 (D. Colo. 1966) in which the term "association" in the Securities Exchange Act of 1934 was interpreted without resort to state law. A common law trust was held not to be an association, by analogy to the provisions of the Securities Act of 1933.

4. Rule 17(b)

Capacity may also be treated as a matter of procedure regulated by Rule 17(b) of the Federal Rules of Civil Procedure.[282] The Rule provides that:

> The capacity of an individual, other than one acting in a representative capacity, to sue or be sued shall be determined by the law of his domicile. The capacity of a corporation to sue or be sued shall be determined by the law under which it was organized. In all other cases capacity to sue or be sued shall be determined by the law of the state in which the district court is held, except (1) that a partnership or other unincorporated association, which has no such capacity by the law of such state, may sue or be sued in its common name for the purpose of enforcing for or against it a substantive right existing under the Constitution or laws of the United States, and (2) that the capacity of a receiver appointed by a court of the United States to sue or be sued in a court of the United States is governed by Title 28, U.S.C., §§ 754 and 959(a).

It is not clear if federal or state law governs the question of whether the account should be deemed an "unincorporated association," or an "individual" or a "corporation" or if it falls within the "all other cases" of Rule 17(b). In *Pavlovscak* v. *Lewis*[283] the Third Circuit, in a diversity suit based on state law, characterized a sui generis fund created pursuant to a federal statute according to the state law of the forum, then proceeded to apply the law of the forum to the fund's capacity under Rule 17(b). On the other hand, a district court in Virginia examined federal authorities to classify this very fund under Rule 17(b) and concluded that under state and federal law the fund was a trust, and not an unincorporated association.[284] An interpretation of a federal procedural rule, which might lead to different results in state courts and in federal courts sitting in diversity jurisdiction raises very difficult questions[285] under the *Erie* doctrine. In a federal court dealing with a federal question this problem does not exist. With respect to classification and capacity of the account, Rule 17(b) ought to be interpreted as a matter of federal law. Even when Rule 17(b) applies state law, that law will yield when it is repugnant to the substance or policy of a federal statute. Thus, in *Miller* v. *Steinbach*,[286] a federal court dealing with a cause of action under the Securities Exchange Act of 1934 granted to a merged corporation and its stockholder capacity to sue, even though under the applicable state law, pursuant to the federal procedural rules, the cor-

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282 The Rule incorporates the decision in United Mine Workers v. Coronado Co., 259 U.S. 344 (1922). See also E. Warren, Corporate Advantages Without Incorporation 648-66 (1929).

283 274 F.2d 523, 527 (3rd Cir. 1959).

284 Yonce v. Miners Memorial Hosp. Ass'n, 161 F. Supp. 178, 186-87 (W.D. Va. 1958).

285 Underwood v. Maloney, 256 F.2d 334, 337-38 (3d Cir. 1958). Criticized 3A J. Moore, Federal Practice ¶ 17.25, at 860-63 (2d ed. 1970); also criticized in Note, The Problem of Capacity in Union Suits: A Potpourri of Erie, Diversity and the Federal Rules of Civil Procedure, 68 Yale L.J. 1182 (1959).

286 268 F. Supp. 255, 268 (S.D.N.Y. 1967). To the same effect: Sonnenschein v. Evans, 21 N.Y.2d 563, 236 N.E.2d 846, 848 (1968).

poration and the stockholder lacked capacity. The court reasoned that federal policy of the Act prevailed. The court distinguished cases to the contrary on the ground that in those cases jurisdiction was based on diversity (and presumably the claim was based on state law).

5. Cause of Action Based on State Law—In State Courts

A state court will apply state law to a state-created cause of action as well as to the question of characterization and capacity of the account. It is hard to predict whether state courts will interpret state law as granting the account capacity to sue and be sued. Wisconsin, Pennsylvania,[287] and California[288] might conceivably accord the account capacity. In *Teubert v. Wisconsin Interscholastic Athletic Association*,[289] for example, the Supreme Court of Wisconsin dealt with a "plan" established under a statute and offered by an unincorporated association. The "plan" had capacity to enter into contracts and become legally liable under the constituting statute. The offering association represented to the purchasers that it would be liable for all the plan's obligations. The court held that the association was suable, by implication from the statute, and that the judgment against the association could be satisfied from the assets of the "plan," also by implication from the statute. Some jurisdictions might classify the account as an unincorporated association and refuse or grant the account capacity to sue and be sued as such.[290] Other jurisdictions might interpret the insurance statutes to preclude the existence of an account as a separate entity, but may permit contractholders to proceed in a class action that might achieve the same results as an action by the account.[291]

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287 Perhaps an account established outside Pennsylvania will be classified in that state as a "foreign 'corporation or similar entity,'" as was the fund in Pavlovscak v. Lewis, 274 F.2d 523 (3d Cir. 1959).

288 See Daniels v. Sanitarium Ass'n Inc., 59 Cal. 2d 602, 603, 381 P.2d 652, 653, 30 Cal. Rptr. 828, 829 (1963). A trade union may sue as an entity (and be defamed as an entity), even without enabling legislation.

289 8 Wis. 2d 393, 99 N.W.2d 100 (1959).

290 At common law an association is not an entity, has no existence independent of its members, has no capacity to contract to take, to hold or transfer property or to sue or to be sued. Rights and obligations running to the association reach its members; property conveyed to it vests in the members; obligations undertaken by it are borne by the members. Venus Lodge No. 62 v. Acme Benevolent Ass'n, 231 N.C. 522, 58 S.E.2d 109 (1950). See also Hecht v. Malley, 265 U.S. 144 (1924); Business Realty, Inc. v. Noah's Dove Lodge No. 20, 375 S.W.2d 389 (Ky. App. 1964). The Supreme Court has adopted the same common law rule. Moffat Tunnel League v. United States, 289 U.S. 113, 118-19 (1933). The general rule has been qualified by legislative provisions designed to alleviate some of the hardships it has created, especially with respect to the capacity of the association to sue and to be sued. E.g., N.J. Stat. Ann. § 2A:64-1 (1952); N.Y. Gen. Ass'ns Law § 12 (McKinney 1942). For a general discussion of the problem see E. Warren, Corporate Advantages Without Incorporation 648-69 (1929); Shockley, Suability of Unincorporated Associations in Indiana, 16 Ind. L.J. 575 (1941); Comment, Enforcing a Contractual Claim Against an Unicorporated Association in Wisconsin, 1960 Wis. L. Rev. 444; Developments in the Law—Judicial Control of Actions of Private Associations, 76 Harv. L. Rev. 983, 1080-1100 (1963).

291 Calagaz v. Calhoon, 309 F.2d 248 (5th Cir. 1962); Kimball v. Whitney, 233 Mass. 321, 123 N.E. 665 (1919). See also Chastain v. Baxter, 139 Kan. 381, 31 P.2d 21 (1934);

If state laws conflict with the overriding federal policy to accord accounts capacity, state laws must yield to federal considerations. Analogies may be drawn from the jurisprudence developed with respect to national banks. National banks are creatures of federal law. Federal law has provided for the constitution of national banks and their operation.[292] Yet in their daily operations national banks are subject to state laws to a greater extent than to federal law:[293] "All their contracts are governed and construed by State laws. Their acquisition and transfer of property, their right to collect their debts, and their liability to be sued for debts, are all based on State law." State laws are applicable to the dealings and contracts of national banks,[294] except when "they expressly conflict with the laws of the United States or frustrate the purpose for which the national banks were created, or impair their efficiency to discharge the duties imposed upon them by the law of the United States."[295] It is only when the state laws incapacitate national banks from discharging their duties to the government that state laws become unconstitutional.[296] Therefore, a New York statute that requires foreign corporations to qualify to do business in New York would have been unconstitutional had it been interpreted to require national banks to qualify as a prerequisite to suing in state courts.[297]

Separate accounts are distinguishable from national banks in that federal law did not provide for them the same comprehensive scheme for regulation and organization as it did for national banks. The Investment Company Act superimposes on a pre-existing organizational structure certain conditions and requirements, but no more. Congress did not preempt the field of capacity of investment companies to sue and be sued when it enacted the 1940 Act. These distinctions do not, however, affect the principle that state law yields if a conflict exists between state and federal law.[298] Separate accounts will have capacity to sue and be sued in state courts on advisory contracts, as a matter of federal law, except, perhaps, when state law prescribes alternative procedures that will provide the

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1 W. Fletcher § 21; 3A J. Moore, Federal Practice ¶ 17.25 n.5, at 851 (2d ed. 1970); E. Warren, Corporate Advantages Without Incorporation 648, 665, 668 (1929); Comment, Enforcing a Contractual Claim Against an Unincorporated Association in Wisconsin, 1960 Wis. L. Rev. 444, 451; N.J. Stat. Ann. § 2A:64-1 (1952); N.Y. Gen. Ass'ns Law §§ 12, 16 (McKinney 1942); Ohio Rev. Code Ann. ch. 1745 (1964).

292 12 U.S.C. § 21 (1964).

293 National Bank v. Commonwealth, 76 U.S. (9 Wall.) 353, 362 (1869). This case dealt with the power of states to tax a national bank's shares, as distinguished from capital. The rationale expressed there has been applied in other contexts.

294 McClellan v. Chipman, 164 U.S. 347, 357-58 (1896). A state law invalidating preferences by debtors made in contemplation of insolvency did not conflict with the federal Bank Conservation Act, 12 U.S.C. § 21 et seq. (1964). The state statute was held not to impair the efficiency of national banks or frustrate the purposes of the federal act.

295 McClellan v. Chipman, 164 U.S. 347, 357 (1896). See also Fitzgerald v. Catherwood, 388 F.2d 400, 405 (2d Cir.), cert. denied, 391 U.S. 934 (1968); State v. University of Maine, 266 A.2d 863, 865-66 (Me. 1970).

296 State Nat'l Bank of Conn. v. Laura, 45 Misc. 2d 430, 256 N.Y.S.2d 1004 (1965).

297 Id.

298 See note 295 supra.

same result as if the account itself had capacity to sue and be sued, such as a class action.

6. Class Action in State Courts

No thorough study of class actions under state laws is intended here. It should be noted that in order to provide a satisfactory alternative to a suit by the account a judgment in a class action must be capable of being satisfied from the assets of the account.[299] If the account is deemed to be beneficially owned by the contractholders, and the insurance company holds the assets as a trustee,[300] then a judgment creditor could, perhaps, reach the assets through the contractholders. But if these assets are owned under state insurance law by the insurance company and not held by it as a trustee,[301] and if the contractholders are deemed to have only a security interest in the assets, query whether a judgment debtor can satisfy his claim from the assets.

If state law does not afford capacity to the account, nor permit contractholders to sue on the advisory contract derivatively or as a class, federal law should apply. Federal law would either provide some characteristics to the account from which state law could then derive capacity,[302] or it may

299 See, e.g., Benz v. Compania Naviera Hidalgo, 233 F.2d 62, 67 (9th Cir. 1956). A federal court sitting in diversity jurisdiction followed Oregon law that an unincorporated association cannot be sued in its name and that a judgment against members of the association cannot be satisfied from the assets of the association. Contra, Thomas v. Dean, 245 Ark. 446, 432 S.W.2d 771 (1968). The Supreme Court of Arkansas entertained a class action against members of an unincorporated association, permitted a judgment to be satisfied from the assets of the association and restricted the execution of the judgment to these assets. See also Massey v. Rogers, 232 Ark. 110, 334 S.W.2d 664 (1960); Executive Committee of French Opera Trades Ball v. Tarrant, 164 La. 83, 113 So. 774 (1927).

300 See, e.g., Iowa Code Ann. § 508.32 (Supp. 1971); Wis. Stat. Ann. § 206.39 (Supp. 1971).

301 See note 57 supra.

302 The account can be deemed a corporate entity, a rib extracted from the insurance company and molded in its image, though smaller and more limited. It can then be argued that the account entered into an advisory contract through its representatives, the board of directors. Since this board is elected by the contractholders, the latter may, under the circumstances prescribed for shareholder derivative suits, step into the shoes of the board of directors and represent the account in the suit. This theory conflicts with state law because it assumes that the account has a separate existence. Alternatively, the account may be deemed to have no separate existence, but the aggregate of the contractholders may be synonymous with the account and with the investment company, an unincorporated association. This theory does not conflict with state law. It raises problems under the 1940 Act because, as was earlier concluded, the account, not the contractholders, is the investment company. It may be argued, however, that for the purposes of capacity to sue and be sued, as distinct from the purposes of regulation, the account and the contractholders are one. Another alternative is to adopt the traditional insurance view, that the rights of contractholders are based on their individual contracts with the insurance company. Finnegan & Garner, note 90 supra, at 116: "A variable annuity contract is just that—a contract between the annuitant and the insurer . . . . In contrast, the mutual fund shareholder is an equity owner of the fund . . . . There is no contractual relationship between the shareholder and the investment manager." This last theory does not recognize a separate existence for an account or an association or organization of contractholders. At the most the contractholders are a class

directly order state courts to recognize the capacity of the account. The grant of capacity is the simpler and better solution.

Finally, state laws might be interpreted to accord contractholders the capacity to sue as a class, or to sue derivatively for the aggregate of contractholders on the basis of state insurance law. Policyholder-members of mutual insurance companies are accorded voting rights and as a corollary and because of their interest in the management of the company they are usually permitted to sue derivatively for the insurance company.[303] By the same token, contractholders might be accorded, as voting-policyholders for the management of the account under state law, the right to sue derivatively, for the aggregate of the group of contractholders.

7. Class Action and Derivative Suits in Federal Courts

If the account is an unincorporated association contractholders may sue and be sued on the advisory contract under Rule 23.2 of the Federal Rules of Civil Procedure.[304] This action is a true class action since the contract was entered into with the aggregate of the contractholders through their representatives. A class action will also be available on causes of action, such as violation of voting rights, if the requirements of Rule 23 are satisfied.[305] Contractholders may perhaps sue derivatively under Rule 23.1, which expressly permits derivative actions by members of unincorporated associations.[306] If the cause of action is based on state law, and if state law

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having special voting rights to elect a special board. This theory conflicts with the 1940 Act because it ignores the advisory contract requirement.

303 In New York a policyholder in a mutual plan of a stock company may bring a derivative suit: Garfield v. Equitable Life Assurance Soc'y of the United States, 7 Misc. 2d 419, 164 N.Y.S.2d 823 (1957); Garfield v. Equitable Life Assurance Soc'y of the United States, 7 Misc. 2d 283, 164 N.Y.S.2d 819 (1956); Young v. Equitable Life Assurance Soc'y of the United States, 49 Misc. 347, 99 N.Y.S. 446 (1906); Young v. Hyde, 112 App. Div. 760, 98 N.Y.S. 1052 (1906). These decisions have been questioned and the issue was left undecided in a later case: Garfield v. Equitable Life Assurance Soc'y of the United States, 24 App. Div. 2d 74, 263 N.Y.S.2d 922 (1965). Policyholder-members of a mutual insurance company may sue for corporate waste: Imberman v. Alexander, 16 Misc. 2d 330, 184 N.Y.S.2d 801 (1959). Policyholders' derivative suits are analogous to stockholders' suits: Koster v. Lumbermens Mut. Co., 330 U.S. 518 (1947). The limitations on derivative suits by stockholders apply to policyholders. The stockholders must exhaust their intra-corporate remedies first: Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951): Young v. Hyde, 112 App. Div. 760, 98 N.Y.S. 1052 (1906): No demand need be made on directors because it would have been made on the same persons against whom the suit was brought. See also Amabile v. Lerner, 64 N.J. Super. 507, 166 A.2d 603 (1960): the New Jersey lower court held that the requirement of contemporaneous ownership under a state procedure rule identical with Federal Rule 23(b), applied to policyholders of mutual incorporated insurance companies. On appeal the decision was affirmed but on the ground that the "plaintiff failed to produce any facts which could withstand defendant's motion." 4 N.J. Super. 443, 181 A.2d 520, 521 (1962). In New York policyholders must also exhaust the administrative remedy afforded them and must first call upon the Superintendent of Insurance to exercise his rights. Clifford v. Metropolitan Life Ins. Co., 264 App. Div. 168, 34 N.Y.S.2d 693, 696 (1942). Policyholders suing derivatively must also overcome the presumption that the directors exercised their powers in good faith.

304 See generally 3B J. Moore, Federal Practice ¶ 23.2 (2d ed. 1969).

305 Id. ¶ 23.02-1, at 23-121 to -126.

306 For a case in which similar problems might arise see Guerrino v. Ohio Cas. Ins. Co., 423 F.2d 419 (3d Cir. 1970).

does not permit contractholders to sue derivatively, Rule 23.1 might, arguably, not apply in a federal court sitting in diversity jurisdiction.[307] If state law recognizes the existence of the aggregate of contractholders, then, arguably, each might sue derivatively on a state cause of action based on the advisory contracts. Diversity of citizenship will be achieved through the choice of plaintiffs-representatives.

Under state law the tendency is to consider the rights of policyholders as based solely on their contracts. Therefore, in a class action on an individual annuity contract asserting, for example, a violation of voting rights, plaintiffs will probably not be permitted to aggregate their claims for the purpose of achieving the jurisdictional amount.[308] However, the special rights of contractholders in the account might bring them in closer analogy

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307 See 3B J. Moore, Federal Practice ¶ 23.1.17, at 23.1-154 to -155 (2d ed. 1969). The question of who is a stockholder might be regarded as a matter of substantive law and arguably Federal Rule 23.1 must then yield to state law. By the same token whether the account is an entity might well be a question of substantive law.

308 In 1969 the Supreme Court held that the new Rule 23 did not change previous decisions that actions characterized under the old Rule as spurious class actions cannot be aggregated to make up the required jurisdictional amount and are treated as joint actions, Snyder v. Harris, 394 U.S. 332 (1969); see Clark v. Paul Gray, Inc., 306 U.S. 583 (1939); Pinel v. Pinel, 240 U.S. 594 (1916); see also 3B J. Moore, Federal Practice ¶ 23.95, at 23-1855 (2d ed. 1969).

Under insurance concepts state courts may treat an action on the advisory contract as an action on the variable annuity contract. Andrews v. Equitable Life Assurance Soc'y of the United States, 124 F.2d 788, 790 (7th Cir. 1941), rehearing denied, cert. denied, 316 U.S. 682 (1942), citing Brown v. Equitable Life Assurance Soc'y of the United States, 142 F. 835 (C.C.S.D.N.Y. 1906), rev'd, 151 F. 1 (2d Cir. 1907), rev'd, 213 U.S. 25 (1909).

Claims based on insurance contracts are joint, not several. An action by policyholders to impress funds of an insurance company with a trust for the benefit of all policyholders was held to be separate and distinct, and could not be aggregated for the purpose of achieving minimum jurisdictional amount: Matlaw Corp. v. War Damage Corp., 7 F.R.D. 349, 532 (S.D. Ind.), aff'd, 164 F.2d 281 (7th Cir.), cert. denied, 333 U.S. 863 (1947). The court distinguished this case from a suit by a beneficiary to protect the property of an established trust. Boesenberg v. Chicago Title and Trust Co., 128 F.2d 245 (7th Cir. 1942): A derivative shareholder suit was distinguished from a policyholder's suit on the same ground. Clark v. Lincoln Liberty Life Ins. Co., 139 Neb. 65, 296 N.W. 449 (1941). The right to aggregate claims depends on whether the policyholder has an interest in the assets that fund his policy. In jurisdictions that deem the surplus of a mutual company or mutual plan a trust for the benefit of policyholders, a true class action regarding the reserves can be brought. But these jurisdictions are few. See Troup v. McCart, 238 F.2d 289 (5th Cir. 1956), rehearing denied, (Feb. 15, 1957); Hughes v. Encyclopaedia Britannica, 199 F.2d 295, 299-300 (7th Cir. 1952). See also Eberhard v. Northwestern Mut. Life Ins. Co., 241 F. 353, 355 (6th Cir. 1917). "The policy is an agreement to pay its holder a computable sum of money upon certain conditions. His interest does not depend upon, and is not related to, the interest of any other policyholder similarly situated. True, there is some relation between the total number of qualified policy-holders and the amount each will receive, but this mutual relationship is remote from that common interest which requires the claims of all to be jointly litigated . . . . The rights of the policy-holders are not derived from the same, or a common, title. The right each has in the fund is based upon the separate, distinct contract each has with the company with respect thereto. The sole matter in dispute is between the defendant and each complainant as to the amount the latter shall recover. . . . The policyholders' claims to the fund are several, and not joint . . . ." Id. at 355-56. To the same effect, Alvarez v. Pan American Life Ins. Co., 375 F.2d 992 (5th Cir.), cert. denied, 389 U.S. 827 (1967); accord, Snyder v. Harris, 390 F.2d 204 (8th Cir. 1968), aff'd, 394 U.S. 332 (1969).

to shareholders[309] and their claims may be considered joint for the purpose of aggregation.[310]

8. Citizenship in Diversity Jurisdiction

Other than in class actions or derivative suits diversity jurisdiction will hardly ever be achieved in suits in which the separate account is a party. If the state law of the forum does not grant the account capacity, the account will probably not have capacity to sue or be sued in federal court sitting in diversity under Rule 17(b). If state law grants the account capacity to sue and be sued, whether on its own terms or because it is constrained to do so under federal law, federal courts will follow suit. The question of citizenship, however, is a matter of federal law.[311] The citizenship of the account may be that of the insurance company or its contractholders, or its board of directors. In our hypothetical litigation if the board memberships' citizenship is decisive, diversity might sometimes be achieved. If the contractholders' citizenship is determinative, diversity will hardly be achieved. If the insurance company's citizenship is adopted, diversity will never be achieved. Even if the account is deemed a corporation under federal law, its state citizenship would be in doubt.[312]

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309 Pomerantz v. Clark, 101 F. Supp. 341, 345 (D. Mass. 1951): "Nothing of legal significance in this case is to be attributed to the mere fact that plaintiff is a policyholder rather than a shareholder. He has voting rights . . . [a]nd his rights to bring a derivative action on behalf of his corporation are parallel to a shareholder's rights to bring a like action." Judge Wyzanski also saw no difference between a stock company and a mutual company. See also Schwartz v. Kemper, 69 F. Supp. 152 (N.D. Ill. 1946).

310 See generally 18 Appleman § 10048.

311 H. Hart & H. Wechsler, The Federal Courts and the Federal System 917 (1953); United Steelworkers of America v. R.H. Bouligny, Inc., 382 U.S. 145, 152-53 (1965); see Note, Diversity Jurisdiction for Unincorporated Associations, 75 Yale L.J. 138 (1965), dealing with history of the case.

312 The account can arguably be deemed to be a corporation. 28 U.S.C. § 1332(c) (1964) provides, among other things, that for the purpose of diversity "a corporation shall be deemed a citizen of any State by which it has been incorporated and of the State where it has its principal place of business. . . ." It seems that the term "corporation" in this section does not embrace an entity that has only some of the attributes of a corporation for some purposes, but that has not been incorporated. Even if the separate account is a corporation (see note 76 supra), its citizenship is not clear. If the account is considered to be incorporated under the laws of the United States, it is a citizen of the United States, but not necessarily of any particular state. Federal Intermediate Credit Bank v. Mitchell, 277 U.S. 213 (1928). Even if the federal act under which the corporation was incorporated authorized it to transact its business in several states, the corporation does not acquire thereby the citizenship of those states. First Carolinas Joint Stock Land Bank v. New York Title & Mortgage Co., 59 F.2d 350 (E.D.S.C. 1932). But if the federal act provides that the corporation shall be doing business or have offices in a particular state, the corporation is deemed to be a citizen of that state. Rice v. Disabled American Veterans, 295 F. Supp. 131 (D.D.C. 1968). The mere fact that the principal place of business of a federal corporation is in a particular state, does not bestow upon it the citizenship of that state, if the federal act which incorporated it is silent regarding this question. Id. at 133. Further, a corporation does not acquire citizenship by having a place where the principal business is carried on if the corporation did not incorporate under the laws of any state. Id. In the case of separate accounts Congress did not provide for a locality in which they must operate. But the 1970 Act defines an account as an account "established" under the laws of a state. See p. 247 supra. The term "established"

V. Capital Structure: The Security

A. *Accumulation and Annuity Units*

The combination of the 1940 Act and state insurance law also governs the account's capital structure. This structure illustrates the difficulties of accommodating a corporation-oriented legislation to an insurance arrangement. The capital structure also demonstrates that with some adjustments the 1940 Act can be applied to insurance arrangements.

A separate account is an issuer of "interests" contained in variable annuities. These "interests" are described in variable annuity contracts as "units" and are divided into accumulation units and annuity units.[313] Generally these units are described in prospectuses and variable annuity contracts as an accounting method or units of measurement that are credited to or provided for contractholders.[314] The difference between an accumulation unit and an annuity unit reflects the difference between the two parts of the variable annuity contract, the pay-in and pay-out periods. In the pay-in period the contractholder accumulates, by installment payments, the amount required to purchase an annuity. In a fixed-dollar deferred annuity the pay-in period resembles a savings account. In a variable annuity the pay-in period resembles an accumulation of shares in a mutual fund. In both cases the amounts that the insurance company must set aside

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is closer to the concept of incorporation than to the place of conduct of business. This is doubly true when the state of establishment regulates the business of the entity. The account could therefore be said to be incorporated under the 1940 Act, established under state law and a citizen of that state.

313 See Part I, p. 183, supra.

314 See, e.g., Specimen Contract, The Paul Revere Variable Annuity Ins. Co. at 2. Prospectus, The Paul Revere Variable Annuity Contract Accumulation Fund, Individual Variable Annuity Contracts at 11, 13 (May 19, 1966). An Accumulation Unit is defined as "the measure of value of the share of the annuitant in the Accumulation Fund prior to the variable annuity commencement date . . . ." Id. at 11. An Annuity Unit is defined as the "measure of the value of the annuitant's variable income from a variable annuity contract on and after the annuity commencement date . . . ." Id. at 13. The prospectus of National Variable Annuity Co. of Florida Separate Account issuing individual variable annuities defines an Accumulation Unit as "[a]n accounting method used to measure the value of a Participant's account before annuity payments begin." Prospectus, National Variable Annuity Co. of Florida Separate Account at 2 (Apr. 30, 1968). The prospectus uses the term "credited" to describe the transaction of accumulation units by annuitants. Id. at 11. An Annuity Unit is defined as "[a]n accounting method used to calculate the amount of annuity payments." Id. at 2. American Republic Assurance Co. Separate Account B in its prospectus defines an Accumulation Unit as "[a] measurement of value used to reflect the interest which the Contract Owner or Annuitant has in Separate Account B prior to the time annuity payments begin." And Annuity Units are defined as "[a] measurement of value used to reflect the interest which the Contract Owner or Annuitant has in Separate Account B after the time annuity payments begin." Prospectus, American Republic Assurance Co. Separate Account B at 2 (Nov. 15, 1968). Preliminary Prospectus dated Aug. 27, 1970, Metropolitan Variable Account B at 9 describes an accumulation unit "an accounting unit of measurement used in determining value under a Contract in relation to the investment experience of the Account during the Accumulation Period." An annuity unit is described as "an accounting unit of measurement used in determining variable annuity payments from month to month in relation to the investment experience of the account." The Accumulation Units are "credited" to the contractholder.

—the reserves—are the amounts paid to the insurance company by the contractholder, minus charges, and allocated to the account. In a fixed-dollar annuity these amounts are augmented by a fixed interest. In a variable annuity these amounts vary with the investment performance of the reserves. There is no insurance arrangement in the pay-in period.

In the pay-out period in a conventional annuity the contractholder receives periodically a fixed-dollar payment. The reserves backing the pay-out period are different from the reserves in the pay-in period, first, because they are calculated according to mortality tables and depend on the age and sex of the contractholder; second, because these reserves change periodically and diminish as the contractholder grows older; and third, because although one can isolate the reserve backing one annuity contract at any particular moment, this reserve is meaningless unless it forms a part of the liabilities to the contractholders as a group. The aggregate payments comprising the annuity that a contractholder may be paid throughout his life is not, except by accident, equal to the amount that he had paid for the annuity, nor to the amount of reserve of his annuity at any particular moment, nor the average of the reserves of his annuity throughout the pay-out period. In short, there is no way to relate the aggregate payments of the annuity to the assets of the account reserved for the pay-out period. In *Prudential* the Commission equated a contractholder in the pay-out period with an investor "in a closed-end company, except that life contingencies affect the measure and duration of his interest."[315] The interest of an investor at the pay-out period is a claim to periodic payments so long as he lives, rather than an interest in an uncertain number of units made certain retroactively at death.

An annuity unit, therefore, relates only to each periodic annuity payment but not to the assets of the account. An accumulation unit, on the other hand, may relate not only to each payment that the contractholder makes to the insurance company, but also represents a pro-rata share in a part of the assets of the account, namely, the part that funds the aggregate number of accumulation units. Accumulation units and annuity units serve essentially the same purpose. They are devices by which the investment performance of the assets accumulated by the contractholder in the pay-in period, and of the reserves of the pay-out period, can be measured and reflected in the payments that the insurance company makes to the contractholder.

Because the value of the assets funding accumulation units equals the value of the units, accumulation units may be valued like shares in a mutual fund. The assets of the account covering the accumulation units can be divided by the aggregate number of accumulation units to give the value of one share, one accumulation unit. This method cannot be used to value annuity units, unless the reserves are always translated into units. In addition, the value of annuity units is adjusted to "squeeze out" the as-

315 In re Prudential Ins. Co. of America, 41 S.E.C. 335, 348 n.30 (1963).

sumed interest rate built into the calculation of the initial annuity payment. This creates a difference between the value of accumulation and annuity units, even if both started with the same basic amount, and the difference will continue to grow. A few companies use the investment-company method of calculation. The accumulation unit value is established by dividing the assets covering the accumulation units by the number of these units at every valuation date. Annuity units are then adjusted to "squeeze out" the assumed interest. Most companies, however, use another system of valuation. When the fund is established, accumulation units and annuity units are both given arbitrary values. These values need not be the same. The net payments of contractholders are then applied to "purchase" accumulation units. These payments are invested in equity securities. In order to measure the investment performance of the fund, the most recently established value of the unit is multiplied by an investment factor. This factor is determined by dividing the net investment income of the fund accumulated as of the last valuation date by the net value of the assets of the fund at the beginning of the valuation period, and adding 1.000000 to it. Net investment income is all income, including capital gains, during the valuation period, minus all capital losses and all expenses charged to the fund. Such expenses include payments for the mortality and expense guarantees, management fees and taxes charged to that period. The net value of the assets is the value of the assets minus liabilities.[316] Both methods of valuing the units produce essentially the same result.

The account may fund a variety of contracts other than variable annuities. Some of these contracts may have insurance components and others may not.[317] Accumulation units can be used for the non-insurance part of these contracts, if severable. But the annuity units cannot always be used for the part of the contracts that contains an insurance arrangement. They may have to be adjusted according to the terms of these contracts, which may result in different values.

This discussion shows that accumulation and annuity units are not only accounting measures. They may represent rights in the assets of the account. They may also be used to measure amounts due to contractholders as shares are used to determine amounts due to their holders. Accumulation units and annuity units differ in the kind of rights that they represent. Accumulation units may represent debt or equity investments. Annuity units represent essentially a debt. Therefore, accumulation units could represent property rights in the assets of an account whereas annuity units may represent only a security interest in these assets.[318]

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[316] See, e.g., New York Life Separate Account Q, Registration Statement of Unit Investment Trust, amend. 1, at 61, file 811-2000 (1971).

[317] A number of insurance companies offer formally or informally the right to use the proceeds of a policy for any other contract that the company may then offer. 4 Loss at 2524 (Supp. 1969).

[318] Under the 1940 Act both types of units must have equal rights in the assets. See p. 297 infra.

B. *The Insurance Company's Powers Regarding the Terms of the Account's Securities and Its Capital Structure*

The variable annuity in the pay-in period can be characterized as a share in a mutual fund. In the pay-out period it is an investment contract based on an insurance arrangement. How much is due under the contract is first determined by the agreement between the insurance company and the insured, and then adjusted according to the investment performance of the assets in the account. This adjustment changes the contract into a security and creates the additional security issued by the account. Thus, to a great extent, the insurance company determines the terms and conditions of the securities issued by the account since they are insurance obligations that shift the investment risk to the insured. The insurance company has all powers regarding the capital structure of the account that are not expressly reserved to contractholders. The company may effectuate any change in the capital structure that is not expressly prohibited under the 1940 Act. Thus, under one prospectus, the insurance company, at its discretion, may effect a split in the value of "[t]he accumulation unit, annuity unit, or both, if such is deemed to be in the best interests of . . . ." contractholders, provided strict equity is preserved and no material effect upon "benefits," provisions, or investment return of the contract results from the split.[319] The power of the insurance company with regard to matters that are usually reserved to shareholders is justified when the matters affect the insurance arrangement in the annuity and do not affect the contractholders. Since the units in the account are not traded and the amount of the units affects calculation of payments under the annuity contracts it is arguable that the insurance company should retain power to change the amounts of the units, split or combine them. It is arguable, on the other hand, that such changes may affect contractholders and may prove misleading. Here again, the security and insurance arrangements overlap. The unit value determines the payment of insurance as well as investment promises. Viewed as policyholders of the insurance company, contractholders should not have a say in the matter unless the 1940 Act so requires. Viewed as security holders, contractholders might have the right to a say in the capital structure of their investment company.

In summary, accumulation units can be accumulated, like shares, while annuity units cannot. The value of an accumulation unit is the sum paid for it as affected, positively or negatively, by the investment factor. The value of an annuity unit is the value of an accumulation unit with the assumed rate of interest "squeezed out."

The reserve of an accumulation unit corresponds to the sum paid for it as affected by the investment factor. The reserve of an annuity unit corresponds to the reserve of a fixed annuity at the time of purchase of such

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319 Prospectus, ISL Variable Annuity Fund B, Series B, at 10 (Apr. 21, 1970). See New York Life Separate Account Q, note 316 supra, at 20.

an annuity, as affected from year to year by appropriate insurance valuations and by the investment factor.

Finally, the "security" issued by the account is composed of two elements. The first is the basic amount to be paid under the variable annuity contract. This basic amount is affected by the second element, the investment factor, the result of the account's investment-business performance. Since the basic amount is determined by the insurance company and regulated by state insurance laws, some of the terms and conditions of the "security" and the number of "securities" issued by the account are determined by the insurance company and subject to state insurance laws.

C. *Voting Rights and Simple Capital Structure*

1. General

The Investment Company Act requires that securities issued by a registered management company shall have equal voting rights, with every other outstanding voting security.[320] Additionally, there is a virtual prohibition in the Act on the issuance of different classes of stock by an open-end investment company.[321] These companies may not issue debt securities at all. Closed-end companies are generally precluded from issuing debt securities unless they have an asset coverage of 300 percent, and cannot issue preferred stock unless the stock has an asset coverage of at least 200 percent. They cannot issue more than one class of debt securities or more than one class of preferred stock.[322] Registered management companies are also prohibited from issuing warrants or rights to subscribe or purchase securities.[323]

The purposes of these provisions are to eliminate the complex capital structures and thin equity capitalizations of investment companies of the 1920's and 1930's, to preserve the financial integrity of open-end investment companies, and to prevent management from favoring one group of shareholders over another.[324]

2. Different "Classes" of Interests and Exemptions

Even though there are differences between accumulation units and annuity units these differences do not run afoul of the provisions of section

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320 § 18(i), 15 U.S.C.A. § 80a-18(i) (1971). There are a few exceptions not relevant in this context.

321 § 18(f)(1), 15 U.S.C.A. § 80a-18(f)(1) (1971). See SEC Investment Co. Growth Report, note 127 supra, at 67.

322 §§ 18(a), (c), 15 U.S.C.A. §§ 80a-18(a), (c) (1971). See SEC Investment Co. Growth Report, note 127 supra, at 67.

323 § 18(d), 15 U.S.C.A. § 80a-18(d) (1971). Note that the Commission, over the dissent of Commissioners Owen and Wheat, refused to grant Valic permission to issue stock options to its officers and employees, considering the equities of Valic's stockholders as well as its contractholders. Variable Annuity Life Ins. Co. of America, Inv. Co. Act Release No. 4686 (Aug. 25, 1966).

324 §§ 1(b)(4), (7), 15 U.S.C.A. §§ 80a-1(b)(4), (7) (1971).

18(f) of the 1940 Act,[325] prohibiting open-end investment companies from issuing senior securities, provided that accumulation and annuity units grant their holders equal rights in the assets of the account. Nor do the distinctions offend section 18(i) of the Act[326] providing equal voting rights because, with respect to voting rights, the two types of units are essentially equal.

The purposes of section 18 accord with state insurance statutes and policies. Those statutes are also aimed at preserving the integrity of management of insurance companies[327] and usually contain a specific prohibition against discrimination among policyholders.[328] Insurance companies may, subject to insurance statutes, issue a variety of contracts funded by separate accounts. Insurance statutes may allow companies to provide special rights in the assets of the separate account.[329] Under section 18 of the 1940 Act there can be no objection to funding a variety of contracts by separate accounts. However, no special rights in the assets may be given to a selected group of contractholders, and they must all have equal voting rights.

The Commission usually did not grant exemptions from the requirements of section 18. The Commission did grant Valic an exemption from the prohibition on issuing senior securities[330] by permitting it to issue variable annuities, even though the company had previously issued life insurance policies, which were senior to the annuities and could be paid from the reserves of the annuities. As a condition precedent, however, insurance risks arising from the life insurance policies and from annuity contracts had to be reinsured or co-insured, and Class A non-voting senior securities, which the company had issued, had to be eliminated.[331]

3. Voting Rights

Section 18(i) of the 1940 Act requires that all shares issued by a registered management company shall be voting and have equal voting rights except "when otherwise required by law," or permitted by the Commission. "Law" was interpreted to mean applicable state law.[332] Valic

325 See pp. 293-95 supra.

326 See p. 297 supra.

327 See generally J. Maclean, Life Insurance 591-95 (9th ed. 1962).

328 12 J. Appleman, Insurance Law and Practice §§ 7017-7019 (1943) [hereinafter cited as 12 Appleman].

329 See pp. 295-96 supra.

330 Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960).

331 Id. Some questioned the justification for the Commission's stringent conditions aimed at ensuring the financial integrity of Valic. Comment, Variable Annuities Exempted from Senior Securities Ban, 13 Stan. L. Rev. 412, 415-16 (1961). See also Comment, The Felxible Fund Annuity: VALIC Revisited, 115 U. Pa. L. Rev. 600, 607 n.35 (1967). With the benefit of hindsight, it is clear that the Commission's caution did not work hardship. Its conditions must have proven a valuable protection to the contractholders when Texas Ins. Co. acquired all Valic's assets and liabilities. See Variable Annuity Life Ins. Co. of America, Inv. Co. Act Release No. 5624 (Feb. 27, 1969). Note that accounts qualifying under § 3(a)(11) are fully exempt from the Act, including the provisions of § 18.

332 In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960); Variable Annuity Life Ins. Co. of America, Inv. Co. Act Release No. 4217 (Apr. 7, 1965).

had requested an order pursuant to section 18(i) to permit it to issue group variable annuity contracts in connection with the funding of employee pension or profit-sharing plans, under which the holders would not be entitled to equal voting rights with all other security holders of the company. It based its request on section 35-525 of the Insurance Act of the District of Columbia,[333] which provides that the employer in every group contract shall be deemed to be the policyholder and, if entitled to vote, "shall be entitled to one vote. . . ."[334] The Commission seemed to agree that the applicable law was the law of the state of incorporation of the company, but interpreted the language of section 18(i) "except . . . as otherwise required by law" very narrowly, to mean except where the state law prohibits equal voting rights.[335] Since the section in question had not been before the courts, the Commission denied an exemption, and suggested that the company seek judicial interpretation in state courts first.

If the account is organized as a unit investment trust the trustee or depositary, in most cases, the insurance company, must vote the shares of the underlying investment company according to the instructions of the contractholders. The insurance company must supply the voting contractholders or payees with periodic reports concerning the investment company and with proxy material and forms on which to give voting instructions.[336]

"Voting security" has been defined in the 1940 Act as a security "entitling the owner or holder thereof to vote for the election of directors of a company."[337] The terms "owner" and "holder" have not been defined. The question of the meaning of these words has arisen in connection with group contracts issued to a trustee or a custodian that involved payments by the beneficiaries. If no trustee or custodian is involved[338] then the beneficiaries are the owners or holders of the contract, presumably jointly. But if a trustee or custodian is appointed, the industry argued that the owner or holder of the contract is the trustee or custodian and not the bene-

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333 D.C. Code Encycl. Ann. § 35-525 (1968).

334 Id.

335 In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960): "if Section 35-525 prohibits equal voting rights . . . there is no conflict with Section 18(i) . . . ." Id. at 696.

336 The following is an excerpt from New York Life Separate Account Q, note 316 supra:

> While the Account is registered as a unit investment trust type of investment company under the Investment Company Act of 1940 and assets of the Account are invested in shares of the Fund, New York Life will, at meetings of shareholders of the Fund, vote shares of the Fund held in the Account representing the interests in the Account of owners of Contracts, and (when appropriate) payees under Contracts and payees under variable settlement options, in accordance with voting instructions from such owners and payees. New York Life will supply such owners and payees with periodic reports concerning the Fund and with proxy materials and forms on which to give voting instructions.
>
> Such voting instructions may be given in connection with the election of directors, the approval of the investment advisory agreement and amendments thereof, any change in the fundamental investment policies or investment restrictions, the ratification of the selection of independent public accountants and such other matters as the Investment Company Act of 1940 requires.

337 § 2(a)(42), 15 U.S.C.A. § 80a-2(a)(42) (1971).

338 Finnegan & Garner, supra note 90, at 130.

ficiaries.[339] The staff disagrees. It requires that when employees make substantial or not insignificant payments to the plan they must be given voting rights as holders or owners of a security.[340] In this case state law or contractual arrangements are not helpful to interpret federal law. Federal law gives those who have a financial stake in an investment company a right to a voice in the management of their funds. Therefore, if beneficiaries of the plan are investors they ought to be given a vote regardless of legal or beneficial ownership of the contract under state law.[341] The 1940 Act applies voting requirements to a common law trust, except to a trust that was established before the date of the Act,[342] even though under state law beneficiaries of a common law trust may have no power to remove their trustees.[343] Even if the principle that employees or participants in a plan have the right to vote is accepted, other questions remain. One is the minimum payment or status which entitles a participant to vote. This question might be best settled by a rule of thumb, through legislation. Another question is how should the trustees exercise their votes on behalf of the employees. The staff requires that the trustees vote as instructed by

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339 Id. at 131.

340 Id. See, e.g., New York Life Separate Account Q, note 316 supra, at 18-19:

The Annuitant under a Contract issued in connection with a tax sheltered annuity plan adopted pursuant to Section 403(b) of the Code will be the owner of the Contract and entitled to give such voting instructions. The Annuitant under a Contract issued in connection with an H.R.10 plan has the right to give such voting instructions, either directly to New York Life or to the owner of the Contract if he is not the owner.

Under qualified plans the Annuitant has the right before commencement of annuity payments to give voting instructions to the owner of the related Contract for the shares of the Fund attributable to his contributions, if any, under the plan and, after the commencement of such payments, the right to give voting instructions directly to New York Life or, if he does not become the owner of the Contract, to such owner, for the shares of the Fund representing his interest in the Account.

In cases where the Annuitant is not the owner of the Contract, New York Life will supply the owner with additional copies of the reports, proxy materials and forms for use in seeking such voting instructions. Neither New York Life, the Account, nor the Fund shall be under any duty to inquire concerning voting instructions received from owners of Contracts and such instructions shall be valid and effective for all purposes.

Under a deferred Contract, the number of votes for which voting instructions may be given during the accumulation period will be determined upon the basis of the number of variable accumulation units credited to the Contract. Under an immediate Contract, and under a deferred Contract after the commencement of variable annuity payment thereunder, or while payments are being made under a variable settlement option, the number of votes for which voting instructions may be given will be determined upon the basis of the amount of reserves in the Account attributable to such Contract or option divided by the value of a variable accumulation unit.

341 See, e.g., Mass. Gen. Laws ch. 175, § 132A(d) (Supp. 1971) that defines the "holder" of a group annuity contract as "the person, firm, association, corporation, trustee or trustees, or trade union or other association of wage workers . . . to whom or to which a group annuity contract is issued."

342 § 16(a), 15 U.S.C.A. § 80a-16(a) (1971).

343 "Unless the power to remove the trustee is conferred upon the beneficiaries by the terms of the trust, they cannot compel his removal merely because they wish him removed." 2 Scott on Trusts § 107.3 (3d ed. 1967). The power of removal is with the court. Id. §§ 107, 107.1.

the employees and if no instruction is given the trustee must vote against or for the proposal "in the same proportion as votes for which instructions have been received."[344] It has been suggested elsewhere that the proper procedure is for the trustee to cast all the votes in accordance with the instructions received from a majority of the employees.[345]

The voting requirement raised issues peculiar to the insurance aspect in variable annuities. In the pay-in period, when no insurance scheme is involved, the number of votes of each contractholder is calculated according to the number of units accumulated and credited to the contract. In the pay-out period this method is inappropriate. A conceptual compromise was reached. The number of votes which a contractholder possesses at a certain date is determined by dividing the reserves of the contract at that date by the then value of an accumulation unit.[346] Since the reserve changes constantly, a cut-off date is usually provided.[347] The number of votes under a contract in the pay-out period will, therefore, decrease from year to year. Generally, cumulative voting is not provided or authorized in separate accounts. Fractional shares are sometimes permitted to vote.[348]

It is submitted that the rules pertaining to elections, such as capacity to vote and voting rights of joint contractholders, should be governed by the 1940 Act and by state laws regulating voting rights of the shareholders or members of the sponsoring insurance company. Voting rights are provided in the annuity contracts. The insurance company provides voting rights by the authority of state law. The account provides voting rights in its securities, the same annuity contracts, by command of the 1940 Act. Therefore, these legal sources together with the account's Rules should govern.

An alternative source of law is the law of unincorporated associations in the state of establishment of the account. This source is inappropriate. With the exception of joint stock companies, most associations do not have the authority to issue stock. This alternative source is undeveloped, rarely used for business purposes and to the author's knowledge is never used for open-end investment companies.

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344 Middlebrook & Gingold, Mass Merchandising of Equity Products by Insurance Companies, 3 Conn. L. Rev. 44, 71 (1970) citing In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680 (1960). See also New York Life Separate Account Q, note 316 supra, at 19:

> New York Life will vote shares held in the Account for which no voting instructions are received in the same proportion as the shares for which voting instructions are received. It reserves the right to make any changes in the voting rights described above that may be permitted by the federal securities laws or regulations or interpretations under them.

345 Id. Again, a full exemption applies to qualified accounts described in § 3(c)(11), 15 U.S.C.A. § 80a-3(c)(11) (1971).

346 In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680, 695 n.19 (1960). See also 4 Loss at 2521 (Supp. 1969).

347 E.g., not more than 90 days before the meeting and not less than 20. Prospectus, National Variable Annuity Co. of Fla. Separate Account at 9 (Apr. 30, 1968).

348 E.g., id.

4. Voting Rights Under State Laws

If the insurance company that is issuing variable annuities is a mutual insurance company, the voting rights of contractholders as member-policyholders are usually preserved under state legislation.[349] California reserved voting rights of contractholders within the insurance company's corporate structure.[350] Florida left this decision to the insurance companies.[351] Many states remained silent, presumably retaining the status quo. This attitude is justified. Contractholders are granted the exclusive right to elect the board of directors of an account because they have a stake in, and bear the investment risk with respect to, the account. But they retain their interests and rights as policyholders of the mutual company and ought to have voting rights as to its management along with all other policyholders.

It should be noted that the grant of voting rights to contractholders, per se, does no violence to insurance practices. Member-policyholders of mutual insurance companies have voting rights.[352] Some states permit the grant of voting rights to participating policyholders.[353] These rights are granted on the ground that the risk of investment carries with it the right to control the management.[354]

The uniqueness of the separate account does not lie in the voting power of the contractholders. It lies in their right to elect a separate board. Yet a deviation from the insurance company's corporate norm[355] has been permitted by a number of state statutes.[356] The past eight years have shown that it is possible to conduct an insurance business through an account whose investment business is exclusively managed by a separate board.

349 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 94 (Supp. 1971).

350 Cal. Ins. Code § 10506(D) (West Supp. 1971).

351 Fla. Reg. § I(c)(4) (Nov. 14, 1961): "The by-laws of a company shall define the extent, method and manner, in which the variable annuity contract owner shall be entitled to vote at the meetings of company's stockholders."

352 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 94 (Supp. 1971).

353 See, e.g., N.Y. Ins. Law § 199.1 (McKinney 1966).

354 Pomerantz v. Clark, 101 F. Supp. 341 (D. Mass. 1951); Mass. Gen. Laws Ann. ch. 175, § 94 (Supp. 1971); 18 Appleman §§ 10041, 10047. Perhaps because of this principle voting policyholders, whether members of mutual insurance companies or participating policyholders, have less control over management than shareholders do. Hetherington, Fact v. Fiction: Who owns Mutual Insurance Companies, 1969 Wis. L. Rev. 1068. See also Note, Distribution of a Mutual Insurance Company's Assets Upon Dissolution, 19 Stan. L. Rev. 1046 (1967) for a discussion of the difficulties arising from the duality in the nature of mutual insurance companies membership. Policyholders' main interest is in the policies and not in any property rights in the assets of the insurance company. Lubin v. Equitable Life Assurance Soc'y of the United States, 326 Ill. App. 358, 61 N.E.2d 753 (1945).

355 See nn. 614, 615 infra.

356 Alas. Stat. § 21.42.370(b) (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651E (Supp. 1970); Ark. Stat. Ann. § 66-3524 (Supp. 1969); Cal. Ins. Code § 10506(D) (West Supp. 1971); Conn. Gen. Stat. Ann. § 38-154a(a) (1969); Del. Code Ann. tit. 18, § 2933(g) (1968); Ga. Code Ann. § 56-1040(D) (1971); Hawaii Rev. Stat. § 431-563(a)(6) (Supp. 1970); Idaho Code Ann. § 41-1936(7) (Supp. 1969); Ill. Ann. Stat. ch. 73, § 857.51(b) (Smith-Hurd Supp. 1971); Ind. Ann. Stat. § 39-3501(a) (Supp. 1970); Iowa Code Ann. § 508-32 (Supp. 1971); Kan. Stat. Ann. § 40-436(k) (Supp. 1970); La. Rev. Stat. Ann. § 22:1500(B) (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537(7) (1969); Mass. Gen. Laws Ann. ch. 175, § 132G

5. Solicitation of Proxies

Section 20(a) of the 1940 Act[357] prohibits the solicitation of proxies in contravention of the Commission's rules and regulations. Rule 20a-1[358] applies all the proxies rules of the Commission under section 14(a) of the 1934 Act to investment companies.[359] As mentioned, voting rights present great difficulties in connection with group contracts. The staff of the Commission is of the opinion that the beneficiaries who have made substantial contributions under these group contracts are security holders entitled to vote through the trustee or custodian. The insurance company must provide the trustee with all proxy material for distribution to beneficiaries.[360] There are no express rules imposing these requirements on the trustees and insurance companies. The staff, however, insists on compliance in connection with its clearance of proxy material.[361] One of the difficulties regarding this requirement is that the insurer does not have the power to force the trustee to disseminate information or vote according to instructions. The Commission seems to have realized that the legal power may not always exist but that the relationship between the insurance company and the trustee is such that a suggestion might be sufficient inducement to comply. Rule 6e-1(b), now superseded by the 1970 Act, is indicative of the Commission's view. It only required the insurance company to furnish the employer with material for distribution to employees. If solicitation is made on behalf of the management of the investment company, or by others with the investment adviser's consent (in our context, the insurance

(Supp. 1971); Mich. Comp. Laws Ann. § 500.925(3)(b) (Supp. 1971); Minn. Stat. Ann. § 61A.14.6 (Supp. 1971); Miss. Code Ann. § 5649-36 (Supp. 1970); Mo. Ann. Stat. § 376.309.3 (Supp. 1971); N.J. Stat. Ann. § 17:35A-9(b) (Supp. 1971); N.M. Stat. Ann. § 58-4-6.1(g) (Supp. 1969); N.Y. Ins. Law § 227.6 (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(k) (Supp. 1969); N.D. Cent. Code § 26-11.1-01-7 (Supp. 1971); Laws of Ohio bk. I, § 3907.15 (1969-1970); Okla. Stat. Ann. tit. 36, § 6061(i) (Supp. 1971); Pa. Stat. Ann. tit. 40, § 506.2(i) (Supp. 1971); R.I. Gen. Laws Ann. § 27-32-1(b) (Supp. 1970); S.C. Code Ann. § 37-333(l) (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-19 (Supp. 1971); Tenn. Code Ann. § 56-312 (Supp. 1970); Tex. Ins. Code art. 3.72, § 12 (Supp. 1971); Vt. Stat. Ann. § 3855(a)(7) (Supp. 1971); Va. Code Ann. § 38.1-443(g) (1970); Wash. Rev. Code Ann. § 48.18A.020(6) (Supp. 1970); Wis. Stat. Ann. § 206-385(5c) (Supp. 1971); Wyo. Stat. Ann. § 26.1-367(g) (1967).

[357] § 20(a), 15 U.S.C.A. § 80a-20(a) (1971). Section 14 of the 1934 Act, 15 U.S.C.A. § 78n (1964), does not apply to separate accounts because it covers only issuers subject to section 12 of the Act, 15 U.S.C.A. § 781 (1964) and subsection (g)(2)(B) of section 12 exempts investment companies registered under the 1940 Act which would have otherwise been subject to the section. Since sparate accounts do not issue securities which are traded on national exchanges, no other provision of section 12 applies to them.

[358] 17 C.F.R. § 270.20a-1 (1971).

[359] If the security is not registered on any national exchange the proxy material need not be filed with any exchange. Id.

[360] 17 C.F.R. § 270.14a-2 (1971). See also Rule 6e-1(b), 17 C.F.R. § 270.6e-1(b) (1971). This requirement is reminiscent of the first form of organization envisioned by the Commission, p. 262 supra, and is similar to that imposed on broker-dealers holding securities for customers under Rule 2752 of the New York Stock Exchange.

[361] For arguments against the "right to instruct" see Finnegan & Garner, note 90 supra, at 131-32.

company) or on its behalf, the investment adviser must submit to the management information about itself for publication in the proxy material. But no such duty exists if proxies are solicited by outsiders.

Proxy material must include information about the investment adviser and investment advisory contracts, transactions and interests by officers, directors[362] and nominees for election as directors of the investment company, or interest in any proposed transaction in which the investment adviser was a party.[363] The Commission granted, by order, an exemption from the proxy rules in a special case when it deemed that the protection afforded by the Act was not necessary, for example, when not more than fifteen institutions related to an insurance company through stock ownership or agreements concerning joint marketing efforts, planned to invest in a management non-diversified investment company to be established by the insurance company.[364]

The proxy rules do not present any conflict with insurance law. As of 1964, insurance companies who issue securities to more than 500 persons and who have assets of more than 1 million dollars must comply with the proxy rules or with comparable rules under state laws.[365]

D. *Limitation on Transferability*

An open-end registered investment company may not restrict the transferability of any security of which it is the issuer, except in conformity with the statements contained in its registration statement.[366] The Commission has granted individual exemptions from this requirement only when there is a complete individual exemption from the provisions of the Act.[367]

Variable annuity contracts are not uniform on the question of assignability. They usually permit assignment of the contract with the consent of the insurance company, and the subject is invariably treated in the registration statement, contracts and prospectuses,[368] thus fully complying with the 1940 Act's requirements. State insurance laws do not conflict with these disclosure requirements.

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362 17 C.F.R. § 270.20a-2 (1971).

363 2 CCH Fed. Sec. L. Rep., ¶ 24,038, Schedule 14A-Item 7 (1968).

364 In re America Group Companies Fund, Inv. Co. Act Release No. 5609 (Feb. 14, 1969) (notice of applicaiton for exemption).

365 15 U.S.C. § 78*l* (1964).

366 § 22(f), 15 U.S.C.A. § 80a-22(f) (1971).

367 In re General Elec. Co., [1967-1969 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,630 (SEC 1968).

368 See, e.g., Specimen Individual Annuity Contract, Horace Mann Life Ins. Co., at 5: "Assignment: Each certificate is not transferable and may not be sold, assigned, discounted or pledged as collateral for a loan . . . to any person other than the Company." Prospectus, National Variable Annuity Co. of Fla. Separate Account, Individual Variable Retirement Annuity Contracts at 10 (Apr. 30, 1968): "The contract may be assigned by the owner, except when issued to qualify under Sections 401 and 403 of the Internal Revenue Code. . . ."

E. *Mandatory Conditions Under the 1940 Act*

1. Redemption

As mentioned[369] the Investment Company Act divides investment companies into face-amount certificate companies, unit investment trusts, and management companies. Management companies are further divided into diversified and non-diversified companies, according to whether their portfolio investments are distributed among the securities of different issuers or not.[370] Management companies are also divided into open-end and closed-end companies, depending on whether or not they sell and issue redeemable securities.[371] The Commission in *Prudential* classified the interests issued by the account as securities, and the investment arrangements under variable annuity contracts as periodic payment plans.[372] The redemption feature is the earmark of an open-end management company and of a unit investment trust.[373] Securities issued by an investment company may be redeemable by their own terms, or if they are periodic payment plans, by virtue of a requirement in the Investment Company Act.[374]

The securities issued by separate accounts resemble, but do not fall within the definition of, redeemable securities under the 1940 Act. A redeemable security is a security "under the terms of which the holder, upon its presentation to the issuer . . . is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."[375] Accumulation units could be described as a proportionate share in the assets of the account, but only of that part of the assets that represents the aggregate value of all accumulation units.[376] Annuity units do not represent a right to a proportionate share of the account's assets or to any part of the assets. At any particular time and for a limited purpose,

369 See p. 261 supra.

370 § 5(b), 15 U.S.C.A. § 80a-5(b) (1971).

371 § 5(a), 15 U.S.C.A. § 80a-5(a) (1971).

372 In re Prudential Ins. Co. of America, 41 S.E.C. 335, 348 (1963). Superficially, variable anuities have some characteristics of face-amount certificates. The amount of a debt security need not be fixed, as long as it can be determined. See, Utah State Nat'l Bank v. Smith, 179 P. 160, 161 (Cal. 1919). A promissory note containing an acceleration clause, which meant that its maturity date was not certain was, nonetheless, a negotiable instrument. The court held that a "matter is determinable 'that may be accurately found out, settled, or determined' . . . That is, 'capable of being determined, definitely decided upon, decided upon or ended.'" Under the law conditioning negotiability on a determinable date of payment, the acceleration clause was found to be within that requirement. The argument that variable annuities are debt securities was not well received by the Supreme Court in SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 92 n.33 (1959) (Brennan, J., concurring). The industry did not request that variable annuities be classified as face-amount certificates, since their issuers are subject to stringent debt-equity ratio requirements. These requirements might also lead to the conclusion that Congress expected these companies to issue fixed-dollar obligations. See § 28, 15 U.S.C.A. § 80a-28 (1971).

373 § 4, 15 U.S.C.A. § 80a-4 (1971).

374 § 27(c)(1), 15 U.S.C.A. § 80a-27(c)(1) (1971).

375 § 2(a)(32), 15 U.S.C.A. § 80a-2(a)(32) (1971).

376 See p. 295 supra.

there may be a relationship between the assets in the account that represent the reserves and the annuity units that these reserves fund. But the relationship is not proportionate since the reserves depend on and change with the age of the contractholders. Neither of the units, therefore, fits the definition of a redeemable security.

2. Periodic Payment Plans

Another conceptual difficulty with variable annuity contracts arises from attempts to fit them into the definition of a periodic payment plan certificate.

> 'Periodic payment plan certificate' means (A) any certificate, investment contract, or other security providing for a series of periodic payments by the holder, and representing an undivided interest in certain specified securities or in a unit or fund of securities purchased wholly or partly with the proceeds of such payments, and (B) any security the issuer of which is also issuing securities of the character described in clause (A) . . . and the holder of which has substantially the same rights and privileges as those which holders of securities of the character described in said clause (A) have upon completing the periodic payments for which such securities provide.[377]

If variable annuities are periodic payment plan certificates, they must, under section 27(c)(1) of the 1940 Act be redeemable at any time.[378] But the issuer of the plan is not required to provide a partial redemption of the certificate, unless the issuer of the underlying security as defined in subsection (B) in the definition of a periodic payment plan, is also the issuer of the plan in which the underlying security is included. In the variable annuity periodic payment plan, is the accumulation unit or the annuity unit the underlying security? A variable annuity contract can be construed as a plan to purchase a number of accumulation units or as a plan to purchase, by installments, annuity units. Supporting the second interpretation is the argument that upon a single payment a contractholder obtains annuity units, not accumulation units. When all installments have been paid, the underlying security is an option to acquire cash, a fixed annuity or annuity units not accumulation units.[379]

Although accumulation and annuity units are different for the purpose of defining a periodic payment plan certificate, the holder of annuity units

377 § 2(a)(27), 15 U.S.C.A. § 80a-2(a)(27) (1971).

378 § 27(c)(1), 15 U.S.C.A. § 80a-27(c)(1) (1971).

379 This interpretation may run afoul of section 18(d) of the Investment Company Act which prohibits a registered investment company from issuing any warrant or right to subscribe to, or purchase, a security of which the company is an issuer, except in the form of warrants or rights that expire not later than 120 days after issuance, and that are issued exclusively and rateably to a class or classes of the company's security holders. Annuity units may be distinguished from warrants or rights on the ground that they offer the same investment contract as that offered by accumulation units, and that the difference between the two units is that annuity units contain insurance features and accumulation units do not. This is yet another instance in which the insurance arrangement is difficult to fit into the Investment Company Act's frame of reference.

may be deemed to have "substantially the same rights and privileges as those which" the holders of a plan certificate will have upon the completion of payments.[380] Accumulation units are used to adjust payments that are not affected by the insurance scheme to the investment performance of the assets in the account. Annuity units are used to adjust payments that are affected by the insurance scheme to the investment performance of the assets in the account. Both units give the holder the right to adjust payments due to him under the contract with the insurance company according to the investment performance of the assets in the account.

By now it is evident that variable annuities present three securities: the whole contract, including its insurance components; the "interests" in the account, consisting of investment promises only; and a periodic payment plan, an installment purchase arrangement of these interests.

Who is the issuer of the periodic payment plan certificates? The Commission suggested in *Prudential* that the issuer of the plan's certificate was what "might be regarded as a separate investment company, a unit investment trust as defined in Section 4(2); but as a practical matter, this would be of no consequence so long as the fund were to register."[381] This statement is not wholly accurate, because the identity of the issuer determines whether the underlying securities are subject to the redemption requirement. If the account is the issuer of a periodic payment plan certificate, and if the underlying unit described in subsection (B) of section 2(a)(27) of the Act, is an accumulation unit, then that unit must also be redeemable. Some variable annuity contracts provide for redemption of the accumulation units.[382] In this case, whether or not the account is the issuer of plan certificates, it is an issuer of redeemable securities and therefore an open-end management company or a unit investment trust, as the case may be. Other variable annuity contracts deny or limit the redemption right of accumulation units, presumably with the staff's consent.[383] The only possible

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[380] § 2(a)(27), 15 U.S.C.A. § 80a-2(a)(27) (1971).

[381] 41 S.E.C. 335, 349 (1963).

[382] The first contracts issued by Valic so provided. However, they were couched in terms of a loan, pursuant to the insurance statute that required the company to grant to insureds a loan up to the amount of the reserves. The original Valic contract, for example, contained a provision which permitted the contractholder to obtain, at any time, the lesser of (i) the redemption value of all or part of the accumulation units credited to the holders, or (ii) the total amount paid under the contract. Upon granting the loan, a number of accumulation units equal to the value of the loan was to be assigned to a special "loan account." On repayment, the contractholder was credited with a number of accumulation units having a current value equal to amount repaid, and the "loan account" was reduced by this number of units. The right of repayment existed as long as interest of 3% was paid annually. During the period of the loan and to the extent of the loan, the contractholder did not participate in the investment experience of the fund. The Commission was of the opinion that the term "loan" was a misnomer. The transaction was a partial redemption at a service charge of 3% annually. 39 S.E.C. 680, 693-94 (1960).

[383] Systematic Investment Plan contracts offered by Prudential provide for total liquidation of all units credited to the contractholder, and for partial liquidation with a minimum of $100, if the amount left in the contractholder's account after redemption is not less than $200. The contractholder may also liquidate the account systematically

way to bring an account that issues these contracts within the definition of an open-end management company is to classify the account an issuer of plan certificates and the underlying security an annuity unit. Under this construction the account issues redeemable periodic payment plans. The accumulation units need not be redeemable. Although annuity units ought to be redeemable, they are exempted by Rule from the redemption requirement.[384] Of course, if the contract provides for redemption of accumulation units, the account can be classified as an open-end management company (even if the issuer of the periodic payment plan is someone other than the account).[385] Under these circumstances, either the excepted insurance company or the account can be the issuer. This theory supports the staff's opinion that a single payment immediate annuity contract is a periodic payment plan certificate if issued by a separate account that issues periodic payment plans.[386]

Prudential suggested that the issuer of the plan is a separate additional entity that need not be registered so long as the account registers. Under Rule 27c-1 however, the exemption from the redemption requirement of annuity units was granted to separate accounts. Presumably, an account that does not issue redeemable securities will be deemed to be an issuer of the periodic payment plan in order to define it as an open-end management company.[387]

3. Exemption from the Redemption Requirement

During the pay-out period annuitants' interests cannot be redeemable, or there would be no mortality guarantee.[388] After a period of ad hoc exemp-

under a predetermined arrangement. Prospectus, Prudential's Investment Plan Account at SP8-SP9 (Apr. 30, 1970).

384 17 C.F.R. § 270.27c-1 (1971).

385 For example, the prospectus issued by Prudential's Investment Plan provides that "Prudential will pay the total value of such shares" upon redemption. Id. at SP8. At the same time the company is described as the "sponsor, depositor and principal underwriter" of the account as well as the investment adviser of the account. Id. at SP5, SP8. The undertaking by Prudential might, therefore, be based on other than its position as an issuer.

386 104 Sec. Reg. L. Rep. at A-3 (BNA June 2, 1971).

387 This conclusion follows the Commission's reasoning in Prudential. Although in the pay-out period the "interests" were deemed to resemble shares in a closed-end management investment company, the account was considered to be an open-end company because the pattern of regulation for open-end companies was more appropriate. 41 S.E.C. 348 n.30 (1963). The necessary adjustments, such as waiver of the redemption requirement in the pay-out period, were achieved by exemptions. The justification for applying the regulatory scheme over open-end companies to the pay-out period is based on the need for more stringent regulation during this period, rather than on equating the structure and content of the interests in the two periods: "[D]uring the pay-in period the contractholder may elect to redeem (in effect, sell) his individual interest in the investment fund at its then value. . . . During the pay-out period, individual interests cannot be so identified or sold. But it is clear that the investment results of the fund affect the amount of each of the payments in this period and therefore the substantive reasons for the application of the Act continue." Id. at 347, citing SEC v. variable Annuity Life Ins. Co. of America, 359 U.S. 65, 89 (1959) (Brennan, J., concurring)..

388 41 S.E.C. at 353-54.

tions,[389] the Commission promulgated Rule 27c-1, under which separate accounts complying with the definition in Rule 0-1(e) are exempt from the requirements of section 27(c)(1) with respect to payments made in the pay-out period, which payments are based upon life contingencies.[390] It is arguable that refund annuities[391] containing a promise of payments regardless of the date of death of the annuitant are not exempt. On the other hand, such annuities also promise life payments that are based on life contingencies. The calculation of the amount paid unconditionally is therefore also based on life contingencies. A promise to pay an annuity for a fixed number of years is not exempt.

An investment company issuing redeemable securities is required under section 22(e) of the Act to redeem the securities within seven days from the date of demand.[392] The industry requested various longer periods,[393] arguing that some group contracts produced reserves for only a small number of variable annuity contracts, especially during the early years of accumulation. Redemptions in the early period of the account would result in liquidation of a substantial part of the portfolio under what might be adverse market conditions, to the detriment of the remaining contractholders. Even if the assets in the account were substantial, the termination of a large portfolio would be undesirable. The industry urged the Commission to permit redemption by installment payments over a longer period than seven days.[394] The Commission was not persuaded. Exemptions were again granted, first on an ad hoc basis,[395] and then by Rule 22e-1.[396] The exemptions for the pay-out period, parallel to Rule 27c-1 exemptions, cover only payments based on life contingencies.

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389 In re Conn. Gen. Life Ins. Co., Inv. Co. Act Release No. 5498 (Sept. 26, 1968) (notice of application for exemption), granted, Inv. Co. Act Release No. 5606 (Feb. 10, 1969); In re Great-West Variable Annuity Account A, Inv. Co. Act Release No. 5516 (Oct. 16, 1968) (notice of application for exemptions), granted, Inv. Co. Act Release No. 5547 (Nov. 25, 1968); In re Equitable Life Assurance Soc'y of the United States, Inv. Co. Act Release No. 5530 (Nov. 1, 1968) (notice of application for exemptions), granted, Inv. Co. Act Release No. 5558 (Dec. 4, 1968); In re American United Life Pooled Equity Fund B, Inv. Co. Act Release No. 5568 (Jan. 2, 1969) (notice of application for exemptions), granted, Inv. Co. Act Release No. 5584 (Jan. 23, 1969); In re Investors Syndicate Life Ins. & Annuity Co.: ISL Variable Annuity Fund B, Inv. Co. Act Release No. 5599 (Jan. 28, 1969) (notice of application for exemptions), granted, Inv. Co. Act Release No. 5612 (Feb. 20, 1969).

390 17 C.F.R. § 270.27c-1 (1971).

391 See Part I, p. 182 supra.

392 § 22(e), 15 U.S.C.A. § 80a-22(e) (1971).

393 The Commission refused Prudential's plan of postponement of redemption, during the pay-in period, for periods up to 36 months after presentation. In re Prudential Ins. Co. of America, 41 S.E.C. 335, 353-54 (1963). It has been argued that variable annuities were designed for long-term investment, and liquidation provisions are not of primary importance and should be available only on a restrictive basis. Day & Melnikoff, The Variable Annuity as a Life Insurance Company Product, 24 Ins. Counsel J. 16, 22 (1957). For refusal to postpone redemption for longer than seven days, see In re Variable Annuity Life Ins. Co. of America, 39 S.E.C. 680, 698 (1960).

394 McDougal, note 28 supra, at 91.

395 See note 389 supra.

396 17 C.F.R. § 270.22e-1 (1971).

4. Load

Because variable annuities have been classified as periodic payment plan certificates, they are subject to section 27 of the Act.[397] Under section 27(a)(1) the sales load on a periodic payment plan certificate cannot exceed 9 percent of the total payments made on the certificate. Although the section does not expressly limit the installment payment period during which the 9 percent limitation applies, the Commission and the industry agreed on an installment payment period of not more than twelve years, or a shorter period as stipulated in the contract.[398] Pursuant to this agreement the Commission granted exemptions on an individual basis.[399] These exemptions were incorporated in Rule 27a-1,[400] which applies to accounts as defined in and qualified under Rule 0-1(e).

Under section 27(a)(2) of the 1940 Act not more than 50 percent of any of the first twelve monthly payments could be deducted for sales load. Further, under section 27(a)(3) the amount of sales load deducted from any one of the first payments could not exceed proportionately the amount deducted from any other such first payment, and the amount deducted from any subsequent payment could not exceed proportionately the amount deducted from any other subsequent payment. The Commission exempted by Rule 27a-2 accounts defined in and qualified under Rule 0-1(e) by permitting them to make more than one reduction in the sales load after the first year of the contract. The Rule prohibits an increase in the level of deductions during the term of the contract.[401] Effective June 14, 1971, section 27(d) of the 1940 Act provides that a plan certificate holder must be given, within 60 days after issuance to him of a periodic payment plan certificate, a written notice of his right to withdraw from the plan within 45 days of the date of mailing the notice. If he exercises his right he must receive a complete refund of all charges. A plan certificate must provide that the certificate holder may surrender the certificate at any time prior to the expiration of eighteen months after the issuance of the certificate and receive the value of his account and an amount equal to the part of the excess paid for sales loading over 15 percent of the gross payments made by the certificate holder. The investment company and the depositor and underwriter of the plan must notify a contractholder who has missed three payments or more, within thirty days of the expiration of fifteen months after the issuance of the certificate, or, if a holder has missed one payment after the expiration of fifteen months but before the expiration of eighteen months after the issuance of the certificate, at any time prior to the expiration of eighteen

397 § 27, 15 U.S.C.A. § 80a-27 (1971).

398 Nelson, Problems Raised by Investment Company Act of 1940, Including Proposals for Revised Rules, Proceedings of the Legal Section, Am. Life Convention 77, 86-87 (1968).

399 See, e.g., In re Equitable Life Assurance Soc'y of the United States, Inv. Co. Act Release No. 5558 (Dec. 4, 1968).

400 17 C.F.R. § 270.27a-1 (1971).

401 17 C.F.R. § 270.27a-2 (1971).

months, of his right to surrender. The investment company may elect[402] to be subject to an alternative regulation under section 27(h).[403] Under this section the sales load may not exceed 9 percent of the total payments made under the certificate; not more than 20 percent of any payment may be deducted as sales load, or not more than an average of 16 percent may be deducted for sales load from the first forty-eight monthly payments; and, further, the amount of sales load deducted from any of the first twelve monthly payments, the thirteenth through the twenty-fourth monthly payments, and the twenty-fifth through the forty-eighth monthly payments respectively, may not exceed proportionately the amount deducted for any other payment, and the amount deducted from any subsequent payment may not exceed proportionately the amount deducted from any other subsequent payment; the first payment is not less than $20 and any subsequent payment is not less than $10; if the registered investment company is a management company, then the proceeds of the certificate, or the securities in which the proceeds are invested, are subject to management fees that do not exceed such reasonable amount as the Commission may prescribe. If the company is a unit investment trust the assets of which are invested in securities of a management company, the fees received by the depositor, underwriter for the trust or any affiliate may not exceed such reasonable amount as the Commission may prescribe. On June 10, 1971, the Commission amended Rules 27a-1 and 27a-2 to grant separate accounts, which the Rules exempt, a similar exemption from the provisions of section 27(h) of the 1940 Act. Thus, the 9 percent limitation will be deemed satisfied if it is imposed on payments during twelve years or a shorter period specified in the contract. Separate accounts are exempted from the prohibition in section 27(h)(3) to the extent that they are exempted from the prohibition in section 27(a)(3) of the 1940 Act.[404] Rule 27c-1 was amended to exempt separate accounts during the pay-out period from the requirements of section 27(d) of the 1940 Act with respect to contracts under which payments are based upon life contingencies.[405]

The applicability of the limitations on load to variable annuities has been challenged on policy grounds. The industry argued that there are basic differences between insurance companies, mutual funds and banks with regard to their products, the method by which they are sold and other determinative factors. With respect to front end load restrictions it may also be argued that the rate of lapses in payments for variable annuities is lower than the rate of lapses in contractual plans. It seems, however, that the sales charge on mutual funds and variable annuities should be regulated on an equal basis to enhance competition for the benefit of investors.

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402 § 27(g), 15 U.S.C.A. § 80a-27(g) (1971). The election is by a written notice to the Commission.

403 § 27(h), 15 U.S.C.A. § 80a-27(h) (1971).

404 Proposed: Inv. Co. Act Release No. 6493 (Apr. 29, 1971), adopted: Inv. Co. Act Release No. 6559 (June 10, 1971).

405 Id.

By and large, state insurance laws do not regulate the load charged by insurance companies.[406] Contractholders are therefore in need of protection. As has been noted,[407] some insurance companies have as of late been selling variable annuities with a level load. Nonetheless, the staff applies section 27(d) to these contracts as well as to single premium annuities. There is good ground for arguing that these contracts should be exempt because Congress never intended the section to apply to them.

5. Payments

Section 27(a)(4) prohibits the issuance of periodic plan certificates under which periodic payments by the investor are less than $10 and the initial payment is less than $20.[408] Effective June 14, 1971, section 27(h)(5) imposes the same limitation.[409] The section was intended to prevent sales of mutual fund shares by installments to persons who cannot afford even these minimum payments, since these persons risk losing, upon a lapse in payments, the front-end load. This reasoning does not apply to pension funds consisting of employers' contributions or to contracts that do not have a front-end load. The Commission under Rule 27a-3,[410] exempted from this subsection separate accounts defined and qualified under Rule 0-1(e) as to payments under variable annuity contracts purchased either (1) under a plan that permits no sales load deduction from any payment to exceed 9 percent of the payment, or (2) in connection with a plan that qualifies under section 401 of the Internal Revenue Code of 1954, or that meets the requirements for deductions of the employer's contributions under section 404(a)(2) of the Code, or that meets the requirements of section 403(b) of the Code. The exemption applies only to contributions within the exclusion allowance for any employee under section 403(b) of the Code except as clause (3) hereof applies. On June 10, 1971, the Commission proposed to amend the Rule to include an exemption under the same terms for section 27(h)(5) of the 1970 Act.[411]

It should be noted that accounts the assets of which are derived solely from contributions under plans that meet the requirements of section 401 of the Code or the requirements for deductions under section 402(a)(2) of the Code, are fully exempt from the provisions of the Act. The Rule applies to these plans if they are funded by accounts whose assets are derived from contributions other than those mentioned in the exemptive section 3(c)(11) of the 1940 Act.

6. Uniform Price

Section 22(d) of the 1940 Act prohibits an investment company from selling "any redeemable security issued by it to any person except either to

406 McDougal, note 28 supra, at 90.
407 See Part I, p. 187 supra.
408 § 27(h)(4), 15 U.S.C.A. § 80a-27(h)(4) (1971).
409 § 27(h)(5), 15 U.S.C.A. § 80a-27(h)(5) (1971).
410 17 C.F.R. § 270.27a-3 (1971).
411 Proposed Inv. Co. Act Release No. 6493 (Apr. 29, 1971), adopted: Inv. Co. Act Release No. 6559 (June 10, 1971).

or through a principal underwriter for distribution or at a current public offering price described in the prospectus. . . ." The section also prohibits any principal underwriter or dealer from selling shares of a class currently offered to the public, except at the current offering price described in the prospectus. The issuer, any other principal underwriter and dealers are excepted.[412] The words "described in the prospectus" have been interpreted to mean that both the sales load and the administrative charges must be computed separately, as a percentage of the offering price per share.[413] The Commission has always taken the position that the section does not necessarily prohibit all deviations from the current offering price. Legislative history shows that the word "the" current offering price was changed to "a" current offering price, indicating that there could be more than one.[414] In 1959 the Commission adopted Rule 22d-1, which contains, with some changes, a codification of its previous ad hoc exemptions.[415] First, the Rule provides for an exemption of quantity discounts.[416] Since quantity discounts led mutual funds and underwriters to organize investors into larger groups,[417] the Commission revised the definition of "person" in its 1959 rule to provide that organizations created for the sole purpose of receiving discounts are not exempt.[418] The amendment was based on the ground that the practice of organizing these groups results in discrimination against investors.[419] The Commission had considered eliminating this restriction,[420] but retained it. The Rule also provides an exemption pursuant to a uniform offer, described in the prospectus, to the directors, officers or partners of the investment company, its investment adviser and underwriter, its bona fide full-time employees, or sales representatives of any of

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412 § 22(d), 15 U.S.C.A. § 80a-22(d) (1971). See also 1 Loss at 405-06. The Commission has taken the position that the section does not apply to a transaction in which one of the parties is a dealer acting for his own account.

413 1 Loss at 404.

414 Greene, The Uniform Offering Price of Mutual Fund Shares Under the Investment Company Act of 1940, 37 U. Det. L.J. 369, 371, 376 n.32 (1960). Orderly distribution of mutual fund shares is essential to the continued existence of the fund if redemptions are not to exceed sales. In 1940 dealers who were not under a contract with the fund competed unfairly with the underwriter and dealers under contract with the fund. The impact of section 22(d) is to require dealers and the issuer not to compete, a rare exception to the general policy against price fixing in this country. 4 Loss at 2431 n.114 (Supp. 1969).

415 17 C.F.R. § 270.22d-1 (1971).

416 17 C.F.R. § 270.22d-1(a)(1) (1971). The scale of the reducing load and method of computation must be described in the prospectus and must be available to all investors. 17 C.F.R. § 270.22d-1(a)(2) (1971). These computations may be made on the basis of (a) the aggregate quantity of securities being purchased at any time, or (b) the aggregate quantity of securities previously purchased plus the securities being purchased, without limitation in time, or (c) the aggregate quantity of securities purchased within 13 months from the date of a written letter of intention by the would-be purchaser to purchase, within that period, securities in a specified aggregate amount. This exemption is a recognition of an industry-wide custom of giving quantity discounts. Greene, note 414 supra, at 377-78 n.37; In re Investors Diversified Services, Inc., 39 S.E.C. 829, 831 (1960). Pre-existing practice permitting quantity discounts to organized groups was discontinued.

417 Greene, 414 supra, at 378-79.

418 17 C.F.R. § 270.22d-1(a)(3) (1971).

419 In re Investors Diversified Services, Inc., 39 S.E.C. 829, 831 (1960).

420 Inv. Co. Act Release No. 5507 (Oct. 7, 1968).

the foregoing who have acted as such for not less than ninety days, and to any employee benefit, trust or plan of the same.[421] The Rule further exempts transactions involving a systematic dividend-investment plan, provided an opportunity to reinvest at lower sales load is given to all non-participants in the plan.[422]

A similar exemption, with few variations, is available to reinvestment of capital gains.[423] An ad hoc exemption was granted when the proceeds of the shares received at the maturity of a trust, were to be reinvested in shares after a short interval,[424] and when the holders of shares in one fund converted them into shares of another fund.[425] To eliminate the possibility of a double-load, Rule 22d-1 exempts a unit investment trust that issues periodic payment plan certificates, the net proceeds of which are invested in redeemable securities of investment companies.[426] An exemption was not available if the payment would result in penalty to the investor, even though all other shareholders would benefit.[427] The Commission refused to exempt a contract allowing a defaulting variable annuity contractholder to resume payments if he covered arrears, because the arrears were calculated at the unit price at the time of default, or at the time of payment, whichever was the higher. If the price at the time of default was higher than the price at the date of payment the contractholder would pay an unjustifiable penalty.[428] Finally, the Commission deemed some institutions worthy of exemption. In conformity with congressional policy, Rule 22d-1(e) exempts sales of tax exempt organizations under section 501(c)(3)(13), and qualified plans under sections 401 and 402(b)(2) of the Internal Revenue Code.

Legislative history is silent as to the reasons for the enactment of section 22(d).[429] The section was introduced by the industry to ensure an orderly distribution of mutual funds shares, to prevent the price competition that has undermined the contractual distribution system of mutual funds. It has also been argued that the purpose of this section is to prevent price dis-

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421 Purchasers must provide sellers with a letter of assurance that the purchase is made for investment, and that the securities will not be sold except through redemption or repurchase by the issuer. 17 C.F.R. § 270.22d-1(h) (1971); Greene, note 414 supra, at 381.

422 If the opportunity to receive such a rebate is given only to participants in the plan, it may still be exempted if the plan is described in the prospectus, if all security holders may participate in it, and if all stockholders are notified of the availability of the plan at least once a year, and if no payment is made by the issuer. 17 C.F.R. § 270.22d-1(b) (1971).

423 17 C.F.R. § 270.22d-1(c) (1971).

424 Greene, note 414 supra, at 382.

425 In re Hamilton Depositors Corp., 25 S.E.C. 141 (1947); Greene, note 414 supra, at 381-82.

426 17 C.R.F. § 270.22d-1(f) (1971).

427 41 S.E.C. 335, 354-55 (1963).

428 Id. The penalty could also be considered a violation of section 27(a)(1), being together with the load grossly excessive, above the maximum 9%, or section 27(a)(5), constituting an unreasonable administrative charge.

429 Greene, note 414 supra, at 371.

crimination among purchasers and to prevent or minimize dilution of the equity of existing shareholders.[430] The exemptions under Rule 22d-1 were justified on the ground that the exempt transactions did not result in normal load to the company or the dealer and were not discriminatory.[431]

Not all of these policy considerations apply to variable annuities. Unlike mutual funds, annuity contracts are not sold through an outside sales force but through the sales force of the insurance company or insurance brokers.[432] Unlike mutual fund shares, annuity contracts are not transferable in the commercial sense, no market for them can exist, and no trading by dealers is possible.[433] Therefore, the danger that the orderly sale of these contracts or of mutual fund shares will be disrupted is very small. Discrimination among contractholders is also unlikely to occur. Insurance statutes prohibit unfair discrimination.[434] Nevertheless, the request of the industry for a full exemption from section 22(d) was not granted, mainly because such an exemption might result in discrimination among contractholders.[435] Ad hoc exemptions, however, were given. They may be divided into groups which parallel Rule 22d-1: the exemptions permit quantity discounts to be computed on payments for the "securities" issued by an account and on the sum of these payments and payment for other insurance promises given by the insurance company, including fixed annuities. Funds accumulated under fixed annuity contracts and funds paid on insurance contracts may be reinvested in variable annuities without charges. The repayments under an experience rating clause, typical of insurance companies' arrangements with pension funds were also exempted.[436] As a matter of principle, the Commission considered the securities issued by accounts as separate from the insurance arrangements with which they are offered. If the combination of insurance and investment were not prejudicial to the purchasers, exemptions from section 22(d) were granted to these combinations along the line of Rule 22d-1. On the other hand, the application of Rule 22d-1(h) to insurance companies was recently limited so that only those directors, officers, and employees of insurance companies who are engaged actively in variable annuities operations will be eligible to take deductions in sales load, thus eliminating the anomalously wide exemption previously available to the total sales force of insurance companies engaged in the sale of conventional insurance products.[437] The problems arising from the application of section 22(d) to variable annuities stemmed from the nature of these contracts rather than from a conflict between state and

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430 See generally Greene, note 414 supra.

431 Id. at 378.

432 For a general description of the insurance industry's sales methods and compensation see SEC Investor Report, note 28 supra, at 535-38.

433 Nelson, note 398 supra, at 90, 94.

434 12 Appleman §§ 7017-19.

435 McDougal, note 28 supra, at 91.

436 In re Variable Annuity Life Ins. Co. of America, Inv. Co. Act Release No. 4217 (Apr. 7, 1965).

437 Inv. Co. Act. Release No. 6347 (Mar. 8, 1971).

federal regulation. With appropriate adjustments the section can be applied. Whether section 22(d) should apply to variable annuities at all is questionable.

F. *Mandatory Conditions Under State Law*

State insurance laws also impose mandatory conditions on variable annuity contracts. New York, for example, requires variable annuity contracts delivered or issued for delivery in the state to include mandatory provisions concerning grace, reinstatement and nonforfeiture.[438] Similarly, under New Jersey law, variable annuity contracts must contain a statement that in the event of default beyond the grace period the insurance company will make payments of the value of the contract not later than the date when payments by the company were to have commenced in accordance with the contract.[439] Some states require that the contract describe how the insurance company determines the dollar amount of variable benefits, and state clearly that the amount may decrease or increase. The first page of the contract must bear, in a prominent position, a statement that values and benefits under the contract are on a variable basis.[440]

New Jersey also requires that variable annuity contracts stipulate mortality and expense guarantees except with regard to investment management fees that are subject to change with the approval of the contractholders.[441] New Jersey limits the minimum amount of the first payment under the contract, as does the Investment Company Act.[442] Finally, New Jersey requires that the contract contain an undertaking by the insurance company to mail to the contractholder an annual report which includes a statement of the number of units credited to this contractholder, the dollar value as of a date no more than two months prior to the date of mailing, and a statement of the investments held in the account.[443] The variety of requirements concerning variable annuity contracts under state and federal law must make the preparation and issuance of these contracts extremely burdensome. A legislative model contract is needed.

G. *Disclosure and Prospectus*

An account that is registered as an open-end management company or a unit investment trust must file a registration statement under the Securities

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438 N.Y. Ins. Law § 227(4) (McKinney Supp. 1971).

439 N.J. Stat. Ann. § 17:35A-5(c)(i) (Supp. 1971).

440 See, e.g., Ariz. Rev. Stat. Ann. § 20-651F (Supp. 1970); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.J. Stat. Ann. § 17:35A-4 (1963); N.Y. Ins. Law § 227.1(i) (McKinney Supp. 1971); Tex. Ins. Code art. 3.72, § 3(a) (Supp. 1971).

441 N.J. Stat. Ann. 17:35A-5(d) (Supp. 1971). Under D.C. Reg. 4, the computation of the net investment factor must be based exclusively on the investment experience of the account. 1 Ins. Law Index Service (D.C.) 55 (Supp. 1970).

442 N.J. Stat. Ann. § 17:35A-5(d) (Supp. 1971); § 27(a)(4), 15 U.S.C.A. § 80a-27(a)(4) (1971); § 27(h)(5), 15 U.S.C.A. § 80a-27(h)(5) (1971).

443 N.J. Stat. Ann. § 17:35A-5(c) (Supp. 1971); Fla. Ins. Reg. 3, 2 Ins. Law Index Service (Fla.) 524-25 (Supp. 1970). This provision may facilitate private action enforcement of the reporting requirements. See also Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971). Model Variable Contract Regulation art. IV, § 6, note 41 supra, at 197.

Act of 1933,[444] and deliver to every prospective purchaser of variable annuities a prospectus.[445] The 1933 Act may apply also to conventional insurance policies of which an investment company is the issuer, even though these policies would be exempt under section 3(a)(8) if issued by an insurance company.[446]

State insurance laws do not usually contain a requirement for a prospectus but require instead that a copy of the contract be filed with the insurance authorities for their approval.[447]

VI. Assets

A. *Source of Assets*

Assets in the separate account emanate from three sources: sums allocated to the account under variable annuity contracts and other contracts, sums contributed by the insurance company to satisfy reserve requirements, and other sums that are permitted, or required, by state laws to be allocated to the account.

Section 22(g) of the 1940 Act prohibits an open-end company from issuing any securities for services or for property other than cash or securities.[448] Parallel to this section, most states permit, or require, insurance companies to allocate to separate accounts payments received under variable annuity contracts, after deduction of expenses, other charges and taxes.[449] The duty to allocate appropriate sums to the account stems from the statute, and is usually limited to amounts required by contracts to be applied to provide variable benefits. Some insurance laws permit the insurance company to allocate to separate accounts the proceeds of insurance or endowment policies, pursuant to agreements with insureds or beneficiaries.[450] Recently some states have amended their statutes to permit insurance companies to issue variable life insurance policies funded by separate accounts.[451]

State laws contemplate, and some specifically require, that the insurance company will keep the reserves funding variable annuities in a separate

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444 § 24(a), 15 U.S.C.A. § 80a-24(a) (1971). The form for a management company is S-5 and the form for a unit investment trust is S-6. See proposed guidelines for the preparation of form S-5 including the prospectus for a management investment company. Inv. Co. Act Release No. 5634, Sec. Act Release No. 4953 (Mar. 11, 1969).

445 § 2(a)(31), 15 U.S.C.A. § 80a-2(a)(31) (1971).

446 § 24(d), 15 U.S.C.A. § 80a-24(d) (1971). When the company issuing variable annuities was an insurance company that is not excepted from the definition of an investment company in the 1940 Act, the Commission granted exemption with respect to the insurance contracts sold by the company. 39 S.E.C. at 699.

447 E.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.J. Stat. Ann. § 17:35A-5(a) (Supp. 1971); Tex. Ins. Code art. 3.72, § 5 (Supp. 1971); Vt. Stat. Ann. § 3852 (1970).

448 § 22(g), 15 U.S.C.A. § 80a-22(g) (1971). There is an exception for stock dividends and distribution to security holders and for distribution in connection with reorganizations.

449 See, e.g., D.C. Code Encycl. Ann. § 35-541(a) (1968); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971). See generally note 143 supra.

450 See, e.g., Cal. Ins. Code § 10506(C) (West Supp. 1971).

451 See note 255 supra.

account.[452] Some statutes specifically require the maintainance of reserves.[453] Even if the statute does not expressly require the insurance company to maintain all reserves funding variable annuity contracts in the separate account, the company may be so bound by the variable contracts. As a practical matter, if contractholders' payments are not so allocated, the company will not be able to honor its obligations under the variable contracts because it is not permitted to invest these payments in equity securities outside the separate account.

State insurance laws permit an insurance company to invest limited funds out of its general assets account in a separate account.[454] Presumably, insurance laws govern the legitimacy of allocation of funds to a separate account. Within its statutory authority the company's management is the final arbiter as to the number and kind of insurance contracts the payments on which are to be allocated to separate accounts.

B. *Protecting the Company's Assets*

Protecting the company's assets is a goal of both state insurance laws and the Investment Company Act.[455] The means which the federal Act uses to ensure integrity of assets are different from those of state insurance laws.

Under section 17(f) of the 1940 Act, securities in a separate account that is registered as a management company must be placed under one of the following arrangements: (a) in the custody of a qualified bank, under an agreement or indenture containing in substance the Act's requirements for a trust indenture of a unit investment trust, or (b) with a member of a

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[452] A typical provision reads as follows: "All amounts received by the life company which are required by a contract on a variable basis to be applied to provide variable benefits . . . shall be placed in the appropriate separate account . . . ." Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971). See note 41 supra.

[453] They are fashioned after the Model Variable Contract Regulations: "The [insurance] company shall maintain in each such separate account assets with a value at least equal to the reserves and other contract liabilities with respect to such account, except as may otherwise be approved by the Commissioner." Model Variable Contract Regulation art. IV, § 6, note 41 supra, at 197. Rule 6e-1, superseded by section 3(c)(11) of the 1940 Act, and 0-1(e), of the Commission, contain similar language. 17 C.F.R. § 270.6e-1(c)(1), § 270.0-1(e) (1971).

[454] See, e.g., Cal. Ins. Code § 10506(B) (West Supp. 1971); Ga. Code Ann. § 56-1040(j) (Supp. 1971); N.C. Gen. Stat. § 58-79.2(c) (Supp. 1969); Wis. Stat. Ann. § 206.385(1) (Supp. 1971).

[455] Much of the act is designed to protect investment companies and their shareholders from outright dishonesty on the part of the companies' managers. It bars from the investment company industry persons convicted of, or enjoined from committing, certain types of misconduct involving security transactions, makes larceny, conversion or embezzlement of investment company assets a Federal crime . . . . The Commission is authorized to establish bonding requirements applicable to those having access to the moneys and securities of investment companies, and to prescribe rules for the protection of investment company portfolio securities. Exculpatory provisions are prohibited to the extent that they purport to relieve any officer or director of any investment company from 'liability to the company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his office.'

SEC Investment Co. Growth Report, note 127 supra, at 66-67. As to state insurance laws see 359 U.S. at 77.

national securities exchange, or (c) in the custody of the investment company itself, in accordance with rules and regulations promulgated by the Commission.[456] Under this last provision the Commission adopted Rule 17f-2, which requires that securities, though deemed in the custody of the investment company, be deposited with a bank or a company whose functions and physical facilities are supervised by a federal or state agency.[457]

Whether insurance companies are companies whose functions and facilities are supervised by state authorities is not entirely clear. The facilities of insurance companies are subject to periodic examinations by state authorities.[458] The rules with respect to the custody of their assets are usually stringent but self-imposed. Few state statutes regulate custody of assets. Nonetheless, the stringent rules imposed or self-imposed in practice by insurance companies, and their successful application, should qualify them under Rule 17f-2 since the purpose of the Rule is to ensure that qualified custodians of investment companies' securities are effectively supervised, the emphasis being on "effectively." The provisions of Rule 17f-2 conflict with some state insurance laws, and partial exemptions have been granted by the Commission to permit compliance with state requirements.[459]

In one case the insurance company was permitted custody of the securities in the account since it maintained superior safekeeping facilities, and was subject to state authorities' examinations. Further, the exempted companies expressed an intent to keep the accounts' securities in their vault, physically segregated from their other assets in a separate safe.[460] Rule 17f-2(d) also limits access to assets of an investment company to persons designated by a resolution of the board of directors of the investment company. They must be responsible employees or officers of the company. Further, only two or more designees jointly, at least one of whom is an officer, may have access. When the insurance company's regulations were similar to those stated in Rule 17f-2(d), the Commission granted an exemption to give access to

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456 § 17(f), 15 U.S.C.A. § 80a-17(f) (1971).

457 17 C.F.R. § 270.17f-2 (1971).

458 19 J. Appleman, Insurance Law and Practice § 10452 (1946) [hereinafter cited as 19 Appleman]. See also, e.g., Mass. Gen. Laws Ann. ch. 175, § 4 (1958); N.Y. Ins. Law § 28 (McKinney 1966).

459 McDougal, note 28 supra, at 93.

460 In re CML Variable Annuity Account B, Inv. Co. Act Release No. 5859 (Oct. 27, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5877 (Nov. 12, 1969) permitting custody of assets by the insurance company in its vault and permitting "not more than twenty duly authorized officers or responsible employees of Insurance Company as well as representatives of the Connecticut Commissioner of Insurance, members of the National Association of Insurance Commissioners duly designated zonal auditing committee and selected responsible members of Insurance Company's internal audit team to have access to the assets of the Account . . . ." In re Equitable Life Assurance Soc'y of the United States, Inv. Co. Act Release No. 5530 (Nov. 1, 1968) (notice of application for exemption), granted, Inv. Co. Act Release No. 5558 (Dec. 4, 1968); In re Mut. Life Ins. Co. of New York, Inv. Co. Act Release No. 5617 (Feb. 20, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5629 (Mar. 11, 1969). In re Prudential Ins. Co. of America, 41 S.E.C. 335, 356-57 (1963).

state insurance examiners, representatives of the insurance company's certified accountants, and such persons as might be designated by the finance committee of the insurance company.[461] Some exemptions permitted authorized personnel of state authorities, officers and responsible employees of the insurance company to have access to securities of the account, but assets were to be deposited with a qualified bank pursuant to a safekeeping agreement.[462]

In April, 1970, the Commission proposed to adopt Rule 17f-3[463] which would permit access to securities of separate accounts to the following persons: (a) to not more than ten persons who are responsible employees and officers "of the separate account of the insurance company," and only to two such persons jointly, at least one of whom is an officer designated by resolution of the board of directors; (b) to authorized employees of the depositor; (c) to the independent accountant examining the assets of the account for the purpose of certification under this exemptive Rule; and (d) to authorized employees or agents of state insurance authorities in the state of domicile of the insurance company. Assets must be available for inspection by the Commission and its agents at all times. The Rule would permit a separate account to be the custodian of the securities, if the securities were deposited in a vault maintained by a bank or a company whose facilities were supervised by federal or state authorities. The securities must be physically segregated and identified as the property of the investment company, the account. The Rule also provides for examination of the assets by an independent public accountant three times a year, at least twice without notice, and a certification to be transmitted to the Commission after each examination. Although the Rule has not been adopted, it reflects the Commission's attitude.

Perhaps a wider exemption should have been granted immediately after *Prudential.* State insurance authorities have successfully imposed stringent inspection and regulation on insurance companies. The Rule's limitations on access to assets, and the requirement that the assets be deposited interfere with inspections by state insurance authorities. Equality of treatment with mutual funds is not called for in this context. In fact, conflicting regulation puts insurance companies at a competitive disadvantage. There is no reason to require deviation from traditional insurance methods. In this area investors do not seem to need added protection.

The Commission, through exemptions, has dealt with another area of con-

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461 In re Equitable Life Assurance Soc'y of the United States, note 460 supra.

462 In re Shenandoah Variable Annuity Fund A, Inv. Co. Act Release No. 5787 (Aug. 20, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5821 (Sept. 22, 1969) permitting "representatives of the Virginia State Corporation Commission and duly authorized officers of [the insurance company] to have access to the securities of the fund, which will be deposited with a trust company pursuant to a safekeeping agreement . . . ." In re Minnesota Mut. Life Ins. Co., Inv. Co. Act Release No. 5575 (Jan. 3, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5593 (Jan. 27, 1969).

463 Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

flict with state law. Under section 26(a) of the 1940 Act an underwriter or a depositor of a unit investment trust may not sell a security of the trust, unless the trust indenture or custody agreement contains provisions specified in paragraphs (1) through (4) of that section.[464] Section 27(c)(2) of the Act prohibits any registered investment company from issuing periodic payment plan certificates, and prohibits any depositor or any underwriter of such a company from selling these certificates, unless the proceeds of all payments, other than sales load, are deposited with a trustee or custodian meeting the requirements of section 26(a), and are held under a trust indenture or a custody agreement containing the required provisions of section 26(a)(2) and 26(a)(3).[465] These provisions apply to a separate account, whether organized as a unit investment trust or as a management company, because variable annuities have been classified periodic payment plan certificates. If the account is a unit investment trust, it is subject to section 26(a) in its entirety.[466]

The industry argued that the requirements of this section were superfluous. Insurance companies are regulated as to solvency "and the standards of fiduciary conduct which have developed under such a system of regulation taken together make the trust provisions of section 26(a) inappropriate and unnecessary."[467] This section conflicts with some state laws that prohibit insurance companies from entering into formal trust agreements.[468] Further, there is no need for the provisions of section 26(a) if the separate account invested solely in mutual fund shares, if the conditions described for the exemption of the management company were satisfied, if the contractholders were notified of any change in the underlying securities, and if the assets in the account were placed in accordance with section 17(f) and the Commission's Rules.[469]

The Commission granted ad hoc exemptions from the requirement of a formal trust.[470] These ad hoc exemptions contain the condition, embodied

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464 The Act requires that the trustee or custodian be a bank having an aggregate capital, surplus, and undivided profits of not less than $500,000. The assets should be held in trust, and only certain charges may be made against them. See note 473, infra. The trustee or custodian must have possession of the assets of the unit investment trust and must segregate the assets. The trustee or custodian may only resign if the trust is completely liquidated or a qualified successor has been appointed. Records of the shares issued and particulars of the shareholders must be kept and notice of any substitution be given to shareholders. § 26(a)(1)-(4), 15 U.S.C.A. § 80a-26(a)(1)-(4) (1971). See Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

465 § 27(c)(2), 15 U.S.C.A. § 80a-27(c)(2) (1971).

466 Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

467 Nelson, note 398 supra, at 88.

468 Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

469 Nelson, note 398 supra, at 88.

470 E.g., In re Washington National Ins. Co., Inv. Co. Act Release No. 5825 (Sept. 30, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5850 (Oct. 17, 1969); In re Shenandoah Variable Annuity Fund A, Inv. Co. Act Release No. 5787 (Aug. 20, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5821 (Sept. 22, 1969); In re Connecticut General Life Ins. Co., Inv. Co. Act Release No. 5797 (Aug. 27, 1969) (notice of application for exemption), granted, Inv. Co. Act Release No. 5820 (Sept. 19, 1969).

in section 26(a)(3) that the charges to variable annuity contractholders for administrative services shall not exceed such reasonable amount as the Commission shall prescribe. The Commission reserved jurisdiction in this matter. The exemptions contain a further condition that

> payment of sums and charges out of the assets of the Account shall not be deemed to be exempted from regulation by the Commission by reason of this order, provided that Applicants' consent to this condition shall not be deemed to be a concession to the Commission of authority to regulate the payment of sums and charges out of the assets of the Account other than charges for administrative services, and Applicants reserve the right, in any proceeding before the Commission or in any suit or action in any court, to assert that the Commission has no authority to regulate the payment of such other sums and charges.[471]

This provision reflects a disagreement between the Commission and the industry and illustrates the difficulty of regulating variable annuities according to the *Prudential*[472] test of "promises." The 1940 Act regulates administrative charges made in connection with the investment company's business.[473] Variable annuities contain additional charges for mortality and expense guarantees. These charges may be viewed as administrative charges or as payments designed to cover the cost of insurance. If viewed as administrative charges they must be subject to the Commission's regulation. Otherwise the competitive equality which the Commission strives to achieve and the purposes of the Act will be frustrated. To inquire into charges other than those mentioned in the Investment Company Act would be, however, to judge their reasonableness and their use as reserves, and in effect to regulate them, thus regulating the business of insurance. On April 30, 1970, the Commission proposed to codify the individual exemptions in proposed Rules 26a-2 and 27c-2.[474] The proposed rules did not contain the provision mentioned in the ad hoc exemptions. The question of whether the Commission may consider the charge for the mortality and expense guarantees to be an administrative charge and regulate it remains unanswered. It is submitted that the Commission should have regulatory power over charges for mortality and expense guarantees unless the industry shows that the charges are meant to serve as a reserve for the insurance risk

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471 Inv. Co. Act Release No. 5820 (Sept. 19, 1969). See Jones, The Variable Annuity and the 1940 Act—An Uncomfortable Combination, 3 Conn. L. Rev. 144, 161-65 (1970) arguing that it is difficult to separate sales load from other charges and suggesting that authority to regulate a comprehensive charge be delegated to the Nat'l Ass'n of Ins. Comm'rs.

472 41 S.E.C. 335, 342 (1963).

473 Section 26(a)(2) provides that the trustee may charge against, and collect from the assets deposited with him such fees and expenses as are specified in the trust; that no such charge shall be made except for services performed or expenses incurred;

> that no payment to the depositor of or a principal underwriter for such trust, or to any affiliated persons [thereof] shall be allowed the trustee or custodian as an expense (except that provision may be made for the payment to any such person of a fee, not exceeding such reasonable amount as the Commission may prescribe as compensation for performing bookkeeping and other administrative services . . . .)

§ 26(a)(2), 15 U.S.C.A. § 80a-26(a)(2) (1971).

474 Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

involved in the guarantee. It is further submitted that even if state insurance statutes regulated these charges, the Commission should retain its jurisdiction unless state regulation requires that the charges constitute reserves for the mortality and expense guarantees.

Proposed Rules 26a-2 and 27c-2 provide that registered separate accounts would be exempt from the requirements of sections 26(a) and 27(c)(2) if:

(a) The sponsoring insurance company has a combined capital and surplus, if a stock company, and an unassigned surplus, if a mutual company, of not less than one million dollars,[475] and

(b) The insurance company files with any state insurance authority or the insurance authority of the District of Columbia, an annual statement of its financial condition in the form prescribed by the National Association of Insurance Commissioners, and

(c) The Insurance company is examined from time to time as to its financial condition by this insurance authority, and is subject to its supervision with respect to the separate account operations, so as to protect the interests of contractholders and ensure that the insurance company will perform its obligations,[476] and

(d) The insurance company maintains a record of all contractholders, insofar as that information is known to it, and informs each contractholder of any substitution of any security in the account, including the name of the security eliminated and the security substituted therefor, and

(e) The certificates of securities which comprise the assets of the account and any other property of the account, are maintained pursuant to section 17(f) of the Act, and the rules thereunder applicable to a separate account registered as a management company, except that actions required or permitted by any rule under section 17(f) to be taken by the investment company (the account), its board of directors, officers or employees, may be taken instead by the insurance company, its board of directors, or officers, and, finally

(f) Charges for administrative services do not exceed such reasonable amounts as the Commission shall prescribe.

The proposed rules were justified on the grounds that (a) state laws do not generally permit a separate account of an insurance company to be organized under a trust indenture, (b) insurance companies sponsoring accounts are subject to extensive state regulation that affords substantially the protection of trusteeship, (c) under applicable state law and Rule 0-1(e), the assets of the separate account are not chargeable with liabilities arising out of any other business of the insurance company and (d) there is no risk of abandonment of the contractholders because the insurance

475 The company's balance sheet contained in the registration statement under the 1933 Act relating to the variable annuities should evidence this sum. Proposed Rule 26a-2 (1). Id.

476 In the case of Canadian corporations, the supervision and other requirements pertain only to their operations within the United States. Proposed Rule 27c-2(e). Id.

company is legally bound to provide life-time benefits under the variable annuity contracts.[477]

The explanation contains assertions that are too general. Not all state laws contain a "not-chargeable" clause.[478] It is far from clear that all insurance companies are bound to provide life-time benefits if investment advisory services and underwriting arrangements are transferred to others.[479] In this area the expertise of state insurance authorities, the record of insurance companies' solvency and the policy of the McCarran Act suggest that the conditions concerning periodic examinations and the provisions limiting access to assets should be eliminated. The other conditions concerning the reasonableness of administrative charges should be retained.

C. *Ownership of the Assets in the Account*

1. General

A contractholder is a policyholder. A policyholder is usually, but not always, a creditor of the insurance company. If the insurance company is a mutual company, a policyholder is also a member of the company, occupying a similar, but not identical, position to that of a shareholder. Having assumed the investment risk he is also an investor, and must be given management powers and other rights pursuant to the 1940 Act. Some insurance companies have argued that contractholders are creditors of the insurance company and have no rights in the assets. These arguments were not accepted by the Supreme Court in *SEC v. Variable Annuity Life Insurance Co.*[480] or by the Commission.[481]

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[477] Some insurance companies are bound by law to continue to provide life benefits even if investment advisory services are terminated. See, e.g., In re American United Life Pooled Equity Fund B, Inv. Co. Act Release No. 5568, at 3 (Jan. 2, 1969), notice of application for exemption:

> Moreover, Indiana law provides that the Fund shall not be liable for charges arising out of any other business which the Insurance Company may conduct; and that the contractual obligations of Insurance Company to the contract holders or to participants under group contracts cannot be abandoned until such obligations have been discharged.

Such a provision would prevent "orphanage" of the account which the trusteeship under section 27(c)(2) was designed to prevent. The same statement appears in In re Equitable Life Assurance Soc'y of the United States, Inv. Co. Act Release No. 5530, at 5 (Nov. 1, 1968); In re Investors Syndicate Life Ins. and Annuity Co., Inv. Co. Act Release No. 5599, at 4-5 (Jan. 28, 1969); In re Variable Annuity Fund I of Southwestern Life, Inv. Co. Act Release No. 5608 at 2-3 (Feb. 11, 1969).

[478] See, e.g., Ala. Code tit. 28, § 4(5) (Supp. 1969); Del. Code Ann. tit. 18, § 2933 (1968); Md. Ann. Code art. 48A, § 362 (Supp. 1970); Neb. Rev. Stat. § 44.310.06 (Supp. 1967); N.M. Stat. Ann. § 58-4-6.1 (Supp. 1969); Ore. Rev. Stat. § 733.180 (1969); S.C. Code Ann. § 37-331 (Supp. 1970); Utah Code Ann. § 31-13-31 (Supp. 1967).

[479] See p. 355 infra.

[480] 359 U.S. 65, 92 n.33 (1959) (Brennan, J., concurring). He thought it doubtful that the contracts were debt securities. A variable annuity contract was no more a debt than a "redeemable share in an orthodox open-end company. . . ."

[481] See, e.g., proposed Rule 17f-3, note 463 supra, in which the Commission would have required that the assets in the account should be marked as the property of the account to qualify the account for exemption.

Much confusion may result from an attempt to classify variable annuities either as "equity investment" or "debt." They are both. The distinction, however, is important in understanding the relationship between the contractholders and the insurance company regarding the assets in the account. It is also important in understanding the differences between the operational frameworks of the Investment Company Act and of state insurance laws. The distinctions between equity investments and debts are discussed in many contexts. The tests developed by the courts to distinguish between interest and dividends for tax purposes and to determine priorities in the case of insolvency of corporations, are similar.

First, an investment involves assumption of risk of loss of capital: "The essential difference between a 'stockholder' and a 'creditor' is that the stockholder intends to embark upon the corporate adventure, taking the risks of loss attendant upon it that he may enjoy the chances of profit. The creditor, on the other hand, does not intend to take such risks so far as they may be avoided but merely to lend his capital to others who do intend to take them."[482]

As a corollary of this criterion the right of an equity investor to share in the assets of the enterprise after its dissolution is subordinate to the right of creditors.[483] In an old bankruptcy case involving the classification of certificates for the purpose of establishing priorities in the distribution of assets of an insolvent corporation, the Supreme Court said: "His [the investor's] chance of gain, by the operations of the corporation, throws on him, as respects creditors, the entire risk of the loss of his share of the capital, which must go to satisfy the creditors in case of misfortune. He cannot be both creditor and debtor, by virtue of his ownership of stock."[484] Therefore an arrangement granting a stockholder priority over creditors in the case of insolvency is void as against public policy.[485] The general rule is subject to statutory modifications. A stockholder may be given statutory priority as a creditor, and at the same time may be permitted to retain all rights and duties incident to the ownership of stock.[486]

Further, in a debt the right to repayment does not depend on the existence of income; the right might be deferred but is not lost for lack of funds. A debt can be collected upon maturity from the principal, not only from income. The converse is true with respect to investment.[487] Moreover,

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[482] Helvering v. Richmond, Fredericksburg & Potomac Ry. Co., 90 F.2d 971, 974 (4th Cir. 1937).

[483] Id. See also United States v. Title Guar. & Trust Co., 133 F.2d 990, 993 (6th Cir. 1943).

[484] Warren v. King, 108 U.S. 389, 399 (1883).

[485] 11 W. Fletcher, Cyclopaedia of the Law of Private Corporations § 5297 (perm. ed. rev. 1971) [hereinafter cited as 11 Fletcher]. See also Spenser v. Smith, 201 F. 647, 655 (8th Cir. 1912); accord, In re Penfield Distilling Co. v. Sachs, 131 F.2d 694 (6th Cir. 1942).

[486] 11 Fletcher § 5297, at 560-61.

[487] Third Scottish Am. Trust Co. v. United States, 37 F. Supp. 279, 283 (Ct. Cl. 1941), determination of whether payments were interest for purpose of taxation.

the absence of a specific maturity date tends to indicate the existence of an investment rather than a debt.[488] Finally, participation in management is, by and large, an earmark of investment.[489]

2. Rights of Equity Investors in the Investment Property

An investor whose fortunes depend on the performance of the enterprise need not have, but usually has, a property interest in the assets of the enterprise. Partners own the partnership property as tenants in common.[490] Members of a joint stock company are also tenants in common unless otherwise provided by statute.[491] Beneficiaries of a trust have an ownership interest in the assets of the trust;[492] and shareholders have a claim to the assets of the corporation upon liquidation.[493] Since ownership of the assets of a corporation vests fully in the corporate entity, the property interests of shareholders can be said to be in abeyance until the corporation ceases to exist. The corporation is interposed between the shareholders and the assets; nonetheless the interests of the shareholders vis-a-vis creditors of the corporation has been characterized as equity rather than a debt.[494] It is important to note that an equity interest is sometimes translated into the right to manage the investment.[495]

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488 11 Fletcher § 5294, at 543.

489 See generally United States v. Evans, 375 F.2d 730, 731 (9th Cir. 1967) (for the purpose of taxation); Federal Employees' Distrib. Co. v. United States, 206 F. Supp. 330, 334 (S.D. Cal. 1962); 11 Fletcher § 5294, at 544. See generally 154 A.L.R. 934, 941-49 (1945) (for the purpose of taxation).

490 1 Fletcher § 20, at 56.

491 Id. § 21, at 66.

492 1 A. Scott, The Law of Trusts § 12.1, at 106-07 (3d ed. 1967):

> A trust involves a duty to deal as fiduciary with some specific property for the benefit of another. A debt involves a merely personal obligation to make payment of a sum of money to another. A creditor as such has only a personal claim against his debtor. . . . [H]e has no legal or equitable interest in the property of his debtor. He may, indeed, have a security interest . . . but even a secured creditor is not the beneficial owner of the debtor's property. On the other hand, the beneficiary of a trust has an equitable interest in the trust property. The beneficiary of a trust has something more than a mere chose in action. . . . If the trustee transfers the trust property to a person who is not a bona fide purchaser, or if the trustee becomes insolvent, the beneficiary is still entitled to the property; and on the other hand, if the property is lost or destroyed without the fault of the trustee, the loss falls upon the beneficiary and not upon the trustee.

There is a fiduciary relation between trustee and beneficiary but not between debtor and creditor as such.

493 The right which a shareholder in a corporation has by reason of his ownership of shares, is a right to participate according to the amount of his stock in the surplus profits of the corporation on a division, and ultimately on its dissolution, in the assets remaining after payment of its debts.

Plimpton v. Bigelow, 93 N.Y. 592 (1883) cited in 11 Fletcher § 5083, at 21.

494 [T]he property of a corporation does not belong, in law, to the stockholders, but to the corporation as a distinct legal entity or artificial person, and the right of the stockholder is merely the right to participate in the management of the corporation, in any dividends which may be declared from profits, and ultimately in the distribution of what remains of its assets, on dissolution, after payment of its debts.

11 Fletcher § 5096, at 63.

495 Id. § 5294, at 544.

3. Rights of Policyholders in the Assets of the Insurance Company Under Insurance Laws

The general rule is that, absent special provisions in the policy, charter or statute, to which a policyholder's rights are subject, both a policyholder and an annuity contractholder are unsecured creditors of the insurance company.[496] A policyholder, therefore, is not usually entitled to accounting[497] and has no right to the assets funding the obligations due to him. Even allegations of fraud or wrongdoing are insufficient to furnish the necessary foundations for equitable accounting.[498] This rule was applied to policies under which payments depended, in part, on profits of the insurance company, for example, participating policies.[499]

The classic theory regarding the relation between a policyholder and an insurance company is expressed in *People v. Security Life Insurance & Annuity Co.*[500]

> Every policy-holder in such a company enters into engagements with the company, and not with any other policy-holder. He pays the premiums upon his policy, not to make a fund to insure others, but solely as a consideration of his own insurance. The company receives the money as its own, and holds it as its own, and may do with it what it will, except as it is restrained by some statute. . . . But they who pay their money for insurances are no more jointly interested, or in any sense partners, than the depositors in a bank. The depositors swell the assets of the bank and also its liabilities, and they have a common interest that the bank shall keep its funds so as to be able to discharge its liabilities; and that is all . . . . The fund produced by the payment of all the premiums does not in any sense belong to the policy-holders, but belongs exclusively to the company; and the policy-holders are interested in it in the same way only that the creditors of any other corporation are interested in its funds.

Policyholders' right to cash surrender value is based on statute and contract,[501] not on a property right in the assets of the reserves. However, the rationale for requiring insurance companies to pay defaulting policyholders the cash surrender value of the policy is that his savings should be returned to him upon default and lapse of the policy.[502] Some decisions recognized a semblence of property right in these savings.[503] The decisions, however,

[496] 19 Appleman § 11061, at 667.

[497] Gourley v. Northwestern Nat'l Life Ins. Co., 94 Okla. 46, 220 P. 645 (1923).

[498] Equitable Life Assurance Soc'y of the United States v. Brown, 213 U.S. 25, 45-50 (1909).

[499] Id.

[500] 78 N.Y. 114, 122-23 (1879).

[501] 3A J. Appleman, Insurance Law and Practice § 1751 (rev. ed. 1967) [hereinafter cited as 3A Appleman].

[502] Id. § 1864, at 213.

[503] Inter-Southern Life Ins. Co. v. Omer, 238 Ky. 790, 801, 38 S.W. 2d 931, 935-36 (1931). For forfeiture purposes the policyholder is deemed to have some property right in the reserve fund, and no forfeiture can occur before this money has been used, and applied to cure premium arrears. But see Spears v. Independent Order of Foresters, Inc., 107 S.W.2d 126 (Mo. 1937).

should be limited to the facts. For other purposes policyholders are creditors,[504] secured and unsecured. The ownership of reserves is vested in the insurance company, but the freedom of an insurance company to deal with its assets is so limited by statutes as to create a strong similarity to a trust, at least with regard to the use of the assets.

The respective rights of policyholders and insurer in the assets of the insurer were discussed in *Ashurst v. Preferred Life Assurance Society.*[505] The plaintiffs were members of a non-stock fraternal society that converted into a stock life insurance company. Under the statute authorizing the conversion the surplus vested in the converted company. The plaintiffs argued that they had a divisible, vested interest in the surplus, and that the statute unconstitutionally deprived them of property without compensation. Under the by-laws of the society members were liable for assessments. They could participate in a distribution of surplus if declared by the board of trustees. Upon conversion, policyholders ceased to be subject to assessments, and lost the possibility of receiving surplus distribution. The court held that "neither of these changes involved vested property rights."[506] On the other hand, the society held the surplus "in trust" for the benefit of policyholders. The converted company inherited the obligations of the society as a debtor to preserve the property that was earmarked for the return of its debts. The surplus could be used only for the payment of policies and could not be paid as dividend by the company.[507]

Policyholders in a mutual insurance company occupy a dual position, as policyholders and as members or beneficial owners of the corporation.[508] As policyholders they are creditors of the company.[509] As members they have rights that are similar to those of shareholders.[510] In Nebraska the reserves of a mutual insurance company were held to be a trust for the benefit of the policyholders[511] so that commingling of funds in order to conceal a surplus constituted a cause of action in a participating policyholder.[512] Policyholders were also entitled to accounting for misappropriated funds.[513] In Illinois a policyholder in a mutual insurance company was held to have a property interest in the surplus and a voice in the

504 Townsend v. Equitable Life Assurance Soc'y of the United States, 263 Ill. App. 432, 105 N.E. 324 (1914).

505 282 Ala. 119, 209 So. 2d 403 (1968).

506 Id. at 134, 209 So. 2d at 416.

507 Id. at 133-34, 209 So. 2d at 415-16.

508 18 Appleman § 10046.

509 Uhlman v. New York Life Ins. Co., 109 N.Y. 421 (1888); Clifford v. Metropolitan Life Ins. Co., 264 App. Div. 168, 34 N.Y.S.2d 693, 695 (1942).

510 18 Appleman §§ 10046-47.

511 Equitable Life Assurance Soc'y of the United States v. Hardin, 166 Ky. 51, 57, 178 S.W. 1155, 1157 (1915); Whaley v. Matthews, 134 Neb. 875, 884-85, 280 N.W. 159, 163 (1938). A member of a mutual company may sue for misapplication of funds of the company on behalf of himself and all others similarly situated because "the surplus of a mutual life insurance company belongs to its members . . . ." Id.

512 Clark v. Lincoln Liberty Life Ins. Co., 139 Neb. 65, 77, 296 N.W. 449, 455-56 (1941).

513 See note 519 infra.

management of the company. If there is an inequitable distribution of surplus, a policyholder may sue to obtain his pro rata share.[514] Yet he is not in the same position as a shareholder.

A basic difference between a shareholder of a corporation and a member-policyholder of a mutual insurance company is that a policyholder's membership is acquired by virtue of his policyholding. His main interest is in the policy. Further, because insurance companies are closely regulated by state insurance authorities some statutes provide that a member-policyholder may not sue derivatively before he has exhausted all administrative remedies afforded to him, including a request to state insurance authorities to exercise their statutory powers.[515] Some statutes limit suits by members to actions which do not interfere with the business of insurance.[516] Accounting may under certain circumstances be considered to be such an interference,[517] whereas an action to declare a trust over specified assets, which were transferred from the company, was not.[518]

It has been held in Nebraska that a policyholder of a mutual life company may bring an equity suit to require directors and officers to account for insurance funds that they have misappropriated and in which the policyholders had an interest, when the company and the insurance department have failed to sue.[519] Receivership is not a remedy available in a suit by a policyholder when a statute provides that the state insurance authority will supervise the company, and report to the Attorney General, who may then take necessary steps to protect the members of the company.[520] In short, policyholders are creditors of the insurance company. In a mutual company they are also members, but their main interest is still that of policyholders. Their rights as members are colored by their status as creditor-policyholders. Therefore, the primary law enforcers with regard to insurance companies have been the states' regulatory departments, ensuring that member-policyholders' rights are not violated. Occasionally in-

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514 People ex. rel. Parkinson v. Williams, 392 Ill. 224, 64 N.E.2d 464 (1945). On the other hand, policyholders were held to have only the rights specified in their policies and the statutes. The distribution of surplus was mandatory under the applicable statute, but the directors of the company were given by statute some discretion to determine the distributable surplus. Policyholders could not force an additional distribution absent a show of fraud by the directors. Fidelity & Cas. Co. v. Metropolitan Life Ins. Co., 42 Misc. 2d 616, 623-26, 248 N.Y.S.2d 559, 565-68 (Sup. Ct. 1963).

515 Clifford v. Metropolitan Life Ins. Co., 264 App. Div. 168, 34 N.Y.S.2d 693 (1942).

516 People ex. rel. Parkinson v. Williams, 392 Ill. 224, 64 N.E.2d 464 (1945).

517 People ex. rel. Benefit Ass'n of Ry. Employees v. Miner, 387 Ill. 393, 401-02, 56 N.E.2d 353, 356 (1944), cert. denied, 324 U.S. 840 (1945).

518 Winger v. Chicago City Bank & Trust Co., 394 Ill. 94, 67 N.E.2d 265 (1946).

519 Pathfinder Life Ins. Co. v. Livingston, 140 Neb. 354, 357, 299 N.W. 537, 539 (1941); Folts v. Globe Life Ins. Co., 117 Neb. 723, 742-50, 223 N.W. 797, 805-07 (1929). But see Garfield v. Equitable Life Assurance Soc'y of the United States, 7 Misc. 2d 283, 164 N.Y.S.2d 819 (1956). As to liability of directors of a mutual insurance company see 18 Appleman §§ 10012-13, 10047-51. As to rights of stockholders in a stock company see id. § 10007.

520 Grand Lodge, A.O.U.W. v. Adair, 182 Ark. 684, 692, 32 S.W.2d 430, 433 (1930). See Equitable Life Assurance Soc'y of the United States v. Brown, 213 U.S. 25 (1909); Russell v. Pittsburgh Life & Trust Co., 62 Misc. 403, 412-16, 115 N.Y.S. 950, 956-58 (1909).

surance companies conduct business both as mutual and as stock companies. In such a case, upon winding up the affairs of the stock department, the surplus and guarantee capital accumulated at the risk of the shareholders was distributed to them.[521] When the charter of an insurance company provided that policyholders had a right to a fixed share in the surplus profits of the company,[522] these rights were held to derive from the provisions of the charter. Policyholders could sue even though they were not a party to the charter. As beneficiaries of the charter provision they were held to have acquired "certain property rights in the surplus" of the company. The shareholders of the company could not, therefore, abrogate these rights by unilaterally amending the charter.

4. Rights of the Account and Contractholders in the Assets of the Account Under State and Federal Laws

A variable annuity contract has the attributes of both a debt and an investment. It has a maturity date, it is a chose-in-action against the insurance company, and the right to payment is not limited to income. On the other hand, the variable annuity carries with it an investment risk and, by virtue of the 1940 Act, a voice in the management of the enterprise. These attributes alone do not require that the variable annuity must carry with it property rights to the assets in the account. The Commission favors an arrangement that vests ownership of the assets, whether legal or beneficial, in the account[523] or, perhaps, the contractholders. But over half the states require that the ownership of the assets in separate accounts shall be in the insurance company and prohibit the insurance company from acting as a trustee or holding itself to be a trustee.[524] Section 3(a) of the 1940 Act defines an investment company as an issuer which

> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities; . . . [or] (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets . . . on an unconsolidated basis.

If an account is organized as a management company, it may fall within the definition of section 3(a)(1) without owning the assets allocated to it. The definition speaks of investment business, not of the ownership in assets. If an account is organized as a unit investment trust, it does not fall within section 3(a)(1) because it is not primarily engaged in investment business. A unit investment trust engages in the business of holding securities as described in section 3(a)(3), but the definition in that section includes

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521 Traders' & Mechanics' Ins. Co. v. Brown, 142 Mass. 403, 411-12, 8 N.E. 134, 135 (1886). In this case the company was solvent.

522 Ohio State Life Ins. Co. v. Clark, 274 F.2d 771, 778 (6th Cir. 1960).

523 See proposed Rule 17f-3, note 463 supra.

524 See note 57 supra.

ownership of assets. The Commission permitted accounts to be organized as unit investment trusts, even though they were established in states that did not permit them to own assets allocated to them.[525] Either the Commission interprets the term "own" in section 3(a)(3) to include "hold" or "be allocated to," or it deems the 1940 Act to require that an account organized as a unit investment trust own at least 40 per cent of the assets allocated to it and that federal law prevails over state law that prohibits this. Perhaps the explanation is that separate accounts are a new form of organization of investment companies that may resemble a unit investment trust, and that these accounts need not own the assets allocated to them. With respect to separate accounts the definition in section 3(a) must be modified in view of the definition of a separate account in the 1970 Act. Section 3(c)(11) speaks of "assets allocated to the account" not assets owned by it. The source of the word "allocate" is "to place," and it means, among other things, to appropriate for a specific purpose, to set apart and earmark or designate.[526] The word denotes possession or designation rather than ownership. This word is also used in the same sense in many insurance statutes with respect to the use of separate accounts.[527]

The Investment Company Act does not require that the account own the assets allocated to it. The Act superimposes its definitions and requirements on legal arrangements to which state law applies.[528] Additionally, there is nothing in the Investment Company Act that requires that the contractholders have property rights in the account's assets. The definition of a "security" in the Act includes a debt security.[529] In fact, a redeemable security can also be a debt security. This means that the Act applies to a creditor-investor, a creditor who is entitled to a "proportionate share of the issuer's current net assets . . . ."[530] on demand, rather than to a fixed-dollar amount on a maturity date. A separate account may therefore issue debt securities, payment under which varies with the investment performance of assets that are owned by someone other than the account or the contractholders. The variable annuity does not usually grant property rights in the assets of the account. The 1940 Act, however, regardless of state law, bestows on contractholders rights that usually accompany equity investment contracts: a right to a voice in management,[531] a right to disclosure,[532]

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525 E.g., New York.

526 As in accounting, it means to apportion cost and expenses to accounts according to some arbitrary rule. See Webster's Third New International Dictionary (15th ed. 1966).

527 See nn. 449, 450 supra.

528 Tcherepnin v. Knight, 389 U.S. 332 (1967).

529 § 2(a)(36), 15 U.S.C.A. § 80a-2(a)(36) (1971).

530 See § 2(a)(32), 15 U.S.C.A. § 80a-2(a)(32) (1971) defining "redeemable security."

531 § 16(a), 15 U.S.C.A. § 80a-16(a) (1971).

532 A registered investment company must file information with the Commission annually. § 30(a), 15 U.S.C.A. § 80a-30(a) (1971). Rule 30a-2, 17 C.F.R. § 270.30a-2 (1971) prescribes the form to be used. The company must also file semi-annual reports. § 30(b), 15 U.S.C.A. § 80a-30(b) (1971). The Commission refused the request of the industry for exemption from the semi-annual reporting requirement. McDougal, note 28 supra, at 84. In addition

a right to bring an action to enforce many of the provisions of the Act.[533] The Act imposes on the insurance company, as an investment adviser, fiduciary duties to the contractholders, duties that are alien to the relation between creditors and debtors.

Contractholders occupy polarized positions with respect to assets of the account. They are creditors when their rights are based on the insurance aspect of the annuity governed by state insurance statutes, and investors when their rights are based on the security aspect of the annuity, not by virtue of ownership of the assets but by virtue of the dictates of the 1940 Act.

D. *Insulation of the Account from Claims of the Insurance Company's Creditors*

1. General

The staff of the Commission is of the opinion that the account is, or ought to be, insulated from claims of the insurance company's creditors, if the insurance company ever becomes insolvent. It has been stated that separate accounts as a separate business are "failure proof" since their obligations match the market price of the assets.[534] This is not necessarily so. If assets of the account are embezzled, the account might be unable to meet its investment obligations. If the obligations of the account include payments of annuities, and if the insurance company refuses, or is unable for other than financial reasons, to replenish the reserve in the account, the account might be unable to meet these obligations regardless of whether the insurance company is able to do so. Conversely, if the insurance company becomes insolvent, it could be argued that the account itself, because of its separate accounting, is solvent, even though state law treats the account as part of the insurance company. The account's position or the position of the group of contractholders vis-a-vis the insurance company then would be that of creditors on the mortality and expense guarantees and on its advisory and underwriting contracts. Whether or not the assets of the account are insulated from claims of creditors of the insurance company depends on who is their legal or beneficial owner, or on who has a security interest, if any, in these assets. The answer to these questions cannot be found in the 1940 Act or the Bankruptcy Act. It is to be found in state law.

2. Federal Law

The 1940 Act does not regulate the property rights to assets in the account. The Act includes an "association" in the definition of an issuer[535]

variable annuity contracts must be registered under the Securities Act of 1933, 15 U.S.C.A. § 77a-77aa (1971) and each purchaser must be provided with a prospectus.

533 See p. 363 infra.

534 See W. Greenough, A New Approach to Retirement Income 14 (1964).

535 An issuer, defined in section 2(a)(22), 15 U.S.C.A. § 80a-2(a)(22) (1971), includes a "person." A person, defined in section 2(a)(28), 15 U.S.C.A. § 80a-2(a)(28) (1971), includes a "company." A company, defined in section 2(a)(8), 15 U.S.C.A. § 80a-2(a)(8) (1971), includes an "association."

even though the association itself, under state law, might not have capacity to own property and the assets are owned by the members. As shown, the 1940 Act does not require that contractholders or the account own the assets.

It can be argued that the Investment Company Act, by implication, prohibits creditors of another business enterprise from collecting their debts from the assets of an investment company. The Act's provisions are aimed at ensuring the integrity of the company's assets and preventing self-dealing by affiliated and interested persons, such as the insurance company. The assets in a separate account are therefore insulated from these creditors. The answer is that if the contract between contractholders and the insurance company grants the company rights in the assets, and especially if these rights are granted pursuant to state laws under which the account is established, it is hard to see how the 1940 Act, by implication, would limit this particular part of the contract.

An interpretation of a statute that bars creditors of the insurance company from claiming assets in the account may raise a constitutional problem. Policyholders have a right to share in the assets of the insurance company upon insolvency subject to provisions in the charter, by-laws or policies, that permit the insurance company to reserve a part of its assets for the benefit of a special class of policyholders to the exclusion of all others. The "laws which subsist at the time and place of the making of a contract . . . enter into and form a part of it, as if they were expressly referred to or incorporated in its terms."[536] If the charter, by-laws or policies do not reserve to the insurance company a right to set apart some of its assets for the benefit of contractholders, an interpretation of the 1940 Act or an express provision in state law that places a part of the insurance company's assets beyond the reach of its present policyholders or other creditors may be in violation of the contract clause. In *W.B. Worthen Co.* v. *Thomas*,[537] the Supreme Court struck down as unconstitutional a state statute which exempted all payments made by life insurance companies on their policies from seizure under judicial process, except when the policies had been previously used as a security for a debt. The exemptive provision was not limited by time or circumstances. The Court indicated that a more limited exemption might have been upheld. More recent cases use a test similar to that applied under the due process clause,[538] that is, how, and to what degree, was the contract changed by legislation with respect to the reasonable expectations of the parties when the contract was entered into.[539] It is arguable that since the parties knew when they entered into

[536] Von Hoffman v. City of Quincy, 71 U.S. (4 Wall.) 535, 550 (1866). See also Home Bldg. & Loan Ass'n v. Blaisdell, 290 U.S. 398, 430, 432 (1934).

[537] 292 U.S. 426 (1934).

[538] Hale, The Supreme Court and the Contract Clause, 57 Harv. L. Rev. 852, 884-92 (1944).

[539] El Paso v. Simmons, 379 U.S. 497, 503-08 (1965); Fornaris v. Ridge Tool Co., 423 F.2d 563, 567 (1st Cir. 1970), retrospective legislation affecting contractual obligations was invalidated on the basis of the due process clause rather than the contract clause.

the contract that the insurance industry is heavily regulated, their expectations included changes by state regulation in reasonable exercise of the police power, unless it is held that the insulation provision is not a reasonable exercise of police power because the investment risk undertaken by contractholders is insufficient to support a state policy of creating a security interest in contractholders as a special class of policyholders.

The Bankruptcy Act does not regulate the ownership of assets of insolvent corporations. If the Act applies to accounts, and this is not clear, a federal bankruptcy court will look to state law and, perhaps the 1940 Act, if applicable, to determine the rights of the account and contractholders to the assets.[540]

3. State Law Applicable to Separate Accounts

(a) *The "Not-Chargeable" Provision.* Thirty out of fifty states and the District of Columbia provide that the assets in a separate account will not be "chargeable with liabilities arising out of any other business of the insurance company."[541] These states also require keeping of a separate balance sheet for the account.[542] The Commission used to request a similar "not-chargeable" provision in the by-laws of separate accounts regardless of state statutes. This provision was a condition precedent to qualification under Rule 6e-1 of the Commission.[543]

The Commission clearly favors this provision, and interprets it to mean that creditors of an insurance company, including its other policyholders, may not satisfy their claims from the assets in the account. This interpretation cannot be based on the literal meaning of the provision. The term "chargeable" can be used in an accounting sense as an entry on the debit side of the ledger. It need not even result in a debt if the balance of the

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540 4A W. Collier, Bankruptcy § 70.07, at 88 n.8 and cases cited there (14th ed. 1969).

541 Alas. Stat. § 21.42.370(b) (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651D (Supp. 1970); Ark. Stat. Ann. § 66-3523(c) (Supp. 1969); Cal. Ins. Code § 10506(A) (West Supp. 1971); Colo. Rev. Stat. Ann. § 72-2-12 (1963); Conn. Gen. Stat. Ann. § 38-154a(a) (1969); D.C. Code Encycl. Ann. § 35-541(a) (1968); Fla. Stat. Ann. § 627-0976 (Supp. 1971); Ga. Code Ann. § 56-1040(i) (1971); Hawaii Rev. Stat. § 431-563(a)(4) (Supp. 1970); Idaho Code Ann. § 41-1936(5) (Supp. 1969); Ill. Ann. Stat. ch. 73, § 857.54 (Smith-Hurd Supp. 1971); Ind. Ann. Stat. § 39-3501 (Class I(c)) (1965); Kan. Stat. Ann. § 40-436(e) (Supp. 1970); Ky. Rev. Stat. Ann. § 304-834(3) (1969); La. Rev. Stat. Ann. § 22:1500(E) (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537(3) (1969); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Mich. Comp. Laws Ann. § 500.925(1) (Supp. 1971); Minn. Stat. Ann. § 61A.14.5 (Supp. 1971); Miss. Code Ann. § 5649-35 (Supp. 1970); Mo. Ann. Stat. § 376-309.1 (Supp. 1971); Nev. Rev. Stat. tit. 57, § 690.460.3 (1967); N.H. Rev. Stat. Ann. § 408:30 (1968); N.Y. Ins. Law § 227.1(j) (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(j) (Supp. 1969); N.D. Cent. Code § 26-11.1-01.5 (Supp. 1971); Laws of Ohio bk. I, § 3907.15 (1969-1970); Okla. Stat. Ann. tit. 36, § 6061(h) (Supp. 1971); Pa. Stat. Ann. tit. 40, § 506.2(b) (Supp. 1971); R.I. Gen Laws Ann. § 27-32-1(b) (Supp. 1970); S.D. Comp. Laws Ann. § 58-28-18 (Supp. 1971); Tenn. Code Ann. § 56-312 (Supp. 1970); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971); Vt. Stat. Ann. § 3855(a)(5) (Supp. 1971); Va. Code Ann. § 38.1-443(a) (1970); Wash. Rev. Code Ann. § 48.18A.020(4) (Supp. 1970); Wis. Stat. Ann. § 206.385 (5m) (Supp. 1971).

542 See note 110 supra.

543 17 C.F.R. § 270.6e-1(1)(c)(1) (1971).

account is greater than the charge.[544] The term "charge" can also mean "to hold liable for payment; enter a debit against . . . a pecuniary burden, encumbrance, tax, or lien; cost; expense; liability to pay . . . ."[545] If "chargeable" is only an accounting term, a provision that a separate account is not chargeable with debts arising out of insurance business does not preclude creditors of the insurance company from claiming these assets in case of liquidation or insolvency. If those assets are not chargeable, in the sense that they are not legally subject to payment of the company's debts, then they cannot be applied to these debts even if the insurance company becomes insolvent. The ordinary meaning of the word, therefore, does not provide the answer. Whether a "not-chargeable" provision in state insurance laws and individual annuity contracts insulates separate accounts from claims of creditors of an insolvent insurance company depends, therefore, on other provisions of state law regulating liquidation of insolvent insurance companies, the establishment of trusts by insurance companies and the ownership of assets in separate accounts.

(b) *State Statutes Regulating Insolvency of Insurance Companies.*

(i) General

Not all state statutes contain a "not-chargeable" clause with respect to separate accounts; and those that do have different provisions regarding priority to, or security rights in, assets of the insurance company upon liquidation. Each jurisdiction must be separately studied and analyzed, a task beyond the scope of this article.[546] The principles that govern insurance statutes should, however, be described. Insolvency of an insurance company results in the termination of all policies.[547] Absent special

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544 Foster v. United States, 17 F. Supp. 191, 194 (Ct. Cl. 1936). See also Travelers Ins. Co. v. Varley, 421 S.W.2d 478, 480 (Tex. Civ. App. 1967). The defendant insurance company was obligated to pay the insured's health expenses, if these expenses were "charged" to him by the hospital. The plaintiff claimed from the insurance company expenses charged to him but paid by Medicare. The term "charged" was held to be of common meaning: "To set to, as a debt; to place on the debit side of an account; as to charge a man with the price of goods sold to him;" to "fix or set down at the price named," as distinguished from "to put liability on the person; . . . or to subject to financial burden;" hence the plaintiff was entitled to the expenses "charged" to him. (Nevertheless, plaintiff was not allowed to recover, due to the court's definition and interpretation of the term "expense," preceded by the word "actual." The "actual expense," in this case, was borne by Medicare, not by the plaintiff).

545 Random House Dictionary (unabridged ed. 1967).

546 Only Texas spells out the legal consequences of the not-chargeable clause:

> The assets held in any such separate variable annuity account shall not be chargeable with liabilities arising out of any other business the company may conduct but shall be held and applied exclusively for the benefit of the owners or beneficiaries of the variable annuity contracts applicable thereto. In the event of the insolvency of the company the assets of each such separate variable annuity account shall be applied to the contractual claims of the owners or beneficiaries of the variable annuity contracts applicable thereto. . . . All amounts and assets allocated to any such separate variable annuity account shall be owned by the company and with respect to same the company shall not be nor hold itself out to be a trustee.

Tex. Rev. Civ. Stat. art. 3.72 § 7 (Supp. 1971).

547 19 Appleman § 11061, at 668.

provisions in the policy or statute to which their rights are subject, policyholders, even if they are entitled to a share in the profits of the company,[548] are unsecured creditors of the insolvent insurance company.[549] To the extent of their claims, they share, pro rata, in the assets of the company.[550] This rule also applies to the relationship between an insurance company and beneficiaries of policies who, upon the death of an insured, become entitled not to a lump-sum payment, but to partial payments, for example interest, leaving the principal in the hands of the insurance company. This arrangement even though it has some attributes of a trust does not create a trust. The insurance company is under no duty to segregate the funds or to account for them, absent special provisions to the contrary. A beneficiary under this arrangement, therefore, is not entitled to priority in the event of insolvency of the insurance company.[551]

(ii) Special Deposits

It is not uncommon for an insurance company to establish, pursuant to statute, and in its charter, by-laws and policies, a fund or funds for the exclusive benefit of a specified class of policyholders. If the insurance company becomes insolvent, the prior rights of this class of policyholders in the assets are usually recognized.[552]

548 People v. Security Life Ins. & Annuity Co., 78 N.Y. 114 (1879). The charter of the company provided that net profits would be divided between the shareholders and the policyholders at a 20-80 ratio respectively.

549 Lubin v. Equitable Life Assurance Soc'y of the United States, 326 Ill. App. 358, 61 N.E.2d 753 (1945); People ex rel. American Bankers Ins. Co. v. Palmer, 363 Ill. 499, 2 N.E.2d 728 (1936); Commonwealth v. Richardson, 29 Ky. L. Rptr. 662, 94 S.W. 639 (1906); National Park Bank v. Clark, 92 App. Div. 262, 87 N.Y.S. 185 (1904), rev'g 38 Misc. 558, 77 N.Y.S. 1089 (Sup. Ct. 1902); People v. Security Life Ins. & Annuity Co., 78 N.Y. 114 (1879); 19 Appleman § 11061, at 667.

550 Mutual Benefit Life Ins. Co. v. Duffy, 295 F. 881, 883 (D.N.J. 1924), aff'd mem., 3 F.2d 1020 (2d Cir. 1925), aff'd, 272 U.S. 613 (1926); Mayer v. Attorney General, 32 N.J. Eq. 815, 822 (1880); 19 Appleman § 11061, at 670-71: matured policies take first as creditors and unmatured policies share pro rata in the reserves. Contra, People v. Security Life Ins. & Annuity Co., 78 N.Y. 114 (1879) holding that matured policies share equally with unmatured policies pro rata. Holt v. Santa Clara County Sheriff's Benevolent Ass'n, 250 Cal. App. 2d 925, 59 Cal. Rptr. 180 (1967) here the constitution of the association limited participation in the assets of the association to members of at least five years standing; Hobbs v. Occidental Life Ins. Co., 87 F.2d 380 (10th Cir. 1937); Caminetti v. Manierre, 23 Cal. 2d 94, 142 P.2d 741 (1943); Boyd v. Wright, 148 Ga. 216, 96 S.E. 388 (1918); Kentucky Home Life Ins. Co. v. Miller, 268 Ky. 271, 104 S.W.2d 997 (1937). The same rule applies to unmatured policies. Upon insolvency they become due on the ground that the company breached an implied warranty to be solvent at all times. The claim of an unmatured policy is usually the amount needed to obtain a similar policy at the date of the breach, namely the date of insolvency. 19 Appleman § 11061, at 673. See also Downey v. Humphreys, 102 Cal. App. 2d 323, 227 P.2d 484 (1951). Unearned premiums in the hands of a general agent became, on insolvency of the insurance company, debts to policy holders. In this case the relation between the company and its agent was held to be that of debtor to creditor, not trustee to beneficiary.

551 1 A. Scott, Law of Trusts § 87.1, at 742 (3d. ed. 1967): "No part of the assets of the company belongs to the beneficiary. For this purpose he is a general creditor of the company and not the beneficiary of a trust. Fortunately, however, the courts have not yet been called upon to decide this question."

552 See generally 19 Appleman § 11107, at 760. See also the Uniform Insurer's Liquida-

When insurance statutes grant state courts, upon insolvency of the company, power to apply assets equitably, this power does not authorize a court to disregard in favor of one group of policyholders, rights in the assets created by statute or charter and by-laws of the company[553] in another group of policyholders.[554]

Funds established for the exclusive benefit of a class are loosely termed "trusts." They do not give rise to all the incidents of a trust. They are trusts in the sense that they must be applied for the benefit of the policyholders for whose benefit they were reserved.[555] In *Withers v. Great American National Life Guardian*[556] a guarantee and a benefit fund were created under a statute. The benefit fund was designed to replenish the guarantee fund, whenever need arose. The funds were administered separately and each was charged with its own costs. It was held that as between the groups of policyholders, the benefit and guarantee funds were trust funds in the sense that they could not be chargeable with expenses of administration of the general assets of the insurance company.[557]

tion Act which divides claims against an insolvent insurance company into four categories which are mutually exclusive: (1) "Preferred claims," namely, claims to which the law of a state or of the United States accords priority, Uniform Insurer's Liquidation Act § 1(9); (2) "Special deposit claims," namely, claims secured by a deposit made pursuant to statute for the security or benefit of a limited class of persons, id. § 1(10); (3) "Secured claims," namely, claims secured by a mortgage, trust or other similar private instrument, id. § 1(11); (4) and claims from "general assets" of the company, id. § 1(8), not subject either to special deposit claims or secured claims if these special deposits or secured claims are held for the benefit of a specified group of persons, and not for the benefit of all policyholders or creditors in the United States. Preferred claims are accorded priority only upon reciprocity of the state of domicile, id. § 6. Special deposit claims are accorded priority against the assets reserved for their benefit in "accordance with the provisions of the statutes governing the creation and maintenance of such deposits." Any deficiency may then be claimed from the general assets of the company, Id. § 7. Secured claimants have a choice between satisfying their claims exclusively from their security, or surrendering the security and claiming as general creditors, id. § 8.

553 19 Appleman § 11066, at 691.

554 Betts v. Connecticut Life Ins. Co., 78 Conn. 442, 62 A. 345 (1905).

555 1 A. Scott, Law of Trusts § 2.3, at 38 (3d ed. 1967). For the distinction between a trust and a debt see id. § 12.1. A trustee is under a duty to keep trust property separated from his own, 2 id. § 179.1; to keep trust property separated from other trusts, id. at § 179.2; and to designate trust property as property of the trust, id. at § 179. A trustee is guilty of a breach of trust not only if he uses trust property for his own purposes, but also if he deposits it in his own account, or even in his own safe deposit box, since he subjects the property to a risk of loss to which it would not otherwise be subject, that is, it may be used to satisfy the personal debts of the trustee, id. § 179.1. A trustee commits a breach of duty when he purchases securities for the trust and receives the certificates in his own name. He should not be permitted to place himself in a position to claim the investment as his own, when the investment is profitable, and to disclaim it as the trust's if there is a loss, id. § 179.3

Under the law of trusts an insurance company will not be permitted to mingle its own funds with the funds in a separate account, as it is free to do under insurance laws. Neither will it be permitted to make adjustments. Further, trustees are held to the highest standards of fiduciary duties, higher than those of an insurance company to its policyholders or those of an investment advisor to his customers. See Inv. Co. Act of 1940, § 36, 15 U.S.C.A. 80a-35 (1971).

556 124 N.J. Eq. 4, 200 A. 485 (1938). See also People v. Life & Reserve Ass'n, 150 N.Y. 94, 45 N.E. 8 (1896); 19 Appleman § 11107, at 763-64.

557 124 N.J. Eq. 4, 9, 200 A. 485, 487 (1938).

In *In re Equitable Reserve Fund Life Association*[558] the constitution of an assessment life insurance company provided for two distinct funds, a death fund and a reserve fund. All death claims were to be paid from the death fund only. The reserve fund was in essence an investment company. Every five years this fund issued a bond to the living members, payable after two years. The company was dissolved at the suit of the Attorney General. Although the death fund was insufficient to pay death claims in full, it was held that the claimants were not entitled to payment from the reserve fund. Death claimants were creditors bound by the limitations imposed in the by-laws and their rights were determined according to law, not equity. The essence of the decision is that when a company creates a separate and distinct fund and plainly announces that the holder of a death claim shall look to no other fund for satisfaction, this promise continues to have effect after dissolution of the company. The reserve fund was designed to assist the living members to pay their insurance and was created for their benefit. The court stated that "The fund is not assets of the company, within the general meaning of that term. It is more in the nature of a trust fund."[559] Upon insolvency the fund was to be applied subject to the conditions under which it was established. Therefore, only living members could share in it.

The theoretical basis for priority rights or secured-creditor status of a class of policyholders to a specified fund upon insolvency involves the notion of an equitable lien, in the sense that use of the fund is so limited for the benefit of the class as to become a charge on the property in the event of alienation or insolvency. This notion was described by an eminent insurance authority thus: "Where funds are collected in an assessment society for the purpose of payment under a specific contract they become trust funds of a sort in that they cannot be applied for any other purpose. And this is so even if the amount of the fund passed to a receiver."[560]

This theory is not limited to insurance. In *Emmert* v. *Drake*[561] a corpora-

[558] In re Equitable Reserve Fund Life Ass'n, 131 N.Y. 354, 30 N.E. 114 (1892). See also In re National Temperance Life Ins. Soc'y, 201 App. Div. 652, 195 N.Y.S. 9 (1922), reserves established under statute could not be used to pay expenses.

[559] In re Equitable Reserve Fund Life Ass'n, 131 N.Y. 354, 372, 30 N.E. 114, 118 (1892). See also People v. Lumbert, 148 App. Div. 444, 132 N.Y.S. 1069 (1911). Assets reserved by an association to pay for its legitimate debts may not be used for any other purpose. Use for another purpose is deemed larceny of the funds. In this case a conviction of larceny was reversed on the ground that the payments made were legitimate under the association's by-laws. National Park Bank v. Clark, 38 Misc. 558, 77 N.Y.S. 1089 (1902), aff'd, 92 App. Div. 262, 87 N.Y.S. 185 (1904); Bird v. Mutual Union Ass'n, 30 App. Div. 346, 52 N.Y.S. 1044 (1898); Farmers' Loan & Trust Co. v. Aberle, 18 Misc. 257, 41 N.Y.S. 638 (1896), modified and aff'd, 19 App. Div. 79, 46 N.Y.S. 10 (1897); People v. Life & Reserve Ass'n, 150 N.Y. 94, 45 N.E. 8 (1896); People v. Life Union, 31 N.Y.S. 1120, 40 N.E. 164 (1895).

[560] Simpson v. Amarillo Mut. Benevolent Ass'n, 68 S.W.2d 597 (Tex. Civ. App. 1934). See National Park Bank v. Clark, 38 Misc. 558, 77 N.Y.S. 1089 (1902), aff'd, 92 App. Div. 262, 87 N.Y.S. 185 (1904); 19 Appleman § 11067, at 697. An assessment levied for payment of a specific claim must be applied to the payment of this claim.

[561] Emmert v. Drake, 224 F.2d 299 (5th Cir. 1955). See also 1 G. Bogert, Law of Trusts and Trustees § 19, at 127-30 and n.34 (2d ed. 1965).

tion borrowed money for the purpose of financing the expenses of a public stock offering. The resolution of the board authorizing the taking of the loan, and the note given in return as security, contained a statement that the loan would be paid from the first proceeds of the public offering. It was held that the terms of the notes and resolution created an equitable lien on these first proceeds, and the directors were personally liable when the proceeds were diverted, the corporation became insolvent, and its assets were insufficient to repay the loan. The same principle appears in the law of trusts. When money is given to a bank for the purpose of investment, the general rule is that no trust is created. The bank may use the money until the investment is made. But under some circumstances, the "party agreeing to make the investment has been held to be a trustee for preference purposes on its [the bank's] failure without investment, or has been held criminally liable as a fiduciary on a conversion of the funds to its own use."[562]

It may be argued that separate accounts fall within the definition of special deposits, even though the "not-chargeable" clause does not specify that they are reserved for the exclusive benefit of contractholders. This is a question of interpretation which, hopefully, will seldom be raised, but should be uniformly treated.

(iii) Statutory Deposits

Another version of an insurance trust, closer to a true trust, is deposits that most jurisdictions require foreign companies to make with state insurance authorities as a condition precedent to doing business in the state.[563] These deposits form a part of the assets of the insurance company subject to the laws of the depositary state,[564] and are deemed to create protective liens,[565] or trust rights in favor of the policyholders.[566] They are not trusts in the classic sense. The interest of the policyholders in the assets is

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562 1 G. Bogert, Law of Trusts and Trustees § 21, at 180-82 (2d ed. 1965).

563 Such a "trust" is created for the benefit of all policyholders and creditors. McMurray v. Commonwealth, 249 Mass. 574, 144 N.E. 718 (1924); 19 Appleman §§ 10487, 10488 n.17.

564 Continental Bank & Trust Co. v. Apodaca, 239 F.2d 295 (10th Cir. 1956); 19 Appleman § 10489 n.45.5.

565 American United Life Ins. Co. v. Fischer, 130 F.2d 643 (8th Cir. 1942), cert. denied, 318 U.S. 767 (1943); Lucas v. Pittsburgh Life & Trust Co., 137 Va. 255, 119 S.E. 109 (1923); 19 Appleman § 10489, at 195: statute requiring deposits was deemed equivalent to a statutory mortgage for the benefit of all citizens of the state, so that no one of the persons so secured could by legal proceedings acquire a prior right to satisfy a claim from the fund.

566 American United Life Ins. Co. v. Fischer, 130 F.2d 643 (8th Cir. 1942), cert. denied, 318 U.S. 767 (1943); Holloway v. Federal Reserve Life Ins. Co., 21 F. Supp. 516 (W.D. Mo. 1937); Boston & A.R. Co. v. Mercantile Trust & Deposit Co., 82 Md. 535, 34 A. 778 (1896); McMurray v. Commonwealth, 249 Mass. 574, 144 N.E. 718 (1924); In re New Jersey Fidelity & Plate Glass Ins. Co., 15 N.J. Misc. 384, 191 A. 475 (1937); Aetna Cas. & Sur. Co. v. International Re-Insurance Corp., 117 N.J. Eq. 190, 175 A. 114 (1934); In re Lloyds Ins. Co., 248 App. Div. 479, 290 N.Y.S. 759 (Sup. Ct. 1936), aff'd sub nom. In re Application of the People of N.Y. by Van Schaick, 274 N.Y. 512, 10 N.E.2d 524 (1937); 19 Appleman §§ 10488, 11092, at 714-15 n.32.

not beneficial or equitable ownership, but only an interest of a secured creditor.[567] Property rights in the assets do not always vest in state authorities, and when they do, they vest only to satisfy policyholders' claims. General creditors may have rights in the assets subject to the preferential rights of policyholders.[568] When legal title in the assets remained with the insurance company, it was reasoned that state insurance authorities obtained title by virtue of state insurance statutes which became operative upon insolvency.[569]

The Uniform Insurers Liquidation Act, adopted by 28 states,[570] limits the definition of special deposit claims to those made pursuant to statute.[571]

The separate account resembles statutory deposits in that it is created pursuant to statute,[572] even though the main purpose of its creation is not to secure a class of policyholders but to segregate the investment business.

4. Segregation of Assets

Under the Commission's Rule 0-1(e),[573] a separate account must be "legally segregated." The Rule does not define the term "legally segregated." The literal meaning of "segregated" is "set apart or separated from others of the same kind of group."[574] It should be noted that compliance with section 17(f)[575] and Rule 17f-2[576] regarding custody of assets of an investment company could also be described as segregation. Yet proposed Rule 17f-3(b)[577] which did not become effective, specified, as a condition precedent to exemption from Rule 17f-2, physical segregation of assets and identification of assets as the property of the account. This may imply the creation of a trust for the benefit of the account, at least in states that do not expressly prohibit the company from being a trustee.[578]

Segregation of funds may, under certain circumstances, create an implied trust, especially if the funds are to be applied to one particular purpose exclusively.[579] In *Bank of Thomasville* v. *Lester*,[580] a depositor cashed a

567 1 A. Scott, Law of Trusts § 10 (3d ed. 1967).

568 Aetna Cas. & Sur. Co. v. International Re-Insurance Corp., 117 N.J. Eq. 190, 175 A. 114 (1934); In re Lloyds Ins. Co., 248 App. Div. 479, 290 N.Y.S. 759 (Sup. Ct. 1936), aff'd sub nom. In re Application of the People of N.Y. by Van Schaick, 274 N.Y. 512, 10 N.E.2d 524 (1937); 19 Appleman § 10489, at 196 n.60, 197 n.66.

569 American United Life Ins. Co. v. Fischer, 130 F.2d 643, 646 (8th Cir. 1942). See also 19 Appleman § 10489, at 196.

570 9B Uniform Laws Annotated.

571 Uniform Insurance Liquidation Act § 1(10) found in 9B Uniform Laws Annotated.

572 At least one case held that a deposit with state authorities can also be created by contract. State v. American Bonding & Cas. Co., 206 Iowa 988, 221 N.W. 585 (1928).

573 Inv. Co. Act Release No. 6039 (Apr. 30, 1970). In a previous definition the account was described as "a legally segregated asset account."

574 Webster's Third New International Dictionary (15th ed. 1966).

575 Inv. Co. Act of 1940, 15 U.S.C. § 80a-17(f) (1964).

576 17 C.F.R. § 270.17f-2 (1971).

577 Inv. Co. Act Release No. 6039 (Apr. 30, 1970).

578 1 A. Scott, Law of Trusts § 24, at 192 (3d ed. 1967).

579 Commonwealth ex rel. Kirkpatrick v. American Life Ins. Co., 162 Pa. 586, 29 A. 660 (1894).

580 Bank of Thomasville v. Lester, 177 Ga. 306, 170 S.E. 189 (1933).

certificate of deposit at a bank and agreed with the bank that the proceeds would be "segregated," and used to acquire other securities for him. The bank became insolvent without having purchased and delivered the securities. The proceeds were held to be a trust fund since "[u]nder the alleged facts, the bank could legally apply the money to no purpose save to purchase warrants as per agreement," and the money was to be "segregated."[581] It is doubtful whether such a ruling would apply to insurance companies. In insurance there must be an express contractual or a customary obligation on the insurance company to keep funds separate.[582] It has been held that if premiums for insurance and investment are not specifically apportioned, the fund created by these premiums is liable for all the insurance company's obligations, both insurance and investment.[583] On the other hand, the creation of various segregated reserve funds is not unusual in insurance law.[584]

Most state insurance statutes do not use the term "segregation" with respect to separate accounts. They require that the net payments made under variable annuity contracts be "allocated"[585] to, or "placed"[586] in, a separate account. The statutes also prohibit any securities dealings between various accounts of the insurance company[587] or between the insurance company and its general account,[588] except upon approval of state insurance authorities. Some statutes require that the "investments and liabilities" of an account be clearly identifiable and distinguishable.[589] There is no blanket prohibition upon placing money of the insurance company into the account, but this placement is usually restricted to the amount that insurance companies may invest in equity securities.[590] It is sometimes also

581 Id. at 310, 170 S.E. at 191.

582 18 Appleman § 10016, at 68-69; State ex rel. Ellis v. Union Cent. Life Ins. Co., 32 Ohio C.C.R. (n.s.) 262, aff'd, 84 Ohio 459, 95 N.E. 1156 (1911). An insurance company is not obligated to segregate funds of its participating and non-participating business absent an express provision by contract or statute.

583 18 Appleman § 10016, at 68; State ex rel. Smrha v. Cosmopolitan Old Line Life Ins. Co., 137 Neb. 742, 291 N.W. 72 (1940).

584 See, e.g., Mayor of City of Newark v. Board of Equalization of Taxes, 80 N.J.L. 258, 77 A. 795 (1910). Without changing existing relations between the company and the insured, an Act required apportionment and segregation of the fund in which deferred dividends policyholders as a class were entitled to participate under their policies. Prior to the Act companies were under no obligation to segregate. See Fla. Stat. Ann. § 627.0976 (Supp. 1971).

585 See, e.g., Cal. Ins. Code § 10506(A) (West Supp. 1971). See generally note 143 supra.

586 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); Minn. Stat. Ann. § 61A.13 (Supp. 1971).

587 See, e.g., Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.J. Stat. Ann. § 17:35A-9(c) (1963); N.Y. Ins. Law § 227.1(g) (McKinney Supp. 1971); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971).

588 See, e.g., Hawaii Rev. Stat. § 431-563(a)(5) (Supp. 1970); Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971); N.Y. Ins. Law § 227.1(g) (McKinney Supp. 1971).

589 See, e.g., N.H. Rev. Stat. Ann. § 408:31 (1968); N.J. Stat. Ann. § 17:35A-9(c) (Supp. 1971); Pa. Stat. Ann. tit. 40, § 506.2(b) (Supp. 1971); Tex. Ins. Code art. 3.72, § 7 (Supp. 1971).

590 E.g., N.Y. Ins. Law §§ 81.13(b).13(c) (McKinney Supp. 1971) Some statutes specifically

restricted to the purpose of "providing for effective and economical diversification of investments by" the separate account.[591] Most statutes require periodic valuation and adjustment in the account to ensure that the account contains sufficient assets to cover liabilities under the variable annuity contracts.[592] Some statutes specifically limit the amounts which the company may deduct from the account for the purpose of distribution as dividends to shareholders.[593]

State statutes require that the account, its assets and accounting, be separate from the other assets of the insurance company that are invested in appropriate conservative investments. This is in keeping with the policy of state insurance legislation to permit almost unlimited investments in equity securities only if the investment risk is shifted to contractholders. Some state statutes also require that assets equal to the reserves of the variable annuities be placed in the separate account,[594] in keeping with the policy of creating a reserve to make more certain the ability of the company to meet its liability to its policyholders when the time arrives for distribution among them.[595] These goals can be achieved without physical segregation of assets. There is, however, no conflict between a requirement for segregation and insurance practice. To sum: insurance laws and practice use a variety of accounts creating different rights and obligations: accounts with (a) assets separated from other assets of the company by accounting only; (b) assets physically segregated for specific uses or for the purpose of effective supervision by state authorities; (c) assets in which policyholders have no rights; (d) assets subject to "an insurance trust" or "a lien" in favor of the policyholders; and (e) assets in trust for policyholders.

The separate account may fall into any of these categories. If a trust is not recognized, there are factors that might lead, in many states, to a recognition of a special deposit. Among these factors are the statutory provisions regarding the establishment of the account, especially "not-chargeable" clauses, similar provisions in the Rules of the account and in the contracts; the separate accounting and segregation of assets; and the strict duty to apply the assets exclusively to investments and payment of variable contracts and benefits.

5. Policy Considerations

An argument against insulation of the assets is that preference is alien to principles of insurance, especially in mutual insurance companies, and in

regulate the investments of insurance companies in their accounts. See, e.g., Cal. Ins. Code § 10506(B) (West Supp. 1971); Ga. Code Ann. § 56-1040(j) (Supp. 1970); N.Y. Ins. Law § 227.1(b)(5) (McKinney Supp. 1971); N.C. Gen. Stat. § 58-79.2(c) (Supp. 1969); Wis. Stat. Ann. § 206.385(1) (Supp. 1971).

591 N.Y. Ins. Dep't Reg. No. 47, 11 N.Y. Code Rules and Regs. § 50.4 (1971).

592 See note 41 supra.

593 Galston, The Regulation of Variable Annuities, ABA Section of Ins., Negligence, & Compensation Law 348, 374 (1967).

594 See p. 239 supra.

595 J. Magee, General Insurance 116 (6th ed. 1961); W. Vance, Insurance 73 (3d ed. B. Anderson 1951).

violation of state laws forbidding unfair discrimination among policyholders.[596] The answers to this argument lie in the many examples of insulation and reservation of funds to classes of policyholders, the unique nature of separate accounts, and their similarity to many of the special reserves of the past.

It may be argued in favor of insulation that the account conducts an investment business that is separate from the insurance company and carried at the risk of contractholders. Therefore, the creditors of the insurance company ought not to avail themselves of the account's assets to satisfy debts due from the insurance company on its insurance or other business. The answers to this argument are that the assets of the account also fund insurance promises; and, more importantly, under state law and under the Commission's theories[597] all the assets of the insurance company are available for payment of variable annuities, should the account's assets be insufficient for any reason. If the general assets of the insurance company guarantee all the obligations under the contracts, the assets of the account should be considered the company's, in the event of insolvency, to offset the amount of potential debt. Further, the fact that contractholders bear the investment risk is at best irrelevant. Equity investors usually come after, not before, secured and unsecured creditors. This is not to say that an "insurance trust" that provides a secured debt for contractholders cannot be created by state law or by contract. Many state statutes might well have done so. Contractholders are also protected by the provisions of the 1940 Act regarding reorganization,[598] proxy solicitation,[599] and exchange of securities.[600] In comparison with shareholders of a conventional mutual fund, contractholders may fare better even if the assets of the account are not insulated from the creditors of the insurance company. Their right to collect from the insurance company may well offset the absence of insulation of the assets of the account.

E. *Restrictions on Investments*

Section 12(a) of the 1940 Act prohibits investment companies from purchasing securities on margin, effecting short sales, participating in joint trading accounts, and acting as distributors of securities or underwriters.[601]

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[596] 12 Appleman §§ 7017-19.

[597] See p. 273 supra.

[598] § 25, 15 U.S.C.A. § 80a-25 (1971).

[599] Id. § 25(a), 15 U.S.C.A. § 80a-25(a) (1971). See also SEC v. National Sec., Inc., 393 U.S. 453 (1969).

[600] § 11, 15 U.S.C.A. § 80a-11 (1971).

[601] § 12(a), 15 U.S.C.A. § 80a-12(a) (1971). This section was designed to abate speculative investments. N.Y. Times, Nov. 12, 1936, at 26, col. 2-3:

> Among the principal abuses of investment trusts have been their use as dumping grounds for unmarketable underwritings participated in by the banking house controlling the trusts; the too rapid turning over of their portfolios (often with the object of obtaining commissions for the banking house); a complicated financial structure; the acquisition of highly speculative instead of sound dividend-paying stocks; and the excessive concentration of investments in one or a few companies. . . . There are also other practices the wisdom of which, on grounds of public policy, is at least

All state insurance laws impose strict limitations on investments by insurance companies, but permit separate accounts to invest in equity securities.[602]

Section 12(d)(1)(A)[603] prohibits a registered investment company from acquiring securities of another investment company if, immediately after purchase, it will own more than 3 percent of the total voting stock of the acquired company. The same prohibition applies if, immediately after purchase, the investment company will own securities of the acquired company that have a value of more than 5 percent of the total assets of the acquiring company, or if the acquiring company will own securities issued by the acquired company and all other investment companies having an aggregate value of more than 10 percent of the total assets of the acquiring company.

Section 12(d)(1)(E) excepts from the provisions of section 12(d)(1) securities, if the depositor or principal underwriter thereof is a registered broker or dealer,[604] and if the purchased security is the only security held by the investment company. This section fits some separate accounts organized as unit investment trusts.[605]

Separate accounts may not invest in stock of their sponsor insurance company under section 12(d)(3), which prohibits an investment company from acquiring securities of a broker-dealer or its investment adviser. If the insurance company is not the investment adviser nor a broker-dealer, then the partial prohibition of section 12(d)(2) applies. Under this section an investment company may not acquire more than 10 percent of the outstanding voting stock of an insurance company, unless at the time of acquisition it was the owner of at least 25 percent of the stock. This prohibition may be waived by the Commission under section 12(g) if the Commission determines by order that acquisition is in the public interest because it might result in improving the financial condition of the insurance company. There is no prohibition on the creation of new insurance companies by investment companies.[606]

State insurance laws also regulate investments in separate accounts. First, since they do not recognize the account as a separate entity they relieve the insurance company from the limitations on investments usually imposed on it with respect to conventional insurance business.[607] Second, they may

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open to debate. These include, for example, the purchase of so large an amount of the stock of particular companies that the trust has a dominating voice in the management of those companies, investment trusts, in any case, are as properly subject to regulation as savings banks and insurance companies.

Cited in Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess. 39 (1940).

602 See note 125 supra.

603 § 12(d), 15 U.S.C.A. § 80a-12(d) (1971).

604 § 2(a)(6), 15 U.S.C.A. § 80a-2(a)(6) (1971); 15 U.S.C.A. § 78c(a)(4) & (a)(5) (1964) for the definition of broker and dealer.

605 For the definition of a unit investment trust see § 4(2), 15 U.S.C.A. § 80a-4(2) (1971).

606 The trend, however, is in the opposite direction. Insurance companies create or acquire investment companies.

607 See note 125 supra.

reiterate the substance of the provisions of the 1940 Act.[608] Third, they may contain additional requirements or limitations.[609] Fourth, they may prohibit the insurance company from effecting without permission from the insurance authorities, any transfer of assets between the insurance company and the account,[610] except to adjust the reserves. And finally, they may require transfers due to adjustment to be made in cash, or in "securities having a valuation which can be readily determined in the marketplace, provided that such transfer of securities is approved by the Superintendent."[611] State statutes that impose more stringent limitations on investments for the account than the limitations of the 1940 Act, might be deemed to be not operative since they conflict with the federal act.[612] The rationale of this result is questionable[613] because additional limitations under state law do not conflict with the protection afforded by the 1940 Act.

VII. Control by Contractholders

A. *General*

It is a fundamental principle of corporate law that directors may not delegate their powers and authority to others.[614] Long-term management contracts are, therefore, forbidden in banking, insurance and industrial corporations.[615] Investment companies are the one exception. In 1939, after a thorough study, the Commission concluded that small investment companies could not afford to employ in-house investment advisory capabilities, and that management contracts ought to be permitted, if safeguards were established.[616] These safeguards were shareholder election of directors,[617] some assurance of independence of the board,[618] shareholder control over investment policies,[619] choice of independent public accountants,[620] and approval of advisory and underwriting contracts.[621]

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608 N.J. Stat. Ann. § 17:35A-9(a) (Supp. 1971) following § 12(d)(1)(A)(iii), 15 U.S.C.A. § 80a-12(d)(1)(A)(iii) (1971).

609 N.J. Stat. Ann. § 17:35A-9(a)(ii) (Supp. 1971).

610 Id. § 17:35A-9(c).

611 Reg. No. 47, 11 N.Y. Code Rules & Regs. § 50.3(a)(3) (1971). See also Colo. Ins. Dep't Bull. No. 35 (Aug. 10, 1961): "The Company establishing separate accounts for variable contracts will effect no transfer of assets or liabilities to or from variable accounts except in making the adjustments necessitated by contract and the mortality experience adjustment. . . . Such adjustments shall be made by a cash transfer only."

612 Investors Diversified Services, Inc. v. Diggles, 272 Wis. 66, 74 N.W.2d 805 (1956).

613 1 Loss at 157 n.95.

614 W. Cary, Cases and Materials on Corporations 210-22, (4th ed. 1969); N. Lattin, The Law of Corporations § 94 (2d ed. 1971).

615 W. Cary, note 614 supra, at 217-22.

616 Investment Trusts and Investment Companies: Hearings on S. 3580 Before the 76th Cong., 3d Sess. pt. I, at 251-52 (1940); Hearings on H.R. 11995, S. 2224, H.R. 13754 & 14737 Before the Subcomm. on Commerce & Finance of Comm. on Interstate & Foreign Commerce, 91st Cong., 1st Sess. pt. I, at 855-56 (1969). Testimony of SEC chairman Hamer H. Budge.

617 § 16, 15 U.S.C.A. § 80a-16 (1971).

618 § 10, 15 U.S.C.A. § 80a-10 (1971).

619 §§ 8(b), 13, 15 U.S.C.A. §§ 80a-8(b), 13 (1971).

620 § 32(a), 15 U.S.C.A. § 80a-32(a) (1971).

B. *Election of Directors*

Shareholders of an investment company are given certain mandatory powers over their management. Section 16(a) of the 1940 Act provides that directors of an investment company may not serve as such unless elected by the holders of the outstanding voting securities of the company. Directors may fill vacancies, but only by a vote of more than one third of the number of directors. Further, transfer of control by seriatim resignations is prohibited.[622] When less than a majority of the acting directors have been elected by the shareholders, a shareholder meeting must be called to fill vacancies.

The Commission had early expressed its opinion that shareholder voting and control rights are one of the essential protections afforded by the Act since there exists a potential conflict of interest between the investment company and its investment adviser. Shareholders' ultimate voice in the management of the corporation is in large part "the very essence of the Act."[623] Therefore, the Commission held that a proposal of an insurance company to keep to itself the power to designate in perpetuity the policy and operation of the fund, as well as the absence of provision for a minimum number of independent directors, was inconsistent with the purpose of the Act.[624] It was no answer that shareholders may sell their interests and seek investment elsewhere. Every shareholder of an investment company may do so. Aside from cost, it is clear that the Act does not regard the possibility of sale by investors as a proper substitute for a management of their choice. In the case of variable annuities, when opportunity to sell is limited to redemption in the pay-in period, sale provides an even poorer substitute for control of management. No exemptions were, therefore, granted from the provisions of section 16, except as to the date of first election,[625] and for accounts covered presently by the full exemption of section 3(c)(11) of the 1940 Act.[626]

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621 § 15(a), 15 U.S.C.A. § 80a-15(a) (1971).

622 § 16(a), 15 U.S.C.A. § 80a-16(a) (1971). See Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962) (Friendly, J., dissenting), transfer of control by seriatim resignation is not prohibited in a corporation that is not an investment company.

623 41 S.E.C. at 350.

624 Id. at 352.

625 A partial exemption was granted under Rule 16a-1, 17 C.F.R. § 270.16a-1 (1971), to persons serving as directors of a separate account prior to the first meeting of contractholders, if the account qualifies for exemption under Rule 14a-2, 17 C.F.R. § 270.14a-2 (1971), or is exempt from section 14(a) of the 1940 Act by order, and the directors have been appointed to act as such by the insurance company which established the account, and an election of directors took place at a meeting of contractholders not later than one year after the effective date of the registration statement of such variable annuities, subject to an extension by the Commission for good cause shown. This exemption and the exemption under Rule 14a-2 were granted for the same reason, because the type of group contract contemplated under Rule 14a-2 was not expected to result immediately in a large number of contractholders. The Rule codified prior ad hoc exemptions granted on the same grounds.

626 § 3(c)(11), 15 U.S.C.A. § 80a-3(c)(11) (1971). Rule 6e-1, 17 C.F.R. § 270.6e-1 (1971) exempted from section 16 accounts which qualified under it because these accounts were

In *Valic* the Commission permitted an arrangement whereby contractholders and stockholders had voting rights to elect together the board of directors of the company. This could have resulted in contractholders being outvoted by stockholders with respect to matters that affected only contractholders. This arrangement is no longer acceptable.[627] In *Prudential* the Commission interpreted the 1940 Act to require that contractholders be given the exclusive right to elect the directors to manage the account. "The effect of these Sections" [sections 13, 15, 16, 18 & 32(a)] the Commission said, "is not only to place the power of control in the holders, but to prevent its usurpation by any others, management or outside party, through long-term contract or otherwise. The purpose is not only to secure honesty and objective 'wisdom' in management, but to make it separately responsive to the wishes and judgment of those who depend upon its results."[628] The account must be managed by a separate management, separately elected by those who have an investment stake in the account.

This structure required a delegation of management powers by the insurance company over a part of its business to persons who were not its board of directors in direct violation of the principles of corporation laws and insurance statutes.[629] At the date of the *Prudential* decision such a delegation of powers was not permitted under any state law.

Since the requirements in sections 15, 16 and 32 of the Act are not subject to state laws as voting is under section 18(i), the Act was held to supersede state laws that provide that the insurance company will be managed by its elected board and prohibit directors from delegating their authority. The Commission expressed the hope and belief that a way will be found to effectuate the policy of the Investment Company Act in accord with state legislation.[630] This hope seems to have been justified. The later trend in insurance legislation is to allow insurance companies to follow the dictates of the 1940 Act regarding contractholders control.[631] But the variety of provisions in state laws is great, and confusing. It is not clear what management powers may be delegated and to whom.

C. *State Laws Providing Voting Powers*

Most state laws permit the insurance company to provide voting rights to contractholders, presumably in the contracts.[632] This authority should

exempt from the provisions of section 18(i) of the Act requiring that the securities issued by investment companies grant voting rights. A qualified account, therefore, need not necessarily have an elected board of directors.

627 McDougal, note 28 supra, at 83-84.

628 41 S.E.C. at 351.

629 See, e.g., "The business and affairs of a corporation shall be managed by its board, except as in this act or in its certificate of incorporation otherwise provided." N.J. Rev. Stat. § 14A: 6-1 (1969). "Any company organized under chapters 17 to 33 of this title . . . its stockholders, members and directors, shall have all the powers granted and be subject to all the duties and obligations imposed by Title 14, Corporations, General, except so far as they may be inconsistent with the provisions of this title." Id. § 17:18-1 (Supp. 1971).

630 41 S.E.C. at 353.

631 See note 356 supra.

632 See p. 302 supra.

correspond to the federal law which requires that the securities shall grant voting rights. Variable annuity contracts contain the security.

Under some statutes the grant of voting power for contractholders requires a change in the constitutional documents of the insurance company. Delaware, for example, provides that:

> Any domestic life insurer which establishes one or more separate accounts . . . [may] amend its charter to provide for special voting rights and procedures for such separate account contract owners giving them jurisdiction over matters relating to investment policy, investment advisory services and selection of certified public accountants, in relation to the administration of the assets in any such separate account.[633]

The power to vote does not include the power to elect directors, as required by section 16(a) of the 1940 Act, nor the power to manage the account, but only to vote on specified matters in relation to the administration of the account. Since in these matters contractholders were granted "jurisdiction," presumably they could elect a committee to act for them, perhaps only with respect to matters enumerated.

Illinois, which also considers voting a matter for a charter amendment effects it automatically:

> Any such company may provide for the beneficial owners of policies or contracts to which the provisions of this paragraph apply special voting rights and procedures relating to investment policy, investment advisory services and selection of certified public accountants in relation to the administration of the assets in any separate account to which the assets in respect to such policies or contracts are allocated and its corporate charter shall be deemed amended to authorize such company so to do. This provision shall not in any way affect existing laws pertaining to the voting rights of the company's policyholders.[634]

Kansas permits an amendment either of the charter or of the by-laws of the insurance company, and in addition to the powers enumerated above, the company may also provide contractholders with powers as to "such other matters as the company deems necessary in the management of the assets in any such separate account."[635]

From the point of view of the corporate law under which the insurance company is incorporated, there is good reason to consider contractholders as a class of policyholders, given special voting rights to elect some of the company's directors. The latter then form a committee to manage a special assets account. But this theory may not be compatible with the regulatory scheme of the 1940 Act.

D. *State Laws Providing Management Powers*

The power of contractholders and the board of an account organized as a management company to manage the investment business of the account

633 Del. Code Ann. tit. 18, § 2933(g) (Spec. Pamphlet 1968).

634 Ill. Ann. Stat. ch. 73, § 857.51(b) (Smith-Hurd Supp. 1971).

635 Kan. Stat. Ann. § 40-436(k) (Supp. 1970). See La. Rev. Stat. Ann. § 22:1500B (Supp. 1971).

may stem from state law, the 1940 Act, or the law of unincorporated associations.

So long as the account is not an investment company, the power to manage the account is in the board of directors of the insurance company, elected by its shareholders, members and/or its policyholders. The decision-making power regarding the account before the 1940 Act applies to it is allocated and defined by the insurance and corporate laws governing the insurance company. Some state statutes permit the insurance company to delegate management powers to the contractholders; others—to the board of the separate account.[636] In the first instance presumably the board is a delegate of the contractholders, who are, in turn, delegates of the power of the insurance company's board of directors.[637] Neither statutory scheme

[636] See, e.g., N.J. Rev. Stat. § 17:35A-9(b)(ii) (Supp. 1971): "Such committee may have the power which may be exercisable alone or in conjunction with others, or which may be delegated to such insurance company or any other person, as investment manager or investment adviser, to authorize purchases and sales of investments for such account . . . ." See also Model Variable Contract Regulation art. IV, § 4(b), note 41 supra, at 195-96. The Model Regulations provide that an insurance company may, "with respect to any separate account registered with the Securities and Exchange Commission as a management investment company, established for such account a committee, board, or other body, the members of which may or may not be otherwise affiliated with such company and may be elected to such membership by the vote of persons having interests in such account ratably as determined by the company. Such committee . . . may have the power, exercisable alone or in conjunction with others, to manage such separate account and the investment of its assets."

[637] See Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971): "Notwithstanding any other provision of law, any domestic life insurance company which establishes one or more separate accounts . . . may provide to the holders of interests in any such separate account voting rights with respect to the management of such separate acount and the investment of assets therein, may establish for such separate account a committee, board or other body the members of which (1) may be elected solely by holders having such voting rights . . . and may provide for compliance with any applicable state and federal law, in order that contracts on a variable basis may be lawfully sold or offered for sale." The statute permits the company to provide in its contracts, "with respect to management of" the separate account the establishment of a board of directors, not to manage the account, but only to be elected by the contractholders. The insurance company is further authorized to provide for compliance with applicable state or federal law in order that variable contracts might be sold. In California a domestic insurance company which has established accounts may provide contractholders with special voting rights with respect to investment policies, investment advisory services, and the selection of certified accountants in connection with "the administration of the assets in such separate account." Cal Ins. Code § 10506(D) (West Supp. 1971). Yet implied in the voting rights are the rights to ratify the advisory and underwriting contracts and to elect directors who have powers similar to directors of a corporation. 1940 Act § 2(a)(12), 15 U.S.C.A. § 80a-2(a)(12) (1971).

Prospectuses of variable annuities usually contain a provision that contractholders shall have the right to vote on:

1. The initial approval of any amendment of an investment management agreement;
2. Ratification of an independent public accountant for the separate account;
3. Change in the fundamental investment objectives and policies of the separate account, and any change requiring approval of the contractholders in the account's investment policies with respect to securities investment;
4. Election of members of the board of managers of the separate acount. See Prospectus, Lincoln Nat'l Variable Annuity Fund A at 24 (April 26, 1968). This prospectus adds to the permitted agenda "any other business which may properly come before the meeting." Id.

accords with the structure that the Investment Company Act envisages. Management powers usually emanate from the investment company. The investment company, not the board or the contractholders is assumed to enter into an advisory contract delegating or authorizing the investment adviser in effect to manage the company.[638] The express provisions of the Act require that contractholders be provided with voting power in the *security*.[639] The Act further prohibits a person from acting as a director unless elected.[640] A director is defined in the Act as a director of a corporation or any person performing similar functions with respect to any organization whether incorporated or unincorporated.[641] Thus, when state statutes either directly or through the board provide contractholders with powers of management the end result satisfies the provisions of the Act.

It is submitted that the effect of state statutes that authorize an insurance company to grant or provide voting power to contractholders or establish a board for the account is to permit the insurance company to delegate, at least as many of its own powers as are necessary to comply with the provision of the Investment Company Act. Within the minimum prescribed in the Investment Company Act and the maximum authorized by state statutes, the insurance company has discretion whether or not to delegate its powers. Some state statutes do not authorize any delegation of management powers over the investment business of the account. Yet, one of the basic holdings made in *Prudential* was that the Investment Company Act requires management powers to be granted exclusively to contractholders.[642] This decision has been followed at least in form. Therefore, state statutes must be interpreted to permit delegation of these powers.

This interpretation enables the insurance company to provide contractholders with the rights and powers required under the 1940 Act and at the same time by-pass the account as an institution. The insurance company regulated department approach prevails again. Further, the powers of the contractholders and the board as specified in the Rules are usually limited to powers granted by the 1940 Act. This interpretation excludes the application of the law of unincorporated associations under which the powers of members and their representatives stem from the constitution of the association.[643]

E. *Division of Power Between the Contractholders and the Board*

The Rules of separate accounts usually provide for the membership and powers of the board of the account.[644] Presumably insurance companies feel constrained to allocate to the board and the contractholders in the

[638] § 15(a), 15 U.S.C.A. § 80a-15(a) (1971).
[639] § 18(i), 15 U.S.C.A. § 80a-18(i) (1971).
[640] § 16(a), 15 U.S.C.A. § 80a-16(a) (1971).
[641] § 2(a)(12), 15 U.S.C.A. § 80a-2(a)(12) (1971).
[642] 41 S.E.C. at 351.
[643] See p. 265 supra.
[644] See p. 264 supra.

Rules the powers that each must exercise under the 1940 Act. If any additional powers are enumerated, they vest in the contractholders or the board, at the discretion of the insurance company. Again the law of unincorporated associations is inapplicable. Under this law members may, according to their constitution, authorize and withdraw authorization from their elected representatives.[645] Under the corporate law applicable to the insurance company this division has been fairly rigidly fixed.[646] It is arguable that if the applicable corporate law permits shareholders to have a greater participation in the governance of the business of the corporation there is no reason why contractholders should not be given an opportunity to exercise this power in the account, for example, to initiate a substitution of an investment policy.[647] Under the present state of the law the powers of contractholders and of the board are determined by the insurance company pursuant to its authority under state law. The account, again, is viewed as a regulated department. Contractholders are granted only the powers that the 1940 Act requires that they have.

This state of the law is unsatisfactory. The model of unincorporated associations is inappropriate because the insurance company's interests are then ignored in the organizational structure of the group of contractholders. Appropriate or not, this law is not applied to separate accounts. Under the present state of the law, the contractholders cannot acquire for themselves the powers of their board except when the insurance company is authorized to give this power, and chooses to give it. An organizational scheme for contractholders ought to be provided by law, whether the account is deemed an investment company or a regulated department of the insurance company. Neither the contractholders alone, nor the insurance company alone should determine the structure of the account for the purposes of enabling the contractholders to exercise their powers under the 1940 Act. The potential conflict of interest between them may be greater than between the insurance company and other groups of policyholders. Legislation should provide a fixed model of organization and should specify the powers of the contractholders and of the board, who may change these powers, and to what extent they may be changed.[648]

[645] See, e.g., Ostrom v. Greene, 161 N.Y. 353, 362, 55 N.E. 919, 922 (1900); see also Goller v. Stubenhaus, 77 Misc. 29, 134 N.Y.S. 1043 (1912); Tanner v. Ranken, 44 Misc. 488, 89 N.Y.S. 770 (1904).

[646] N. Lattin, The Law of Corporations 242 (2d ed. 1971).

[647] Under the 1940 Act contractholders have only the right to veto a change in investment policies. § 13, 15 U.S.C.A. § 80a-13 (1971).

[648] At present the laws applicable to the question of what is a proper subject for a proposal by shareholders under Rule 14a-8 of the proxy rules, 17 C.F.R. § 240.14a-8 (1971), are the 1940 Act and state laws, and the rules of the account insofar as they do not conflict with the former. It may well be, therefore, that contractholders may propose a change in the investment policies of the company, notwithstanding the fact that they have no power to initiate such a change. See Medical Committee for Human Rights v. SEC, 432 F.2d 659, 680-81 (D.C. Cir. 1970), cert. granted, 91 S.Ct. 1191 (1971). Except in cases of day-to-day management, contractholders may initiate proposals as to how their company should be managed. In a matter over which they have veto power the reasoning of the case makes the position of proposing contractholders even stronger. On April 30, 1971, the

A breach of voting rights arising under the 1940 Act will constitute a cause of action against the account, or its board of directors. There may be both personal and derivative actions against the insurance company under section 18 of the 1940 Act if the company had caused the violation.[649] Whether a violation of state insurance statutes or the Rules will give rise to a personal or derivative action against the insurance company depends on the applicable laws. For the purpose of effectuating their voting rights under state law contractholders should be treated as shareholders. In a stock company contractholders will, perhaps, be put in the position of shareholders. In a mutual insurance company they would be deemed members with special rights regarding the assets and management of the account.[650]

F. *Control over the Business of the Account*

The Investment Company Act grants security holders mandatory veto powers in matters that under corporate laws are normally within the discretion of management. Under section 8(b) of the Act the registration statement must contain a detailed recital of the important investment and business policies of the company.[651] Management cannot be granted discretion regarding these policies.[652] Section 13 of the Act provides that the vote of the majority of the outstanding voting securities is required to permit any deviation from the recited policies,[653] including policy with respect to concentration of investments in any particular industry or groups

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staff of the Commission decided that a proposal of a shareholder concerning the investment policies of Fidelity Trend Fund, Inc. and the advisory fees of its investment adviser (with certain adjustments) were proper subjects to be included as stockholder proposals in the proxy materials. 101 Sec. Reg. L. Rep. at K-1 (BNA May 12, 1971). For the arguments for inclusion of the proposal see letter of Roy A. Schotland to Snyder H. Mendelsohn, Ass't Director of Div. of Corp. Reg., 97 Sec. Reg. L. Rep. at El-5 (BNA Apr. 12, 1971).

649 By analogy to the remedies available for violation of rights under the proxy rules, see J.I. Case v. Borak, 377 U.S. 426 (1964). See generally, 2 Loss at 956-73. The insurance company may be liable under section 48 of the 1940 Act, 15 U.S.C.A. § 80a-47 (1971), which makes it unlawful for any person to cause a violation of the Act through another person.

650 Insurance statutes sometimes permit insurance companies to conduct different types of business in separate departments governed by different rules. See note 50 supra.

651 The recital must contain a statement whether the company reserves the freedom of action to engage in the following activities, and, if yes, the extent to which the company intends to engage in: (a) changes in classification and subclassification of the investment company; (b) borrowing money; (c) issuance of senior securities; (d) engaging in the business of underwriting securities issued by other persons; (e) constraining investments in a particular industry or group of industries; (f) purchase of real estate and commodities; (g) making loans to other persons, and (h) portfolio turnover. The registration statement must also contain a recital of all investment policies not enumerated above which are changeable only if authorized by shareholder vote, and policies in respect of matters which the company deems to be of fundamental policy.

652 A majority means "the vote, at the annual or a special meeting of the security holders . . . duly called, (A) of 67 per centum or more of the voting securities present at such meeting, if the holders of more than 50 per centum of the outstanding voting securities . . . are present or represented by proxy; or (B) of more than 50 per centum of the outstanding voting securities of such company, whichever is the less." § 2(a)(42), 15 U.S.C.A. § 80a-2(a)(42) (1971).

653 §§ 13(a)(2), (3), 15 U.S.C.A. §§ 80a-13(a)(2), (3) (1971).

of industries, or to deviate from a policy that is changeable only if authorized by shareholder vote.[654] In addition, a majority vote is required in order to change the subclassification of the company from a diversified to a non-diversified company, or to change the nature of the business of the company so that it ceases to be an investment company.[655] If the recitals of policy in the registration statement do not expressly permit the company to engage in specified business practices, such as borrowing money, issuing senior securities, purchasing or selling real estate or commodities and making loans, the company may not engage in these activities unless authorized to do so by the vote of a majority of its outstanding voting securities.

The Act requires that advisory and underwriting contracts contain, among other things, a provision that, after the initial two years, the contracts shall continue to be in effect only if specifically approved at least annually by the board of directors or by a vote of a majority of the outstanding voting securities of the company.[656] The advisory contract must also provide that it may be terminated at any time by the board of directors or by the vote of the majority of the outstanding voting securities.[657] The contract is also automatically terminated in the event of its assignment by the investment adviser.[658] The selection of an independent public accountant by the directors must also be ratified by shareholders.[659]

The Commission granted exemptions from these requirements in two types of cases. In the case of *General Electric Co.*,[660] it granted to an employees' securities company[661] exemption from the requirement of advisory and underwriting contracts, election of directors and approval of an independent accountant (sections 15(a), 16(a) and 32(a)), because the existing arrangement provided adequate investor protection. The plan could not be terminated if this would have adversely affected employees' units in the plan. The trustees were obligated to diversify reasonably the fund's holding and were not permitted to invest in securities of the employer or its affiliates. A nationally known firm was elected as an independent accountant.

The Commission also exempted, first on an ad hoc basis,[662] and then by Rule 6e-1, an account funding qualified pension plans from the requirements of the approval of the initial advisory and underwriting contracts

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[654] In addition the 1940 Act § 8(b)(3), 15 U.S.C.A. § 80a-8(b)(3) (1971) refers to policies not enumerated in paragraphs (1) and (2) in respect of matters which the registrant deems to be of fundamental policy.

[655] §§ 13(a)(1), (4), 15 U.S.C.A. §§ 80a-13(a)(1), (4) (1971).

[656] § 15(a)(1), 15 U.S.C.A. § 80a-15(a)(1) (1971). Inv. Co. Amendments Act of 1970, amending 15 U.S.C. § 80a-15 (1964).

[657] § 15(a)(3), 15 U.S.C.A. § 80a-15(a)(3) (1971).

[658] Assignment is defined in § 2(a)(4), 15 U.S.C.A. § 80a-2(a)(4) (1971), and was held not to include a transfer of control in the publicly held adviser if the transfer was the result of proxy solicitation and a power struggle. Willheim v. Murchison, 342 F.2d 33 (2d Cir. 1965).

[659] § 32(a), 15 U.S.C.A. § 80a-32(a) (1971).

[660] Inv. Co. Act Release No. 5830 (Sept. 29, 1969).

[661] § 2(a)(13), 15 U.S.C.A. § 80a-2(a)(13) (1971).

[662] See, e.g., In re Continental Separate Account (B) (1966), Inv. Co. Act Release No. 4798 (Dec. 21, 1966).

and the ratification of independent public accountants.[663] This Rule is now superseded by the full exemption of section 3(c)(11) of the 1940 Act.

G. *Advisory and Underwriting Contracts Between the Account and the Insurance Company*

1. General

The effectiveness of contractholders' control and supervision over investment advisory and underwriting contracts is less than it seems. Shareholders of mutual funds rarely, if ever, refuse to ratify investment advisory contracts.[664] This has been attributed to dispersed share-holdings, shareholder apathy, and the choice of redemption over a costly proxy fight. Further, the fund may incur losses upon a change of investment advisers. The Act grants shareholders the power to refuse to ratify an investment advisory contract, but no power to enter into a new contract on their own initiative. The name of the investment company might belong to the adviser.[665] Termination of the advisory contract may therefore entail loss of goodwill and further hampering of the recruitment of a new investment adviser. Refusal to ratify took place only when it was too late, namely, when the fund did not perform profitably and was in financial difficulties.[666]

Variable annuity contractholders have an additional incentive to ratify advisory contracts that are usually entered into with their sponsor, the insurance company. Termination of the advisory contract might result in a loss of the insurance promises. Regardless of whether insurance promises and investment promises are legally separable, economically, the two support each other. An insurance company might not consider it economically feasible to guarantee mortality and expenses without serving simultaneously as the investment adviser. Insurance promises and investment promises are linked in the minds of contractholders. If the investment performance of the account is poor, this fact will inevitably reflect adversely on the insurance company, even if the investment adviser is totally independent. Further, the assets of the separate account support both insurance and investment promises. If the insurance company is obligated, together with the account, to pay annuities, it will have to cover its obligations from assets that are managed and controlled by others. The company may therefore not take kindly to a transfer of the contract.

With respect to the underwriting contract there is an additional reason why the insurance company will object to the separation of the combined

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663 A separate account exempt under Rule 14a-2 will not have many contractholders upon establishment. Compliance with the provisions of the Act was therefore postponed until the first meeting of variable annuity contractholders, and not later than one year after the effective date of the registration statement under the 1933 Act. 17 C.F.R. § 270. 15a-3 (1971).

664 SEC Investment Co. Growth Report, note 127 supra, at 129.

665 See Inv. Co. Act Release No. 5510 (Oct. 8, 1968).

666 In re Managed Funds, Inc., 39 S.E.C. 313 (1959), cited in SEC Investment Co. Growth Report, note 127 supra, at 128-30. See also complaint in Arnold Berenhard & Co. v. Keystone Custodian Funds, Inc., 92 Sec. Reg. L. Rep. at I-1 (BNA Mar. 10, 1971).

services offered by it. The securities issued by the account are an integral part of the variable annuity issued by the insurance company. Both are sold by the insurance company.[667]

Theoretically, however, contractholders might refuse to ratify the contracts and the insurance company might refuse to continue its advisory and underwriting services. Perhaps less theoretically, the insurance company might be enjoined from continuing to offer these services.[668]

2. Legal Consequences on Termination or Non-Ratification of Advisory or Underwriting Contracts

Existing prospectuses are vague as to the legal consequences of contractholders' refusal to ratify, or the termination of, advisory contracts.[669] Some prospectuses do not provide for this eventuality. Others offer a variety of solutions: a promise to continue the mortality and expense guarantees,[670] or a provision for the liquidation of the account,[671] or a termination provision on the acceptance, without recourse, of the insurance promises by another insurance company.[672]

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667 McDougal, note 28 supra, at 94-95; see Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. Pa. L. Rev. 1058 (1967).

668 Under section 36(a) of the Act the insurance company cannot be enjoined from acting as an investment adviser or underwriter. See note 718 infra. But under section 42(e) a federal court can restrain an insurance company from acting as an investment adviser and underwriter, or if the investment company acts as a broker-dealer under section 21(e) of the Securities Exchange Act of 1934, 15 U.S.C. § 78u(e) (1964), or revoke its registration as a broker-dealer under sections 15(a) & (b), 15 U.S.C. § 78o(a) & (b) (1964).

669 Prospectus, National Variable Annuity Co. of Fla. Separate Account at 4 (July 31, 1967). Prospectus, American Variable Annuity Life Assurance Co., American Variable Annuity Fund at 2 (Dec. 7, 1967); the advisory function is performed by a bank that is unrelated to the insurance company. Prospectus, American Republic Assurance Co. Separate Account B (Group Variable Annuity Contracts) (Sep. 20, 1968); the advisory function is performed by the insurance company.

670 The Paul Revere Variable Annuity Contract Accumulation Fund, Individual Variable Annuity Contracts, provides that "[if] the investment advisory agreement between the Insurance Company and the Accumulation Fund were to be terminated, it would be probable that the federal and state regulatory authorities would require appropriate steps to be taken to insure the continued operation of the investment activities of the Accumulation Fund in the interest of the variable annuity contract owners." This contract also promises that mortality and expense guarantees "might be sustained no matter who its investment advisor is." Prospectus, The Paul Revere Variable Annuity Ins. Co., Variable Annuity Contract Accumulation Fund at 10 (May 19, 1966).

671 Prospectus, Group Variable Annuity Contracts Continental Assurance Co. Separate Account (B) at 4 (Apr. 1968) provides:

> In the event the Management Agreement is so terminated, the Company will liquidate all assets of the Separate Account. The interest of any retired participant therein shall be transferred by the Company to its regular reserves and the Company will pay a fixed annuity for the lifetime of the participant in the same form as the variable annuity held. Each participant who is not retired will be offered an option to receive a lump sum settlement, or, to receive an immediate or deferred fixed annuity. Under Sec. 1035(a)(3) of the Internal Revenue Code of 1954 no gain or loss will be recognized on the exchange of a variable annuity for a fixed annuity. Termination of the Management Agreement may have adverse tax consequences if a participant elects to receive a lump sum settlement since the full amount of the settlement received will be taxable as ordinary income realized in the year of receipt.

672 Preliminary Prospectus, American United Life Pooled Equity Fund B Group

Under general contract law and insurance law, unless otherwise expressly provided for, the insurance promises in variable annuity contracts will probably continue to have effect notwithstanding the termination of the investment advisory contract. Though investment advisory contracts are mentioned in the individual annuity contracts, they form a separate agreement, between different parties.[673] Even within the variable annuity contract, insurance and investment promises are separate promises for which separate consideration is given. The possibility that the investment advisory contract will not be ratified is mentioned in the variable annuity contract, as well as in the advisory contract itself. Unless the variable annuity contract states that an investment advisory contract is a condition precedent to the continued legal effectiveness of the insurance promises,[674] the latter promises will remain in force although the advisory contract has lapsed. Even if the promises are considered part of one contract, they should be treated as severable[675] because they cover different risks.[676] The insurance company can be sued separately on each promise; it can commit a breach on each promise; and if, for example, performance of one promise is illegal, it seems that the insurance company could be compelled to perform the remaining promise.[677]

A more difficult question is presented by the expense guarantee, under which the insurance company might be compelled to guarantee the rate of advisory fees charged by another investment adviser. A court might rule that the parties had not contemplated this result and release the insurance company from its obligation under this guarantee. However, if the mortality and expense guarantees are paid for in a lump sum, a court might refuse to apportion and adjust the charges,[678] especially when no guidance is provided in other types of insurance or annuity contracts. This is because life insurance policies and fixed annuities do not contain such guarantees.

As to the underwriting contract it has been argued that the sales function should remain unconditionally with the insurance company because the purchasing public will continue to identify that variable annuity contract

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Variable Annuity Contract: "However, no termination by Fund B may take effect until and unless a qualified insurance company has accepted and assumed without recourse, the annuity risks and obligations of AUL under the Group Contracts pursuant to the provisions of the Indiana Insurance Law." The binding effect of this provision may be questioned inasmuch as it limits the power of the fund to terminate the contract. It is clear, however, that the company considers the investment advisory contract to be an integral part of its other obligations under the variable annuity contracts.

673 4 J. Appleman, Insurance Law and Practice § 2371 (rev. ed. 1969) [hereinafter cited as 4 Appleman]. When a policy applies to different parties, it is severable with respect to each party.

674 See 3A A. Corbin, Contracts § 628 (rev. ed. 1960).

675 See Id. § 695.

676 4 Appleman § 2371. See also Metropolitan Life Ins. Co. v. Glassman, 224 Ind. 648, 65 N.E.2d 503 (1946); Guardian Life Ins. Co. of America v. Barry, 213 Ind. 56, 10 N.E.2d 616 (1937); Anair v. Mutual Life Ins. Co., 114 Vt. 217, 42 A.2d 423 (1945).

677 3A A. Corbin, Contracts § 695 (rev. ed. 1960); Annot., 131 A.L.R. 780 (1941).

678 3A A. Corbin, Contracts § 697, at 298 (rev. ed. 1960).

with the company issuing it.[679] Many insurance companies employ their own sales force. Insurance salesmen usually offer potential customers alternatives to variable annuities, which include investments in mutual funds, as well as straight life insurance. In the pay-out period the company conducts, through the variable annuities, an insurance business. The variable annuities also offer at the end of the pay-in periods options that are pure insurance products, for example, fixed annuities. Therefore, if contractholders do not approve the underwriting agreement, the company might lose the right to sell its own contracts. The economic loss resulting to an insurance company from revocation of the underwriting contract might be greater than that resulting to a mutual fund investment adviser in the same position.

In answer, it might be pointed out that if an underwriting contract is not ratified, no one can sell the particular variable annuities contracts. The insurance company might have to establish a new account in order to sell similar contracts, and the contractholders might have to find another insurance company, if they wish to continue to augment the assets in the account and the original sponsoring insurance company refuses to issue insurance promises to be sold by others. No doubt, non-ratification is a powerful weapon in the hands of contractholders; but it is one which they deserve to retain. In view of the weakness of contractholders' bargaining position against the insurance company, this provision seems to be the only real check on abuse. The chances that contractholders will ever refuse to ratify are very small. The threat, however, is an effective deterrent. If contractholders are unreasonable, or are led by corrupt motives, there is always a resort to the Commission's power of exemption from the requirement of ratification.[680]

The Investment Company Act might be interpreted to prohibit termination of insurance promises in the wake of non-ratification of advisory or underwriting contracts. Under section 15(a)(3) of the 1940 Act, advisory contracts must contain a provision that they "may be terminated at any time, without the payment of any penalty . . . ."[681] There is no similar provision regarding underwriting contracts. A strong argument can be made to the effect that contractholders ought to have the same freedom in exercising their power not to ratify the underwriting and investment advisory contracts as they have to terminate the investment advisory contract. Therefore a provision that avoids an important right of contractholders upon non-ratification is invalid. The loss by the contractholders of the insurance company's obligations under the variable annuity contract upon termination of advisory or underwriting contracts may prove a heavy penalty. Finally, the Commission, in its explanatory note to proposed Rules

679 McDougal, note 28 supra, at 95.

680 Investment Company Act of 1940, § 6(e), 15 U.S.C.A. § 80a-6(e) (1971).

681 § 15(a)(3), 15 U.S.C.A. § 80a-15 (a)(3) (1971).

26a-2 and 27a-2, expressed the opinion that insurance companies have legally binding insurance obligations to contractholders.[682]

A problem peculiar to the variable annuity may be presented when the insurance company discontinues the offer and sale of variable annuities funded by a specified account to the detriment of the contractholders. In *Dresser v. Hartford Life Insurance Co.*,[683] an insurance company was held not to be obligated to continue the sale of interests in what was, in essence, an investment fund, even though the motives of the officers of the insurance company were improper, and even though discontinuance resulted in deprivation of benefits to the existing policyholders who were the beneficiaries of the fund.[684] In a later case, however, it was held that when the value of an endowment policy is dependent on the number of the insured, its sale carries with it an obligation to endeavor in good faith to market it.[685]

If insurance laws permit an insurance company to cease offering variable annuities or to offer a competing product to entice contractholders into exchanging their variable annuities for this new product, causing shrinkage in the assets of an account and consequential loss, contractholders may, under the 1940 Act, turn to another underwriter. Since the insurance company ceases to offer its annuities, a new underwriter cannot sell the account's securities with the insurance component. On the other hand, the account may not have power to sell conventional mutual fund shares without an insurance component if under the insurance laws the insurance company has no power to issue these shares. It is doubtful whether an account may make separate arrangements with another insurance company. Under state insurance laws, insurance companies are permitted to issue variable annuities funded by an account which they themselves had established.[686] An insurance company may have no authority to offer mortality and expense guarantees to participants in an account established by another insurance company.

Neither the regulated-department approach nor the independent investment-company approach seem to offer a solution. Again, legislation is needed. A separate account should be permitted, under specifically enumerated circumstances, such as when the insurance company ceases to sell variable annuities without contractholders' consent, to sever its connection

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682 Inv. Co. Act Release No. 6039 (Apr. 30, 1970): "[B]ecause of the legally binding obligation of the insurance company to provide lifetime benefits under its contracts, there is no substantial risk of the abandonment of participating security holders."

683 80 Conn. 681, 70 A. 39 (1908).

684 To the same effect, Wall v. Bankers' Life Co., 208 Iowa 1053, 223 N.W. 257 (1929), appeal dismissed for lack of a substantial federal question, 282 U.S. 808 (1930) (per curiam).

685 Owens v. American Bankers Ins. Co., 242 Ark. 343, 413 S.W.2d 663 (1967).

686 See note 143 supra. § 2(a)(37), 15 U.S.C.A. § 80a-2(a)(37) (1971), might be interpreted to exclude the possibility of an account that is independent of an insurance company since it defines an account as one established and maintained by an insurance company. But the definition does not require that the same insurance company establish and continue to maintain an account.

with the insurance company. An insurance company should be allowed to combine its product with the separate account that had been established by another insurance company. Or a federal act could exempt separate accounts from the requirements of section 15 of the Act if alternative protection is offered to contractholders.[687]

VIII. The Board of Directors

A. *Establishment of a Board*

The 1940 Act does not require that an investment company have a board of directors. A unit investment trust is by definition a trust that does not have a board of directors.[688] Further, under the common law an unincorporated association may exist without officers.[689] If the investment company, however, is not a passive holder of securities and a recipient of income, and if it employs persons who manage its affairs, then its managers are directors, subject to the requirements of the 1940 Act.[690] The Act defines a director as "any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust."[691] The Act does not regulate the relationship between the directors and the investment company or the members, except in specific instances. Since associations cannot, as such, appoint agents,[692] directors and officers of unincorporated associations are agents of the members and are accountable to the members individually, rather than to the aggregate. Whether the directors of the account act for the contractholders individually, or for the account as an entity, depends on the theoretical framework used and on the applicable state statute.

Section 10(a)[693] of the Investment Company Act provides that not more than 60 percent of the directors of an investment company may be the investment advisers, or officers or employees or affiliated persons of the investment company. The 1970 Act substituted for "affiliated persons" a

[687] The insurance industry proposed to the Commission in 1967 a plan that in essence substitutes the right to convert variable into conventional insurance contracts for the advisory contract, and the right of termination and ratification of the contract by the contractholders. Finnegan & Garner, note 90 supra, at 124-25. It is doubtful whether this substitute is adequate. Sale of shares has not been considered an adequate substitute for shareholder control over investment advisory services. In re Prudential Ins. Co. of America, 41 S.E.C. 335, 352 (1963). At the time of conversion the market price of the shares upon whose price the value of the units is based may be low and the contractholders may sustain heavy losses. Finnegan & Garner, note 90 supra, at 126.

[688] § 4(2), 15 U.S.C.A. § 80a-4(2) (1971).

[689] Commonwealth v. Rozen, 176 Mass. 129, 57 N.E. 223 (1900).

[690] Chabot v. Empire Trust Co., 301 F.2d 458, 460 (2d Cir. 1962), a corporate trustee responsible for the entire management of an investment company except the purchase and sale of the portfolio securities is a "director" to whom § 17(h) of the 1940 Act applies.

[691] § 2(a)(12), 15 U.S.C.A. § 80a-2(a)(12) (1971).

[692] Brower v. Crimmins, 67 Misc. 68, 121 N.Y.S. 648 (1910).

[693] § 10(a), 15 U.S.C.A. § 80a-10(a) (1971).

wider concept of "interested persons,"[694] effective December 14, 1971. The Commission's Rule 6e-1[695] exempted qualified separate accounts from the provision of this section, and was superseded by section 3(c)(11)[696] as amended by the 1970 Act, which fully exempted such accounts from the provisions of the Act. Effective December 14, 1971, section 10(b)[697] prohibits the account from employing as regular broker any of its directors, officers or employees or any person of which they are an affiliated person, unless the majority of the board of directors of the account is not the broker or an affiliated person of the broker. The account may not use as a principal underwriter of its securities any of its directors, officers or employees or persons of which the directors, officers or employees are an interested person, unless a majority of the board of directors of the account is not the principal underwriter or an interested person of the underwriter. The Act provides in section 10(d)[698] an exemption to open-end companies that do not charge a front-end load and satisfy other additional requirements.

Persons convicted of violations in connection with the sale of securities are prohibited by section 9[699] of the 1940 Act from serving as directors, officers, members of an advisory board, investment advisers, or underwriters of any investment company. Rule 6e-1[700] granted to the insurance company affiliated with a qualified separate account an exemption from the restrictions of section 9(3),[701] provided that the convicted persons who are employed by, or affiliated with, the insurance company do not participate in any way in the operation or the sales of interests in the separate account. Section 3(c)(11) as amended by the 1970 Act again supreseded the Rule by granting a full exemption to qualified separate accounts.

B. *Duties*

1. State Law

If the account is governed by the law of unincorporated associations, its directors and officers are under a duty to act for the promotion of the

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694 § 2(a)(3) of the 1940 Act, 15 U.S.C.A. § 80a-2(a)(3) (1971), defines an affiliated person as "(A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person . . . ." § 2(a)(19), 15 U.S.C.A. § 80a-2(a)(19) (1971) defines an interested person to include an affiliate, any member of the immediate family of any natural person who is an affiliated person of the investment company, any interested person of an investment adviser or underwriter to the investment company.

695 17 C.F.R. § 270.6e-1 (1971).

696 Investment Co. Amendments Act of 1970, 84 Stat. 1413, amending § 3(c)(13), 15 U.S.C. § 80a-3(c)(13) (1964).

697 § 10(b), 15 U.S.C.A. § 80a-10(b) (1971). This section presently applies to affiliated persons.

698 § 10(d), 15 U.S.C.A. § 80a-10(d) (1971).

699 § 9, 15 U.S.C.A. § 80a-9 (1971).

700 17 C.F.R. § 270.6e-1 (1971).

701 A company becomes ineligible under this subsection if any of its affiliated persons is ineligible. § 9(3), 15 U.S.C.A. § 80a-9(3) (1971).

common interest of all members.[702] They are individually liable to contractholders as members of the association for fraud and breach of trust in the conduct of the affairs of the association. They will not be allowed to keep secret profits but must account to all members.[703]

Alternatively, the directors should be subject to state and corporate laws governing the duties of directors of the sponsoring insurance company[704] and the Rules of the account. Under some state insurance statutes the board of an account is permitted, subject to the provisions of the 1940 Act, to enter into an advisory contract with the insurance company.[705] This provision implies that, barring an express authority in the statute, directors of an account may not delegate their power.[706]

It is proposed that state insurance statutes prohibiting directors from receiving, directly or indirectly, commissions on the "business transactions of the company"[707] and from investing in any company if this investment will create a conflict of interest between the officers and directors of the insurance company and the corporation whose stock was purchased, should apply to the board of the account.[708] If the account is an unincorporated association its directors could arguably be liable on agency principles for its obligations, if the directors contracted as agents for an account as a principal that was found to be non-existent.[709] This result will not be reached when the account is held to be a corporate entity or when the plaintiff could be shown to have agreed, expressly or impliedly, that he would look to the account or to its sponsoring insurance company and

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702 Ferguson v. Crawford, 151 Ark. 503, 236 S.W. 837 (1922).

703 Id. For a discussion of trustees of an association for profit see S. Wrightington, The Law of Unincorporated Associations §§ 33, 44 (2d ed. 1923). For a discussion of the duties of underwriters of securities and syndicates see id. at § 50.

704 The directors exercise the powers of the directors of the insurance company. This interpretation is in accord with section 2(a)(12) of the 1940 Act under which a director is a person carrying out the duties of directors. The proposed legal source will create uniformity within the corporate structure of the insurance company. This source is predictable and more appropriate to the needs of the account than the law of unincorporated associations.

705 See, e.g., N.J. Rev. Stat. Ann. § 17:35A-9(b)(ii) (Supp. 1971).

706 This rule is in accord with general principles of corporate law prohibiting directors from delegating their powers; see note 614 supra.

707 D.C. Ins. Dep't Reg. 5 (Oct. 27, 1961); Fla. Ins. Dep't Reg. VIII(A) (Nov. 14, 1961).

708 Fla. Ins. Dep't Reg. IV(D) (Nov. 14, 1961). Note that for the purposes of state insurance statutes prohibiting self-dealing between insurance companies' directors and the company, the account is part of the insurance company's business. See also Model Variable Contract Regulation art. IV, § 7, note 41 supra:

> Rules under any provision of the Insurance Law of this State or any regulation applicable to the officers and directors of insurance companies with respect to conflicts of interest shall also apply to members of any separate account's committee, board or other similar body. No officer or director of such company nor any member of the committee . . . of a separate account shall receive directly or indirectly any commission or any other compensation with respect to the purchase or sale of such separate account.

709 E. Warren, Corporate Advantages Without Incorporation 831 (1929). Restatement (Second) of Agency § 326 (1957):

> Unless otherwise agreed, a person who, in dealing with another purports to act as agent for a principal whom both know to be nonexistent . . . becomes a party to such a contract.

not to the board for satisfaction. It is doubtful that directors of an account will be subject to tort liability for torts committed in the course of the business of the account, even if the insurance company refuses to pay for this liability and the account is not permitted to do so by law.[710]

Even though under state law the board is a delegate of the insurance company, directly or indirectly through the contractholders, the board owes the insurance company no duty. Under the 1940 Act board members are fiduciaries of the account.[711] They may serve as directors only if elected by contractholders.[712] The board of the insurance company must act for the benefit of its electors, the shareholders or members. They have the right to elect the board because they are equity investors. Since contractholders are the equity investors in the account, the management of the investment business of the account ought to be vested in the contractholders. On these grounds the account's board is responsible to them and them alone.[713] Yet the board also manages assets in which the insurance company has a vital interest. Changes in the investment performance of the account might detrimentally affect the insurance company. The investment results might prove so good that the insurance company will risk incurring high losses on its mortality guarantee. The investment results might be so disastrous as to reflect adversely on the insurance company and its other business. Should not the board have some fiduciary duties towards the insurance company on this ground? Or, perhaps, as has been suggested,[714] should not the board of the insurance company exercise some supervisory power over the board of the account and retain the last word with respect to investments? The answer should be an emphatic "No." In reality the insurance company manages the account as a principal with respect to its insurance obligations. The adjustments in the reserves of the account, the calculations of premiums, and payments of annuities, except for the determination of the investment factor, are all determined by the insurance company under state insurance laws. The company also manages the account with respect to its investment business, as an adviser, under a contract. The account's board is obligated, under the 1940 Act, to supervise the performance of the insurance company with regard to investment.[715] The last word must be with the board when renewal of the advisory contract is considered. In this it acts as a representative of the contractholders. It is responsible only to them. It owes the insurance company no duty.[716]

710 Restatement (Second) of Agency § 357 (1957), unless the directors expressly authorized the tort or participated in its commission. 1 G. Hornstein, Corporation Law and Practice § 518 (1959).

711 See § 36(a), 15 U.S.C.A. § 80a-35(a) (1971); § 15(c), 15 U.S.C.A. § 80a-15(c) (1971).

712 See § 16(a), 15 U.S.C.A. § 80a-16(a) (1971); § 2(a)(12), 15 U.S.C.A. § 80a-2(a)(12) (1971).

713 41 S.E.C. 335, at 351.

714 Finnegan & Garner, note 90 supra, at 117-20.

715 § 15(c), 15 U.S.C.A. § 80a-15(c) (1971) effective December 14, 1971, requires directors of an investment company "to request and evaluate . . . such information as may reasonably be necessary to evaluate the terms of any" advisory contract before approval.

716 Even if the directors of the account fail in their duties to the contractholders, thereby causing harm to the insurance company, they need not become liable to the

2. The 1940 Act

(a) *Contractholders' Private Right of Action.* Section 36(a) of the 1940 Act grants the Commission authority to seek injunction for a breach of a fiduciary duty involving personal misconduct[717] against any director, officer, member of the advisory board, investment adviser or depositor of any investment company or a principal underwriter of an open-end company, unit investment trust or face-amount certificate company. "This section is intended to deal only with such violations committed by individuals."[718] Therefore no action for injunction can be brought against a corporation, except as a controlling person.

In *Brown v. Bullock*[719] it has been suggested, before the passage of the 1970 Act, that section 36 creates a private right of action, but the authority of this decision is weakened by the fact that the Second Circuit affirmed exclusively on other grounds.[720] In *SEC v. Wong,*[721] a receiver of an investment company was substituted for the Commission upon an application by a private party, in an action based on section 36. However, the action was originally instituted by the Commission.[722]

It has also been argued that an implied private right of action under section 36 is inconsistent with the language of the statute, and that the basis of a derivative suit regarding misuse by an investment adviser of its power to allocate brokerage fees, the custom of "give-ups," is a violation of section 1[723] of the 1940 Act containing the declaration of congressional policy, not section 36. It has been recognized, however, that this position is not a strong one in view of other sections of the Act that provide specifically for private rights of action.[724] In *Tanzer v. Huffines,*[725] failure to file annual reports on form N-1R in violation of section 30(b) of the 1940 Act and misleading statements in the report to shareholders were sufficient to create a private right of action under the 1940 Act. It was also held that the allegations of a scheme to acquire control of portfolio companies for personal gain and to use their funds to finance private ventures satisfied the definition of wilfull abuse of trust under section 36 of the Act, as well as of conversion under section 37[726] of the Act, and that section 36 afforded

insurance company. Restatement (Second) of Agency § 357 (1957). An agent who intentionally or negligently fails to perform duties to his principal is not hereby liable to a person whose economic interests are harmed.

717 § 36(a), 15 U.S.C.A. § 80a-35(a) (1971). The standard before the passage of the 1970 Act was "gross misconduct or gross abuse of trust."

718 S. Rep. No. 184, 91st Cong., 2d Sess. 36 (1969).

719 194 F. Supp. 207 (S.D.N.Y. 1961). See also Eisenberg and Phillips Mutual Fund Litigation—New Frontiers for the Investment Company Act, 62 Colum. L. Rev. 73, 99-103 (1962).

720 Brown v. Bullock, 294 F.2d 415, 418 (2d Cir. 1961).

721 42 F.R.D. 599 (D.P.R. 1967).

722 SEC v. Wong, 252 F. Supp. 608 (D.P.R. 1966).

723 § 1, 15 U.S.C.A. § 80a-1 (1971).

724 See Comment, The Use of Brokerage Commissions to Promote Mutual Fund Sales: Time to Give Up the "Give-Up," 68 Colum. L. Rev. 334, 342-44 (1968).

725 314 F. Supp. 189 (D. Del. 1970).

726 § 37, 15 U.S.C.A. § 80a-36 (1971).

a private right of action by an investment company against its directors, and by shareholders in derivative suits. Recently, *Moses v. Burgin* held that section 36 gives rise to a private right of action.[727] In general, private rights of action have been implied from many of the provisions of the Act and the trend to widen the scope and efficacy of these rights is persistent and growing.[728] The 1970 Act did not clarify the question whether section 36(a) gives rise to a private right of action. Legislative history indicates that Congress left the question to the courts.[729]

(b) *The Problem of Management Fees.* Under section 27(a)(5) of the 1940 Act and under section 27(h)(6) of the 1970 Act a registered investment company that is a management company, issuing periodic payment plans, or a depositor of, or underwriter for, the investment company may not sell any certificate, if the proceeds of the certificate or the securities in which the certificate are invested are subject to management fees exceeding such reasonable amount as the Commission may prescribe.[730] Under section 27(a)(6) of the 1940 Act and section 27(h)(7) introduced by the 1970 Act a registered investment company that is a unit investment trust, issuing periodic payment plans, or a depositor of, or underwriter for, the investment company may not sell any certificate, if the assets of the company are securities of a management company, and the depositor of, or principal underwriter for, the trust is to receive from this management company any fee or payment on account of a certificate, exceeding such reasonable amount as the Commission may prescribe.[731] The Commission has not prescribed rules under these provisions.[732] The Commission in its report to Congress in 1966 recommended that the 1940 Act be amended to expressly provide that compensation received by affiliated persons for services furnished to the

[727] 39 U.S.L.W. 2714 (1st Cir. June 4, 1971).

[728] Esplin v. Hirschi, 402 F.2d 94, 103 (10th Cir. 1968):

> In view of the recent developments of the law in implying private civil remedies for violations of the various federal securities laws, the strong indication is that when given the opportunity, the Supreme Court following the policy announced in J.I. Case Co. v. Borak . . . will find an implied civil liability arising from the Investment Company Act . . . . This court, therefore, finds that although the Investment Company Act makes no specific provision for private civil liability arising from the violations of the Act such liability may be implied.

See Entel v. Allen, 270 F. Supp. 60 (S.D.N.Y. 1967). To the same effect: Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967); Werner, Protecting The Mutual Fund Investor: The SEC Reports on the SEC, 68 Colum. L. Rev. 1, 37 (1968) arguing that there is an implied private right of action under the Act to challenge management fees. Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. Pa. L. Rev. 1058, 1066 (1967); see also Levitt v. Johnson, 334 F.2d 815 (1st Cir. 1964), cert. denied, 379 U.S. 961 (1965); Brown v. Bullock, 194 F. Supp. 207 (N.Y.S.D.) aff'd on other grounds, 294 F.2d 415 (2d Cir. 1961); 3 Loss at 1757-1805.

[729] S. Rep. No. 184, 91st Cong., 2d Sess. 16 (1969): ". . . the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a)."

[730] § 27(a)(5), 15 U.S.C.A. § 80a-27(a)(5) (1971); § 27(h)(6), 15 U.S.C.A. § 80a-27(h)(6) (1971).

[731] § 27(a)(6), 15 U.S.C.A. § 80a-27(a)(6) (1971); § 27(h)(7), 15 U.S.C.A. § 80a-27(h)(7) (1971).

[732] See criticism of this inaction, Werner, Protecting the Mutual Fund Investor: The SEC Reports on the SEC, 68 Colum. L. Rev. 1 (1968).

investment company be reasonable.[733] The Commission recommended that the proposed standard of reasonableness should be established in the light of all relevant factors, and that the application of the standard should not be affected by shareholder or director approval of the contracts. These recommendations were adopted with modification in the bill that passed the Senate in 1968[734] and was reintroduced in 1969.[735] The bill that was reported to the Senate in 1969[736] deleted the reasonableness standard and amended instead section 36(b) of the Act[737] to provide that an investment adviser shall be deemed to have a fiduciary duty with regard to its investment advisory fees. The change in language from reasonable to fiduciary was made at the request of the industry, presumably because the industry wanted to shift the focus of possible litigation onto the investment adviser rather than the directors of the fund.[738] It seems, however, that there was no intention to make a substantive change in the standard.[739] At present, therefore, the Commission and the courts are entrusted with the power to interpret the reasonableness of the fees. The payments that contractholders make on a variable annuity are subject to sales and administrative charges.

The assets of the account are subject to management fees, mortality and expense guarantee charges, and sometimes administrative charges. Usually, none of these charges is regulated by state insurance statutes. One of the difficulties in regulating charges under federal securities acts is that the variety of formulas used by insurance companies makes it virtually impossible to calculate the charges, let alone compare them with charges in other contracts. Both the services offered for the fees and the basis upon which fees are calculated vary.

Section 27(f) as introduced by the 1970 Act requires a custodian bank for periodic payment plans to notify certificate holders, within sixty days after the issuance of the certificate, of the charges to be deducted from the projected payments on the certificate. On April 29, 1971 the Commission issued a notice of proposed rule 27f-1 that would permit notice to be sent by a person other than the custodian bank, under certain circumstances. In the

733 SEC Investment Co. Growth Report, note 127 supra, at 144.

734 S. 3724, 90th Cong., 2d Sess. 13 (1968). See Hearings on H.R. 11995, S. 2224, H.R. 13754 & 13737 Before the Subcomm. on Commerce & Finance of the Comm. on Interstate & Foreign Commerce. 91st Cong., 1st Sess. pt. 1, at 176 (1969). The Commission's basic recommendation was that the standard of "waste" and gross abuse of trust be replaced.

735 Hearings, note 734 supra.

736 Hearings, note 734 supra, at 177. See also S. Rep. No. 184, 91st Cong., 1st Sess. 15-16 (1969).

737 § 36(b), 15 U.S.C.A. § 80a-35(b) (1971). The adoption of this standard precludes the assertion of a claim of ratification of directors and shareholders although this may be taken into account by the court in determining the fairness of the contract.

738 Hearings, note 734 supra, at 190.

739 Id. at 189. The fiduciary duty of the adviser to the fund takes precedence to the fiduciary duty of the adviser to its shareholders. Id. at 199. Therefore, an insurance company's fiduciary duties as an investment adviser will take precedence to its duties to its shareholders and policyholders.

case of a variable annuity contract the notice would be sent under Form N-27F-3. This form shows how complex the calculation of the deductions made under variable annuity contracts are.[740] Yet, the alternative to full disclosure may be direct government regulation. Perhaps investment companies ought to be required to conform to a standard formula concerning the kind of services that they render and the basis for calculating the charges. If that were done there might be less need for itemized fees.

Management fees also receive special treatment in the new section 36(b).[741] Effective June 14, 1972, an investment adviser is deemed to owe a fiduciary duty to the company with respect to his fees. The Commission, as well as a security holder in a derivative capacity, may bring suit on violation of this duty. No personal misconduct need be alleged or proven. Only the recipient of the fees can be sued, and the remedy cannot exceed the amount of compensation paid.[742]

Directors of the account who are also officers of the investment adviser insurance company may have a fiduciary duty to the account and its contractholders to seek the most favorable execution of portfolio transactions in their status as the investment adviser. This duty was held violated when the investment adviser interposed another broker-dealer between the investment company and the best market performance.[743] In *Moses v. Burgin*[744] the First Circuit held that the investment adviser and its affiliated directors on the board of the investment company breached their duty under section 36 of the Act because they did not disclose to the unaffiliated directors a possible method in which "give-ups" that benefited the investment adviser could be recaptured for the investment company. The standard of section 36 may be different from that under state law. The Act "imposes a more fundamental and pervasive requirement where, because of the structure of investment trusts, self-dealing is not the exception but, so far as management is concerned, the order of the day." When the affiliated direc-

[740] Inv. Co. Act Release No. 6493 (Apr. 29, 1971). This regulation has not been adopted as yet. The cost of preparing and filling the form for each contractholder might be prohibitive. For a criticism of the investment and insurance industry of the proposed regulations, see 104 Sec. Reg. L. Rep. at A-3 to A-6 (BNA June 2, 1971).

[741] Investment Co. Amendments Act of 1970, 84 Stat. 1413 amending, § 36(b), 15 U.S.C.A. § 80a-35(b) (1971).

[742] A derivative suit under this section will probably be treated similarly to a suit under section 16(b) of the Securities Exchange Act of 1934. Contemporaneous ownership of shares as required by Rule 23.1 of the Federal Rules of Civil Procedure is probably not a condition to bringing suit, cf. Blau v. Mission Corp., 212 F.2d 77, 79 (2d Cir.) cert. denied, 347 U.S. 1016 (1954); Dottenheim v. Murchison, 227 F.2d 737, 739 (5th Cir. 1955).

[743] Delaware Management Co., Exch. Act Release No. 8128 (July 19, 1967). This decision was based on section 15(b) of the Securities Exchange Act of 1934 and the status of the investment adviser as a broker-dealer, rather than as an affiliated director. Unaffiliated directors were not held liable. An additional cause of action was found in the registration statement of the investment company under the Securities Act of 1933 that was held misleading because it failed to disclose that the investment company did not intend to obtain the most favorable price in executing portfolio transactions. Section 36 of the 1940 Act did not furnish a basis for the cause of action. This suit might perhaps have been maintained under the new section 36(a) with the same result.

[744] 39 U.S.L.W. 2714 (1st Cir. June 4, 1971).

tors see a question that they know to be in an area of potential conflict between their personal interests and the interests of the investment company, they should inform the unaffiliated directors and submit the problem to their consideration. The unaffiliated directors were not held liable because it was not shown that they had any knowledge that give-ups could be recaptured and did not have conflicting interests which "should have sharpened their attention."

It has been proposed that investment companies should be viewed as a conglomeration of investment advisory contracts, and that the 1940 Act, transferring to shareholders some of the traditional powers of directors, such as the power to veto an adviser, is an added proof of this analysis. This theory is compatible with the attitude of conventional insurance, that the rights of contractholders concerning investment advice are based only on their individual contracts,[745] and that these are rights in law, not equity.[746] The logical conclusion was that investment company directors should be held to a lesser responsibility in areas in which shareholders have an opportunity to decide the matter directly, provided there is full disclosure.[747]

This conclusion finds support in new corporate statutes that couple transfer of directors' responsibilities to shareholders with a shift in duties following such transfer.[748] But the Investment Company Act was designed to solve different problems. The Act's shift of power to shareholders, as well as the provision ensuring a minimum number of independent directors, is based on the theory that shareholders of investment companies need protection. Thus viewed, unaffiliated directors ought to be held to a high standard of duty, to exercise active supervision over the investment adviser.

This standard was imposed in *Lutz v. Boas*.[749] When an investment adviser had, in effect, delegated all its duties to a broker-dealer, and in con-

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745 Although one legacy of the Prudential decision is the tendency to regard the variable annuity separate account as 'just another mutual fund,' there are basically important structural and operational differences between the two. . . . A variable annuity contract is just that—a contract between the annuitant and the insurer sponsoring the separate account. In contrast, the mutual fund shareholder is an equity owner of the fund which in turn contracts with the investment manager. There is no contractual relationship between the shareholder and the investment adviser.

Finnegan & Garner, note 90 supra, at 116.

746 See p. 327 supra.

747 See Lobell, The Mutual Fund: A Structural Analysis, 47 Va. L. Rev. 181 (1961); Lobell, Rights and Responsibilities in the Mutual Fund, 70 Yale L.J. 1258 (1961). For objections to imposing higher standards on unaffiliated directors, see also Jaretzki, Duties and Responsibilities of Directors of Mutual Funds, 29 Law & Contemp. Prob. 777, 792-94 (1964).

748 See, e.g., Delaware Corporation Law:

The business and affairs of every corporation organized under this chapter shall be managed by a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

Del. Code Ann. tit. 8, § 141(a) (Supp. 1970).

749 39 Del. Ch. 585, 171 A.2d 381 (1961).

sideration received loans and substantial monetary favors, it was found to have violated the 1940 Act, and was required to repay the company all fees and commissions received by it.[750] The importance of the decision is in the severity with which the court dealt with the independent directors. The directors had been giving almost automatic approval to the management agreement, did not examine the registration statements carefully, did not discuss at their meetings any pertinent facts or transactions, and did not have information regarding the company's activities. They were negligent because they did not fulfill their duty to inquire.[751] They were held jointly and severally liable for management fees that the adviser had received without consideration, and for losses resulting from churning of the account. The mere showing that a violation of the 1940 Act had occurred was not sufficient to impose liability; but a showing of negligent supervision was.

It has been suggested that section 1(b)[752] is the prime source of director responsibility under the Act,[753] and that this section specifically imposes on directors duties to supervise the performance and financial integrity[754] as well as the contract of an investment adviser.[755] It has also been suggested that the relationship of stockholder to managers in a mutual fund is akin to that of depositors or stockholders to directors of a bank and that this relationship requires a higher degree of supervision by directors.[756]

The 1970 Act may have changed the old standard under the Act. On the one hand it reiterates the holding in *Boas* in that it requires directors to request and evaluate information reasonably necessary to judge the terms of the advisory contract.[757] The new section 36(a) also strengthens the arguments that section 1(b) of the Act is a source, if not a prime source, of directors' duties,[758] since relief may be awarded as the court in its discretion deems "appropriate in the circumstances, having due regard to

750 The broker-dealer was similarly liable under the 1940 Act and under the New York laws, where most transactions took place, for all commissions received by it. It was also held liable for damages caused by churning of the investment company's account. Id. at 608-09, 171 A.2d at 395.

751 Id. at 608-10, 171 A.2d at 395-96.

752 § 1(b), 15 U.S.C.A. § 80a-1(b)(1971).

753 Neilson, Fiduciary Standards of Conduct Under the Investment Company Act, Conference on Mutual Funds 153, 156 (Hodes, Geerlings & Simpson eds. 1966).

754 Speech of Commissioner Owens of the SEC before the Mutual Fund Seminar on Investment Adviser Responsibilities and Recent SEC Developments, 101 Sec. Reg. L. Rep. at E-3 (BNA May 12, 1971).

755 Gopman, The Management Fee Problem and the Investment Company Act of 1940, 7 Am. Bus. L.J. 153 (1969); North, A Brief History of Federal Investment Company Legislation, 44 Notre Dame Lawyer 677 (1969); see Comment, Securities Regulation—Management Fees, Conspiracy or Compensation, 36 U. Mo. K.C.L. Rev. 348, 351 (1968); Note, 28 U. Pitt. L. Rev. 705 (1967).

756 Neilson, note 753 supra, at 154.

757 Investment Co. Amendments Act of 1970, 84 Stat. 1413, § 8(c), amending 15 U.S.C. § 80a-15(c) (1964) and 15 U.S.C. § 80a-35 (1964).

758 Eisenberg & Lehr, An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940, 20 Rutgers L. Rev. 181, 189-92 (1966).

the protection of investors and to the effectuation of the policies declared in Section 80a-1(b) of this title."[759] On the other hand, section 36(a) gives rise to a right of action upon a "breach of fiduciary duty involving personal misconduct." The standard set forth in this section is not limited to "situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct."[760] As mentioned, these words indicate that only individuals are subject to this section.[761] Conversely, under section 36(b) it seems that only on rare occasions would inividual directors be subject to suit, because the section limits suit to the recipients of the advisory fees.[762]

Lutz v. Boas held that unaffiliated directors are also subject to the duties imposed upon them by state corporate laws.[763] Presumably, the higher of the standards prescribed by state or federal law would apply. The 1970 Act does not seem to have changed this holding. In the case of separate accounts the standard imposed on directors under state law will be that imposed on agents, if the account is deemed to be an unincorporated association, or the standard imposed on the insurance company's directors, if the account is deemed to be governed for this purpose by state insurance and corporate laws.

Lest a wrong impression result from this discussion, it should be noted that state law standards have not been very clear.[764] Unaffiliated directors have not been proven to check and supervise effectively the investment adviser.[765] It is hoped that the new 1970 Act might result in clearer standards and better terms for shareholders of mutual funds under advisory contracts.

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[759] Investment Co. Amendments Act of 1970, 84 Stat. 1413, § 8(c) amending 15 U.S.C. § 80a-35 (1964).

[760] S. Rep. 184, 91st Cong., 2d Sess. 36 (1969). The courts are to apply "prevailing standards of fiduciary duty involving personal misconduct." The standard is meant to cover "nonfeasance of duty or abdication of responsibility." Id. This statement was reiterated by Commissioner Owens of the SEC in his speech before the Mutual Fund Seminar on Investment Adviser Responsibility and Recent SEC Developments, 101 Sec. Reg. L. Rep. at E-2 (BNA May 12, 1971).

[761] S. Rep. 184, 91st Cong., 2d Sess. 36 (1969).

[762] § 36(b)(3), 15 U.S.C.A. § 80a-35(b)(3) (1971):

> No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments.

[763] 39 Del. Ch. 585, 608, 171 A.2d 381, 395 (1961). See also Fleischer, "Federal Corporation Law": An Assessment, 78 Harv. L. Rev. 1146, 1153 (1965); Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. Pa. L. Rev. 1058 (1967); Survey—The Mutual Fund Industry: A Legal Survey, 44 Notre Dame Lawyer 732, 936-45 (1969).

[764] See, e.g., Fleischer, note 763 supra, at 1154-57; contra, Eisenberg & Lehr, note 758 supra, at 189-92.

[765] Hearings on S. 34 & 296 Before the S. Comm. on Banking & Currency, 91st Cong., 1st Sess. 179 (1969), testimony of Abraham L. Pomerantz. See also id. at 110; SEC Investment Co. Growth Report, note 127 supra, at 130-31. See Note, Commingled Trust Funds and Variable Annuities: Uniform Federal Regulation of Investment Funds Operated by Banks and Insurance Companies, 82 Harv. L. Rev. 435, 452 (1968).

C. *Indemnification of Directors and Officers*

Under section 17(h)[766] the charter, by-laws or other instrument under which an investment company is organized, may not provide protection to a director or officer against liability by reason of "willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."[767] It was held that the section also applies to negligence.[768]

The limitations of this section do not apply to the insurance company as an investment adviser. The insurance company may indemnify its employees, officers and directors sitting on the board of the separate account against liability arising from any wrongdoing, subject only to general contract law limitations.[769] The insurance company can also purchase insurance to cover its employees. Coverage of liability for negligence or lesser degrees of wrongdoing may be provided by the accounts, as well as by the insurance company.[770]

D. *Prohibited Self-Dealings*

Under section 10(f) of the 1940 Act[771] an account may not, with an exception not here applicable, knowingly purchase or otherwise acquire during the existence of any underwriting or selling syndicate, any security a principal underwriter of which is an officer, director, or investment adviser of the account.[772] The insurance company, being an underwriter of one account, cannot invest in it funds of another account of which it is an investment adviser.[773] Further, under section 17(a) of the Act, a sponsoring insurance company that is an investment adviser or principal underwriter or promoter of an account may not sell to, or exchange with, or purchase from, an account any securities, or borrow from the account, except that the insurance company may invest in, and purchase the securities of the account.[774] The prohibition in section 17(a) applies to an affil-

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766 § 17(h), 15 U.S.C.A. § 80a-17(h) (1971).

767 Section 17(i) applies a similar prohibition to indemnification of an investment adviser and underwriter in the management or underwriting contract. See generally 3 Loss at 1829-36; G. Washington & J. Bishop, Indemnifying the Corporate Executive 87-90 (1963).

768 See also SEC v. Continental Growth Fund, Inc., [1964-1966 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 91,437 (S.D.N.Y. Oct. 7, 1964).

769 See 6 S. Williston, Law of Contracts § 1751 (rev. ed. 1938).

770 See 6 Loss at 3980-81 (Supp. 1969).

771 § 10(f), 15 U.S.C.A. § 80a-10(f) (1971).

772 Qualified accounts under Rule 6e-1 were not exempt from the provisions of this section, but under section 3(a)(11) as amended by the 1970 Act qualified separate accounts are exempt.

773 17 C.F.R. § 270.10f-1 & § 270.10f-3 (1971) provide exemptions from this prohibition under circumstances that make abuse unlikely.

774 § 17(a), 15 U.S.C.A. § 80a-17(a) (1971). Unless the Commission grants an exemption under § 17(b), section 17(a) prohibits an affiliated person, a promoter of, or principal underwriter for a registered investment company from knowingly (1) selling any security or other property to the investment company unless the sale involves solely (A) securities of which the buyer is the issuer; or (B) securities of which the seller is the issuer and

iated person of the account. Other separate accounts that the insurance company may have established will probably fall within the definition of affiliated persons.[775] It has been held that two open-end investment companies that had substantially the same officers and directors and the same investment adviser and principal underwriter were deemed under "common control" and affiliated persons of each other.[776]

Many state statutes contain provisions similar to section 17(a) prohibiting transfers and exchanges among accounts, including the company's general account, except for limited investments by the insurance company in an account, usually to provide initial capitalization.[777]

The prohibition of section 17(a) does not apply if the insurance company is making a general offering to the holders of a class of its securities.[778] Since an account is prohibited from becoming a holder of the securities of the insurance company this exception will not apply to it.

It could be argued that section 17(a) prohibits the adjustments that the insurance company must make in the assets of the account, under state law[779] and for the purpose of qualifying under Rule 0-1(e). These adjustments may be viewed as a sale and purchase of "units" of the account, whether or not so calculated. Since the term "purchase" under the securities laws is a federal term,[780] the fact that state laws do not consider adjustments in the reserve a sale is immaterial. Neither the Commission, nor the industry, however, consider these adjustments a violation of the 1940 Act.

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which are part of a general offering to holders of a class of its securities; or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof; (2) purchasing a security or other property from the investment company except securities of which the seller is the issuer; or (3) borrowing from the investment company except as permitted by section 21(a). Various exemptions are provided by the Rules. See 17 C.F.R. § 270.17a-7 (1971).

775 See § 2(a)(3) defining affiliated persons and § 2(a)(9) defining control. See the admonition delivered by Comm'r James J. Needham in his address before the American Management Ass'n meeting in New York, 81 Sec. Reg. L. Rep. at A-19 (BNA Dec. 16, 1970).

776 In re Equity Fund, Inc., 15 S.E.C. 288 (1944). Rule 17a-7, 17 C.F.R. § 270.17a-7 (1971) recognizes by implication that two investment companies may be affiliated persons of each other by virtue of common control by the investment adviser. The discussions regarding proposed amendments to Rule 17d-1, that were not adopted, stand by implication for the same proposition. Proposed amendment to Rule 17d-1, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,809 (SEC 1970).

777 Massachusetts, for example, provides:

> No investment shall be transferred by sale or substitution or otherwise between any separate account and the life company's general investment account, provided that the commissioner may authorize such transfers in circumstances where such transfers would not be inequitable.

Mass. Gen. Laws Ann. ch. 175, § 132G (Supp. 1971). See also Model Variable Contract Regulation art. IV, § 5, note 41 supra, at 196.

778 § 17(a)(1)(B), 15 U.S.C.A. § 80a-17(a)(1)(B) (1971).

779 See note 41 supra.

780 See, e.g., SEC v. Sterling Precision Corp., 393 F.2d 214, 217 (2d Cir. 1968). "Purchase" under section 17(a) of the 1940 Act was interpreted according to federal standards not to include redemption of debentures in the circumstances of that case; see also SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959) in which "insurance" and "annuity" are defined.

No exemptions were requested or granted in respect thereof.[781] Since they are made under strict supervision of state insurance authorities for the purpose of protecting contractholders as policyholders, no prohibition should apply. Adjustments should not be deemed a sale or purchase of units, but should be deemed a performance of insurance obligation.

Under section 17(d) of the Act the insurance company acting as a principal may not effect a transaction in which the account is a joint or joint and several participant with the insurance company or another account established by the insurance company, in contravention of the rules of the Commission prescribed to prevent a different or less advantageous participation by the account. The insurance company is in most cases an affiliated person to the account that it establishes and maintains, and if it is deemed to control its accounts each account is also an affiliated person of the other.[782] The Commission's Rule 17d-1 prohibits a joint enterprise or other joint arrangement or profit-sharing plan between an investment company and affiliated persons except with the Commission's approval. The arrangement need not be formal. A tacit "understanding" to effect jointly a transaction will fall under the prohibition.[783] This section prevents the insurance company from causing an account to finance, through the purchase of equity or debt securities, a corporation in which the insurance company has an interest by reason of its being a creditor. The insurance company will also be subject to fiduciary duties as an investment adviser with respect to these transactions. It must obtain for all its accounts the best available market prices.[784] This even-handed treatment is difficult to achieve.[785] The problems in this respect are shared by insurance companies with every investment adviser advising more than one fund.[786]

E. *Exemptions*

In 1967 the industry requested that the Commission consider the account and the insurance company as one entity for the purpose of section 17(d).[787] The Commission did not agree, and ordinarily does not grant

781 Valic requested an exemption from section 17(a) in order to consummate a transfer of all its assets to a new company, Variable Annuity Life Ins. Co., Texas, in a manner acceptable to the Superintendent of Insurance for the District of Columbia. Variable Annuity Life Ins. Co. of America, Inv. Co. Act Release No. 5624 (Feb. 27, 1969).

782 See note 776 supra.

783 SEC v. Talley Indus., Inc., 399 F.2d 396 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969); Recent Decision, 20 Syracuse L. Rev. 1022 (1969). See also SEC v. General Time Corp., 407 F.2d 65 (2d Cir. 1968), cert. denied, 393 U.S. 1015 (1969) (connected case).

784 SEC Investment Co. Growth Report, note 127 supra, at 175. See also In re Delaware Management Co., Exch. Release No. 8128 (July 19, 1967).

785 SEC Investor Report, note 28 supra, at 760-71. Conflicts may arise in many contexts when the insurance company sponsors only one account if the participants in the account have different investment objectives. Id. at n.379. Conflicts may arise among various accounts when the insurance company is purchasing or selling for them. Sometimes investment activities may conflict with the interests of the insurance company's shareholders. The study shows that there is no uniform treatment or awareness by insurance companies regarding these questions.

786 Glazer, A Study of Mutual Fund Complexes, 119 U. Pa. L. Rev. 205 (1970).

787 After the industry raised the question of what the meaning of joint participation

exemptions from this section to separate accounts. For example, it refused Valic a blanket exemption from the provisions of section 17(a)(3) and Rule 17d-1 when the company wanted to make loans, in the form of advances against future commissions, to sales personnel, and to compensate these persons by bonuses and payments based on the volume of sales. The Commission did leave the door open for a more restricted exemption.[788] An exemption was granted when a group of affiliated life insurance companies, not to exceed fifteen, planned to pool their equity investments and incorporate a non-diversified fund whose shares were to be sold to members of the group. It was anticipated that the fund would invest in corporations whose debt and equity securities were held by members or affiliates of the fund. The exemption was requested on the ground that the potential conflict of interest that might exist between the small investor and the affiliate did not exist in the case at hand. All members of the group shared a common interest because securities transactions that were detrimental to the fund would automatically be detrimental to the member institutions.[789]

IX. Winding Up, Dissolution and Reorganization

A. *General*

If the account is viewed as an institution, it may perhaps be dissolved apart from the insurance company, by a vote of its members. Viewed as an institution the law of unincorporated associations or corporate law will apply to it. Unincorporated associations, being the creatures of contract, may be dissolved either according to the provisions of their constitution, or absent an applicable provision, by a vote of a majority of their members.[790] If this rule is applied to the separate account, a majority of the contractholders may dissolve it at any time. It can be said that by joining the association, members have placed the dissolution of the account in the hands of their majority, and that the insurance company has done so by implication. It is difficult to accept this result. It ignores the right of the insurance company to continue its concurrent insurance business. It ignores the contract rights of minority contractholders, and it ignores the reason for which the account came into being in the first place—to give investors control over the management of the investment business of the account, not its existence. Unless the Rules of the account expressly provide for

is, the Commission proposed to revise the rule and substitute for the casual action quantitive restrictions on investments and holdings by the insurance company and the separate account in securities of the same company. The industry considered the restrictions unrealistic and worse than the existing criterion. Nelson, Problems Raised by Investment Company Act of 1940, Including Proposals for Revised Rules, Proceedings of the Legal Section, Am. Life Convention 77, 90-93 (1968).

788 In re Variable Life Ins. Co. of America, 39 S.E.C. 680, 692-94 (1960).

789 The America Group Companies Fund, Inv. Co. Act Release No. 5609 (Feb. 14, 1969), granted, Inv. Co. Act Release No. 5788 (Aug. 19, 1969).

790 Strong v. Garvey Memorial Liberty Hall, Inc., 380 Pa. 236, 110 A.2d 244 (1955). See also, Liederkranz Singing Soc'y v. Germania Turn-Verein, 163 Pa. 265, 29 A. 918 (1894).

dissolution by contractholders, no such power can be implied, especially when a decision to dissolve may affect the continuation of annuity payments and terminate variable annuity contracts. On the other hand, the insurance company may dissolve the account without the contractholders' consent. There is nothing in the 1940 Act to require such a consent.

Section 11 of the 1940 Act regulates the exchange of a security issued by an investment company for another security.[791] This section envisages an exchange that is not submitted to the security holders for ratification. The Act further regulates the solicitation of security holders' proxies to a plan of reorganization, but does not require such a solicitation.[792] Security holders may elicit from the SEC a written advisory report on the fairness of the plan.

On the state level there is at least one state statute concerning a structural change in an account without contractholders' consent. New Jersey's insurance statute provides that if only a portion of an account requires compliance with the 1940 Act, an insurance company may establish a committee for such a portion only. The committee may be given power to require a division of the account.[793] No mention is made of contractholders' consent.[794]

New York Life Insurance Company established New York Life Separate Account Q as a unit investment trust and reserved the right, without notice to, or consent of, the contractholders, to "transfer assets of the account, determined by [the insurance company] to be associated with the class of contracts to which the variable contracts belong, to another separate account."[795] Presumably, the dissolution of the account is determined by the contract between the insurance company and each contractholder.

B. *Applicability of the Bankruptcy Act*

Is the account an entity for the purposes of the Bankruptcy Act, and will a bankruptcy court assert jurisdiction over its liquidation? Under the Bankruptcy Act any "moneyed, business or commercial corporation" may be adjudged an involuntary bankrupt,[796] and any "corporation" may be adjudged a voluntary bankrupt.[797] A corporation includes "unincorporated companies and associations."[798] Insurance companies are expressly excepted from all the provisions of the Act.[799] The applicability of the Bankruptcy Act to separate accounts depends on whether (a) the accounts are "unin-

[791] § 11, 15 U.S.C.A. § 80a-11 (1971).
[792] § 25, 15 U.S.C.A. § 80a-25 (1971).
[793] N.J. Rev. Stat. § 17:35A-9(b)(ii) (Supp. 1971).
[794] If a division of the account pursuant to the New Jersey law is effected, id., it might be considered to be an exchange of securities within section 11 of the 1940 Act, subjecting the transaction to the jurisdiction of the Commission.
[795] Amend. No. 1 to Form N-8B-2 file No. 811-2000, at 20 (1971).
[796] Bankruptcy Act, 11 U.S.C. § 22(b) (1964).
[797] Id. § 22(a). This section refers to "any person" and corporations are included in the definition of "person." Id., 11 U.S.C. § 1(23) (1964).
[798] Id. § 1(8).
[799] Id. § 22.

corporated companies" or "associations" or any other entity recognized as a "person" under the Act, and (b) whether they are deemed to conduct an insurance or an investment business, the latter clearly falling within the definition of a moneyed, business or commercial operation. Whether an account is a "person" is controlled by the Bankruptcy Act.[800] The characteristics of the account, including the question of who owns the assets, are determined by state law.[801] The account's characteristics under the 1940 Act will probably also be taken into consideration. Unless there are valid reasons for piercing the corporate veil, a bankruptcy court will not disregard the corporate entity of a subsidiary when only the parent is undergoing a reorganization. The tendency is to limit jurisdiction to the parent's ownership of the stock.[802] It is submitted that the converse is also true. Unless there are valid reasons for separating the account from the insurance company, a bankruptcy court should not disregard the corporate entity of the insurance company.

Whether or not an entity exists for the purposes of the Bankruptcy Act depends on economic reality rather than legal form. Two legally separate entities may be treated as one, according to the nature and substance of the transaction, notwithstanding a decision that for tax law purposes these very entities are separate.[803] A bankruptcy court will therefore separate the account from the insurance company if it finds that the account represents a separate economic arrangement that is relevant to the Bankruptcy Act's policy and purposes.

The group of contractholders, although it has been defined as an organized group of persons for the purposes of the 1940 Act, will probably not fall under the definition of an "unincorporated company" in the Bankruptcy Act. The term "unincorporated company" includes a group of persons associated and joined together, at least in part, for some common business purpose and "conducting their affairs somewhat after the pattern of corporations."[804]

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800 See, e.g., Associated Cemetery Management, Inc. v. Barnes, 268 F.2d 97, 99 (8th Cir. 1959), rehearing denied (July 10, 1959).

801 See, e.g., In re Associated Trust, 222 F. 1012-13 (D. Mass. 1914).

802 6 W. Collier, Bankruptcy ¶ 3.11, at 500-01 (14th ed. 1971).

803 In, Selected Investments Corp. v. Duncan, 260 F.2d 918, 920 (10th Cir. 1958), rehearing denied (Nov. 10, 1958), cert. denied, 359 U.S. 914 (1959), a common law trust and a corporation were co-issuers of face value certificates, redeemable at the option of the holders. Similar to an investment trust certificate, the redemption price was the aliquot share of the total valuation of the equity trust fund, determined by reference to the face value of the certificate. For twenty-nine years, however, the corporation and the trust treated the certificates as debt obligations, paying fixed dividends without regard to fluctuations in the value of the assets of the fund. Investors were told that they were lending money at a fixed interest rate, and that they could cash in the certificates, at face value, after three years. The corporation and the trust became insolvent due to misappropriation of funds by the president of the corporation, who also controlled the trust. For the purpose of determining insolvency, the corporation and trust were held to be one entity; and certificate holders were held to be creditors. Therefore, the whole enterprise was found to be insolvent.

804 Pope & Cottle Co. v. Fairbanks Realty Trust, 124 F.2d 132, 134 (1st Cir. 1941).

"Company" implies an "association of individuals, not partners, carrying on business under a distinct name, and having common rights inter se, but having no individual ownership in the joint property, no individual control over the business in which their joint capital is embarked, and no direct individual liability for the company's debts. Its use in connection with the word 'unincorporated' would seem to imply that the organization should have some of the attributes usually found in corporations."[805]

An unincorporated company under the Bankruptcy Act need not be "an entity, recognized by the law as a legal person."[806] The case of *Associated Cemetery Management, Inc.* v. *Barnes*[807] raised the question of the existence of an "entity" for the purposes of the Act. A corporation established a profit-sharing plan for its employees and the employees of its members-corporations by setting up a private trust. The duties of the trustees were to keep records, to invest and reinvest the funds of the trust in securities, and to vote these securities. Title to the trust property vested in the trustees. The employee-beneficiaries had the power to elect four of the eleven trustees of the trust, and the right to participate in the distribution of the benefits. These participation rights were non-transferable and non-assignable.[808] The question presented was whether the trust was a "person" under the Bankruptcy Act, and therefore capable of being adjudicated a bankrupt, apart from the trustees. The court adopted two tests. First, had the employees joined together for the purposes of transacting business and conducted their affairs on a corporate pattern? Second, assuming they did join together in this manner, was their object to conduct and did they conduct a business similar to a business corporation?

As to the latter test, the court held that the trust itself did not conduct or operate a business, although the trustees contracted to purchase securities, executed a note in the name of the trust, and were directors of various corporations, as trustees of the trust. The court also noted that the trust agreement did not confer power on the trust to engage in business but delegated this power to the trustees.[809] As to the former test, the court held that the individual members themselves must associate and establish the

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805 In re Associated Trust, 222 F. 1012-13 (D. Mass. 1914): the term "company" connotes a group of persons "whose object and purpose are either wholly or chiefly of the same kind as the object and purpose of a moneyed business, or commercial corporation." In re Order of Sparta, 242 F. 235, 238 (3d Cir. 1917).

806 In re Tidewater Coal Exchange, 274 F. 1008, 1009 (S.D.N.Y. 1921), aff'd, 280 F. 638 (2d Cir.), cert. denied, 259 U.S. 584 (1922). In order to fall under the Act the unincorporated company must have as its purpose the conduct of some independent business. For example, if a debtor assigns property for the benefit of his creditors, the assignee is not conducting an independent business. But when a corporation is formed to take over the assets of an insolvent firm, to receive contributions for the debtors, and to conduct some business operations in order to liquidate the assets, the corporation is doing business and is distinguishable from an assignee. In re Cochrane & Harper Sec. Co., 27 F.2d 917, 919 (D. Mass. 1928).

807 268 F.2d 97 (8th Cir. 1959), rehearing denied (July 10, 1959).

808 Id. at 100-01.

809 Id. at 103-04.

unincorporated company.[810] The court concluded that, "[b]y no stretch of the imagination can it be said that the legal effect of the trust agreement was to form an association of the beneficiaries of the trust for the conduct of a business."[811]

By the same token the Act does not apply to a separate account organized as an open-end management company. First, the account is established by a unilateral act of the insurance company. According to *Prudential* the association is not a group of contractholders voluntarily combined to conduct a business, but a group combined under compulsion of the 1940 Act for the purposes of managing the business of the account through its elected representatives. According to the rationale of *Associated Cemetery*, this is not an association within the meaning of the Act. Second, the aggregate of contractholders possesses some, but not all of the characteristics of an unincorporated company. For example, members of unincorporated companies, like shareholders, can terminate the association or amend its by-laws.[812] Contractholders do not possess this power. On the other hand, an important trait of an association or an unincorporated company is the power of its members to manage its business. Contractholders possess this power by law. For the purpose of the Bankruptcy Act the first characteristic is the more important, since the Act deals with dissolution of entities that are formed voluntarily by their members. By definition its provisions will not be appropriately applied to a sui generis entity established pursuant to law. Third, it is not clear whether the account, the contractholders alone or the board of managers, possess the power to conduct investment business. The distinction made in *Associated Cemetery* may be pertinent here. The trust, as such, was not an entity because it did not have powers to conduct business. The trustees were granted these powers.[813] If a separate account is viewed as a pool of securities without capacity to act, as it is under most state laws, and contractholders or board of managers have the powers to conduct investment business, then the account is not an entity under the Bankruptcy Act although it might be classified as an issuer and an investment company under the 1940 Act.

The Bankruptcy Act will not apply to most separate accounts that are organized as unit investment trusts. The Bankruptcy Act applies only to trusts that issue certificates evidencing interests in the trusts, and then only if the certificates are assignable and transferable. A separate account organized as a trust will not be subject to the Act if it does not issue certificates evidencing the interests of the contractholders. Prudential, for example, emphasizes in its prospectus that it does not issue such certificates.[814]

810 Id. at 103.
811 Id.
812 In re Associated Trust, 222 F. 1012, 1014 (D. Mass. 1914).
813 268 F.2d 97, 104 (8th Cir. 1959).
814 Prospectus, Prudential's Investment Plan Account, Systematic Investment Plan Contracts at SP6 (Apr. 30, 1970), "Securities Shares are not evidenced by the issuance of certificates. Instead, after each purchase payment is made under the Plan, the Planholder will receive a notice . . . ."

Variable annuities are subject to restrictions on transferability. The interests that they contain may not fall within the definition, although the redemption feature in the pay-in period might be deemed sufficient to constitute transferable certificates. Finally, since a trust qualifies under the Bankruptcy Act only when its business is conducted by a trustee or trustees, unit investment trusts without a board of directors do not qualify. In any event, all separate accounts organized as unit investment trusts are exempt because they do not carry on an investment business. The business is carried on by the investment company in whose shares the unit investment trust invests.

Is the account conducting the excepted business of insurance?

> Generally, in determining whether a corporation falls within the excepted classifications, a bankruptcy court will first look to the state statute under which the corporation has been formed. If that statute denominates the corporation as one which the Act excludes, then the immediate, if not final, inference should be that the corporation is not amenable to bankruptcy.[815]
>
> If the corporation, however, fails to utilize the powers given it by its charter, or develops into a different type of corporation, then its charter will be no longer conclusive.[816]

Courts might look not only to classification of the company under state law, but also to the character and extent of the activities in which it is actually engaged.[817] If the corporation is under the supervision of state authorities the tendency is to classify its business as insurance.[818] An underwriting corporation that was attorney-in-fact for an insurer was held excepted as an insurance company,[819] as was an unincorporated insurance company subject to all the restrictions of insurance laws and under the supervision of insurance authorities.[820] But a corporation that was established solely to enter into a management contract with an insurance company was held amenable to the Bankruptcy Act.[821]

The separate account is a hybrid. It conducts an investment business that is subject to the Bankruptcy Act and an insurance business which is excepted from the Act. When the business of a corporation as stated in its

815 1 W. Collier, Bankruptcy ¶ 4.05(2), at 591-92 (14th ed. 1971). See, In re Union Guarantee & Mortgage Co., 75 F.2d 984, 985 (2d Cir.), cert. denied sub nom, Union Guarantee & Mortgage Co. v. Van Schaick, 296 U.S. 594 (1935); cf. In re Supreme Lodge of the Masons Annuity, 286 F. 180, 183-85 (N.D. Ga. 1923); annot., 22 A.L.R.2d 1021, 1029-35 (1952).

816 1 W. Collier, Bankruptcy ¶ 4.19, at 634-35 (14th ed. 1971).

817 Id., ¶ 4.05(2), at 591. See In re International Underwriters, 157 F. Supp. 367, 368-69 (W.D. Mo. 1957); In re Fidelity Assurance Ass'n, 42 F. Supp. 973, 982-83 (S.D. W.Va. 1941); Annot., 22 A.L.R.2d 1021, 1025-29 (1952); 6 W. Collier, Bankruptcy ¶ 4.05(2), at 772-73 (14th ed. 1971).

818 See, In re Union Guarantee & Mortgage Co., 75 F.2d 984, 985 (2d Cir.), cert. denied sub nom, Union Guarantee & Mortgage Co. v. Van Schaick, 296 U.S. 594 (1935).

819 In re International Underwriters, Inc., 157 F. Supp. 367, 368-69 (W.D. Mo. 1957).

820 In re Manufacturing Lumbermen's Underwriters, 46 F. Supp. 343, 346 (W.D. Mo. 1937).

821 United States v. Martin, 408 F.2d 949, 953 (7th Cir.), cert. denied, 396 U.S. 824 (1969).

charter includes some pursuits both within and outside the operation of the Bankruptcy Act, the courts have determined whether the corporation was within the Bankruptcy Act on the basis of the chief or principal business that it actually conducted at the time of the act of bankruptcy.[822] Some courts follow state classification, especially when the state subjects the corporation to regulation and supervision.[823]

It has been emphasized that the intent of Congress was to leave the winding up of such excepted business to the states.[824] Under this rationale a separate account is an insurance company for the purposes of the Bankruptcy Act. But if state law classification is disregarded, the account may be classified as a "moneyed corporation." It was established to conduct an investment business and Congress found that this business is sufficiently similar to an investment business to subject the account, at least by implication, to the 1940 Act regulatory scheme.

The question of the applicability of the Bankruptcy Act to separate accounts cannot be adequately treated on the basis of the past cases alone. None of the cases has dealt with the question of whether the Bankruptcy Act ought to be applied to an investment company that is viewed, at least for some purposes, as a regulated department of an insurance company. Had the separate account been a subsidiary corporation of the insurance company, and had its business been classified as investment, the Bankruptcy Act would apply to it, absent special circumstances that would justify disregard of the corporate entity. But separate accounts constitute, in many respects, an integral part of the insurance company's operations, even though they maintain a separate balance sheet for some purposes. Had a subsidiary's business been conducted in the same fashion as a separate account, a court might have disregarded its separate corporate existence.[825]

A comparison of the purposes of the Bankruptcy Act with those of the Investment Company Act suggests that the separate account should not be subject to the Bankruptcy Act. The Bankruptcy Act was passed "to secure

822 In re Dairy Marketing Ass'n of Ft. Wayne, Inc., 8 F.2d 626, 627 (D. Ind. 1925); Cate v. Connell, 173 F. 445, 446 (1st Cir. 1909).

823 In Sims v. Fidelity Assurance Ass'n, 129 F.2d 442 (4th Cir. 1942), aff'd on other grounds, 318 U.S. 608 (1943), a company issuing face amount certificates and annuities that was classified by some of the states where it did business, including the state of its domicile, as an insurance company, amended its charter to permit it to issue life insurance policies in order to escape regulation under the 1940 Act. The company became insolvent after liquidation proceedings began in the state courts. The company requested a federal court to consider a plan for reorganization under the Bankruptcy Act. The court held that the company was an insurance company, adopting state law classification even though the company was previously classified as a face-amount certificate company under the Investment Company Act, and its present predominant business was to collect payments on the annuities, not to issue life insurance. The court went so far as to assert that mere authority to issue life insurance policies, even if in fact none were issued, would except the company from the Act. See also State v. Hayes, 62 F.2d 597, 599-600 (10th Cir. 1932).

824 Sims v. Fidelity Assurance Ass'n, 129 F.2d 442, 449 (4th Cir. 1942), citing In re Union Guarantee & Mortgage Co., 75 F.2d 984, 985 (2d Cir. 1935).

825 1 Fletcher §§ 41-46.

the equal distribution of the assets of the insolvent party among the unsecured creditors,"[826] and to prevent fraudulent transfers by a debtor in favor of a few preferred creditors.[827]

The purpose of the Investment Company Act is to protect investors in investment companies.[828] The 1940 Act was applied to separate accounts because contractholders who assumed investment risk deserved this protection. As a secondary purpose, the investment, insurance and banking industries were to be put on an equal competitive footing. The paternal attitude of state insurance statutes affords contractholders as effective a protection as that afforded by the Bankruptcy Act. Additional protection may be available to contractholders under sections 11, 25, 26 and 42(e) of the Investment Company Act of 1940.[829] Notwithstanding the McCarran Act, the applicability of state insurance statutes does not prevent the application of these sections. *SEC v. National Securities, Inc.*[830] applied the anti-fraud provisions of the 1934 Act to a merger of two insurance companies, although the merger was subject to state insurance regulations. The applicable statute regulating insolvency does not affect the competitive position of insurance and investment industries. Finally, the imposition of a different system of dissolution or reorganization to what is admittedly an integral part of the insurance company's business may prove unnecessarily disruptive and onerous.

C. *Application of the 1940 Act*

Under state laws a separate account will be wound up or liquidated with the insurance company since it would not be permitted to secede from the company. It has been concluded earlier that the Bankruptcy Act does not apply to separate accounts. However, under section 42(e)[831] of the 1940 Act, a federal district court, upon application by the Commission, may as a court of equity, take exclusive jurisdiction of the company, and appoint a trustee to the assets of the company in connection with proceedings to enforce compliance with the registration requirement of section 7 of the 1940 Act.[832] In addition, federal courts have power, as courts of equity, to appoint a receiver and to order liquidation on violation of the securities acts, even though this power is not specified in the acts.[833] When rights under the securities acts were endangered by absence of judicial supervision of a state-chartered savings and loan association and the liquidators in a

[826] In re Parker, 275 F. 868, 869 (N.D. Ill. 1921). See also Quigley v. Kimbrough, 395 F.2d 100 (5th Cir. 1968); 1 H. Remington, Bankruptcy Law 19-20 (5th ed. 1950).

[827] 11 U.S.C. § 21 (1964).

[828] See § 1(b), 15 U.S.C.A. § 80a-1(b) (1971).

[829] §§ 11, 25, 26 & 42(e), 15 U.S.C.A. §§ 80a-11, 25, 26 & 41(e) (1971).

[830] 393 U.S. 453 (1969).

[831] § 42(e), 15 U.S.C.A. § 80a-41(e) (1971).

[832] Nielson, Neglected Alternatives for Investor Self-Help: The Unregistered Investment Company and the Federal Corporate Law, 44 Notre Dame Lawyer 699 (1969).

[833] SEC v. Bartlett, 422 F.2d 475, 478 (8th Cir. 1970). Federal courts will sparingly exercise their power to administer and liquidate corporations. The court distinguished cases when liquidation under the Bankruptcy Act would have been appropriate.

voluntary liquidation did not pursue it diligently, the federal district court appointed a receiver when the state authorities did not object.[834] The court may order liquidation if no alternative procedure is provided by state law, or if such an alternative is available but has not been pursued, or is not effective.[835] If the directors are unreliable and there is no hope that redemptions will be made promptly, a federal court may appoint a receiver even in the event that the company is solvent.[836] The federal court will not order liquidation of a solvent investment company unless there is no other alternative,[837] for example, when the company has no functioning management.[838] The court acts as a court of equity and can take exclusive jurisdiction over the investment company. Its powers are not derived from state law.[839] A federal court of equity under this subsection may disregard state procedural-law requirements regarding trust indentures, in order to give effect to the provisions of the 1940 Act.[840] A federal court has power to order the liquidation of a separate account for the protection of contractholders, notwithstanding state law provisions. Section 26(d)[841] of the 1940 Act grants federal district courts the power to liquidate an investment company organized as a unit investment trust, on a complaint of the Commission if the Commission believes that the trust is inactive or that liquidation is in the best interest of the security holders. The court may order liquidation if it finds that it is in the interest of the security holders. When state insurance law applies, instead of liquidation, the company's assets, rights and liabilities are usually transferred to another insurance company. This transfer might require the contractholders' consent to the transfer of the advisory and underwriting contracts,[842] if the reorganization is treated as an assignment of the advisory contract.[843] Further, this transfer may be con-

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[834] Tcherepnin v. Kirby, 416 F.2d 594 (7th Cir. 1969). The absence of an objection by state authorities was emphasized. The court noted, however, that when state authorities did not diligently act to appoint a liquidator, federal courts may properly appoint one. Intermountain Bldg. & Loan Ass'n v. Gallegos, 78 F.2d 972 (9th Cir. 1935). See also SEC v. Keller Corp., 323 F.2d 397 (7th Cir. 1963); SEC v. Midland Basic, Inc., 283 F. Supp. 609, 619 (S.D.S.D. 1968).

[835] Esbitt v. Dutch-American Mercantile Corp., 335 F.2d 141, 143 (2d Cir. 1964). The court refused to assume jurisdiction when the company was hopelessly bankrupt, the application of the Bankruptcy Act was appropriate, and proceedings under the Act had been almost finished.

[836] SEC v. Fifth Ave. Coach Lines, Inc., 289 F. Supp. 3, 42-43 (S.D.N.Y. 1968). In, Tanzer v. Huffines, 314 F. Supp. 189 (D. Del. 1970), the district court appointed a receiver to an investment company whose directors breached their duty to file annual reports under the 1940 Act. This remedy was harsh and should be resorted to only in extreme cases. Since the defendants had committed illegal acts in the past and the probability of future repetition existed, receivership was appropriate.

[837] SEC v. Fiscal Fund, Inc., 48 F. Supp. 712 (D. Del. 1943).

[838] Id. at 714.

[839] Id. at 715.

[840] Townsend Corp. of America & Townsend Management Co., Inv. Co. Act Release No. 4045 (Sept. 2, 1964).

[841] § 26(d), 15 U.S.C.A. § 80a-26(d) (1971).

[842] SEC v. Insurance Sec., Inc., 254 F.2d 642 (9th Cir. 1958).

[843] § 2(a)(4), 15 U.S.C.A. § 80a-2(a)(4) (1971). Transfer of control of the investment

sidered as an exchange of shares subject to the provisions of section 11 of the 1940 Act.

Section 25(c) of the 1940 Act authorizes the federal district court sitting in the state of incorporation of the registered investment company, or any district court for the district in which the company maintains its principal place of business, to enjoin the consummation of any plan of reorganization of the company upon proceedings instituted by the Commission, if the court determines that the plan is not fair and equitable to all security holders. The Commission is authorized to proceed on behalf of the security holders and any class of security holders of the company. For the purposes of this section the account is a conventional investment company. If the plan of reorganization of the insurance company is examined in the state court, the federal district court may, nonetheless, consider the plan for the security holders and enjoin its consummation if the plan is unfair to them.[844]

The regulated-department theory finds its greatest support in the disappearance of the separate entity of the account with its deregistration as an investment company. A conventional investment company will continue to be a separate person, unless dissolved. The account will disappear.

Section 8(f) of the 1940 Act authorizes the Commission, upon application or on its own motion, if it finds that an investment company has ceased to be an investment company, to declare so by order, whereupon the registration of the company shall cease to be in effect. The Commission may also in certain circumstances suspend or revoke the registration statement under which the company had registered.[845] Once deregistered, a separate account ceases to be an investment company and an entity separate from the insurance company except, perhaps, for past deeds and misdeeds.[846]

A separate account may cease to be an "issuer" and, therefore, an investment company, if it redeems all contracts in the pay-in period and has no outstanding contracts in the pay-out period. An account may cease to be an investment company if the investment risk in all its outstanding securities is reallocated to the insurance company. If only a more conservative investment policy is adopted, the account will retain its identity. A change in investment policy, even to the extent of conforming with insurance statutes, affects the quantity of investment risk, not its location. Both changes require the consent of all contractholders and the insurance company. An account may also cease to be an investment company if it is no longer engaged in investing and reinvesting in securities under section 3(a)(1)[847]

adviser as a result of a proxy fight does not constitute an assignment of the advisory contract. Willheim v. Murchison, 342 F.2d 33 (2d Cir. 1965).

844 The answer to the argument, based on the McCarran-Ferguson Act that this will be an interference with the business of insurance, can be found in SEC v. National Sec., Inc., 393 U.S. 453 (1969).

845 E.g., after notice and hearing, if the company fails to file the registration statement required by section 8, or reports required by section 30(a) or (b), or has filed a statement or report but omitted material facts, or filed a registration statement or report in violation of section 34(b). § 8(e), 15 U.S.C.A. § 80a-8(e) (1971).

846 E.g., Miller v. Steinbach, 268 F. Supp. 255 (S.D.N.Y. 1967).

847 § 3(a)(1), 15 U.S.C.A. § 80a-3(a)(1) (1971).

of the 1940 Act, or if it ceases to hold and own securities according to section 3(a)(3) of the Act.[848]

Under section 13[849] contractholders have the right to veto any changes in fundamental policies of the account, including its demise as an investment company. In a conventional investment company the board of directors has the power to initiate these changes in fundamental policies. Under state corporate laws that initially governed the separate account, management of the insurance company had full discretion over investments.[850] Superimpose upon this structure the provisions of section 13 and contractholders will fare no better than shareholders in a conventional company.[851] Yet they may need more protection.

In the pay-out period contractholders are completely locked-in. Even shareholders of a closed-end investment company which does not have a market can dispose, at least theoretically, of their shares, but contractholders in the pay-out period cannot. If the stock market falls as it did in the thirties, the annuity payments to these contractholders will continue to be affected by a ruinous investment policy, unless their board of directors, which may be controlled by the insurance company, proposes a change. There is a logical correlation between the extent of an investment risk, the degree of control over investment decisions, and the length of an investment. A debt investment does not usually carry with it power of control and may be made for a long period of time. The investor's risk is essentially the risk that the debtor will become insolvent. This is the type of risk that is involved in insurance. It is not illogical to make such an investment for life. An investment that carries with it an equity risk usually carries with it the ability to terminate it. These two elements, control (voting) and termination (redemption) were provided under the 1940 Act for investors in long-term installment equity investments, the periodic-payment plans. Variable annuities in the pay-out period are an anomaly. They are life-long equity investments. Contractholders in the pay-out period should be given, by law, the exclusive power to initiate changes in the investment policy, and the cessation of the business of the account to the extent of eliminating the separate account's separate existence. In addition, dissenting contractholders should have the power to convert their contract into a comparable insurance product or perhaps even to receive the value of the reserve in cash.

X. Applicability of the 1940 Act to Separate Accounts

A. *Separate Accounts Funding Variable Annuities*

At this point one might pause to consider the validity of applying the 1940 Act to insurance companies' separate accounts. The division proposed

848 § 3(a)(3), 15 U.S.C.A. § 80a-3(a)(3) (1971).

849 § 13, 15 U.S.C.A. § 80a-13 (1971).

850 See note 629 supra.

851 They may, perhaps, fare worse. For example, under the registration statement of New York Life Separate Account Q, Amend. 1 to Form N-8B-2, file No. 811-2000, at 20 (1971), New York Life Ins. Co. reserved the right to terminate the registration of the account to the extent permitted by federal securities laws and regulations.

by *Prudential* has not proven easy to apply. The insurance business and investment business are carried on simultaneously through the account. Conflicts arise between state and federal laws regulating the different businesses but governing the same assets and transactions. The 1940 Act cannot be applied to an insurance product without adjustments, for example, in voting rights or redemptions. In some instances the account should be treated as a regulated department of the insurance company, for example, for liability for the actions of the account. In some instances the account should be treated as an independent investment company, for example, for income tax purposes. In some instances the account should be treated as both a department and as an independent investment company, for example, in dissolution and deregistration. There is a need for a uniform application of principles and solutions to specific problems. Although the problems are abundant, the 1940 Act should apply.

The application of the 1940 Act is not violative of the prohibition of the McCarran Act. The provisions of the 1940 Act were applied for the protection of investors but did not derogate from the protection of policyholders or interfere with the insurance business. The Supreme Court held in *SEC v. National Securities, Inc.*[852] that when a merger between two insurance companies was contested on the basis of federal law that provided for protection of investors, the federal law applied since it did not impair, except indirectly, state law regulating the business of insurance. This was so even though under state law the contested merger was deemed satisfactory as affording protection to policyholders.

A survey of the conflicts between the state and federal law regulating variable annuities shows that in most cases federal law did not impair state law aimed at protecting policyholders. When a direct conflict arose, as with respect to custody of the assets, the Commission granted appropriate exemptions. The difficulties between the SEC and the industry stemmed mainly from the resistance of the industry to regulation, not from conflict between state and federal law. For example, load, the regulation of which was strenuously contested by the industry, is not regulated under state insurance laws. The requirement of daily valuation of assets that was strongly resisted by the industry does not conflict with state laws' annual valuation of liabilities and assets. The application of two regulatory systems to insurance business is not necessarily disruptive of smooth business operations. Insurance laws furnish examples of application of different regulatory patterns to different activities of the same insurance company.[853]

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[852] 393 U.S. 453, 461-64 (1969).

[853] In Traders' & Mechanics' Ins. Co. v. Brown, 142 Mass. 403, 411-12, 8 N.E. 134, 135 (1886), a stock insurance company carried through two separate and independent departments a stock insurance and mutual insurance business. The two departments were separate in every respect, and governed by different provisions of the law. Note, however, that some statutes prohibit one company from issuing policies on both stock and mutual plans. 18 Appleman § 10054, at 128. In Ohio this prohibition was overcome by means of a separate corporate entity. Ohio State Life Ins., Co. v. Clark, 274 F.2d 771, 776 (6th Cir. 1960). When this was done the two entities were held separate for income tax pur-

The system of double regulation has proven workable. Regulation did not deter the insurance industry from entering the field, and double regulation has been functioning more or less efficiently for the past eight years.

The industry, however, concentrated in the area of exempt or partially exempt business.[854] This may be due in part to the burden of doubt regulation. Balanced against these difficulties is the need for investor protection afforded by the Investment Company Act to contractholders, especially in the pay-out period. Additionally, the application of the Act to the insurance and investment industries may enhance competition to the benefit of investors. Following Justice Harlan's tests in *United* it seems that the 1940 Act applies to separate accounts, but that legislation is needed to solve the difficulties which this application raises. The appropriateness of applying the substance of the 1940 Act is not challenged any more. Details of this application and the regulatory agency to administer the Act or an adjusted version of it are still open for discussion.

B. *Separate Accounts Funding Variable Insurance Policies*

In the first part of this article the conclusion was reached that some variable insurance policies are securities. The question of whether the 1940 Act applied to the separate account funding these policies was deferred until after a discussion of accounts funding variable annuities, because the application of the 1940 Act raised different problems from those arising in connection with the application of the 1933 Act. It is submitted that under the present state of the law, separate accounts funding variable insurance policies that are securities should be subject to regulation under the 1940 Act.

The need for the 1940 Act protection to which variable annuity contracts give rise is also present in variable insurance policies that are securities. The need for protection might be even greater. The policyholder is "locked-in" throughout the period of the policy except that upon default the cash surrender value must be returned to him. Therefore, barring special circumstances, the 1940 Act ought to apply.

The conceptual difficulties in applying the 1940 Act to variable annuities in the pay-out period are also present in the case of variable insurance, and for the same reasons. In variable insurance, however, the problems arise in a slightly different context. Some of the most serious problems which the application of the Act to variable insurance raises follow.

First, how should the number of votes under variable insurance policies be calculated? Should the number be based on the reserves, the amount of premiums paid, the cash surrender value, or the death benefits? In the pay-out period of a variable annuity the number of votes is based on the

poses and could not file a consolidated income tax return. Ohio Farmers Indem. Co. v. Commissioner, 108 F.2d 665 (6th Cir. 1940); Clark v. Lincoln Liberty Life Ins. Co., 139 Neb. 65, 296 N.W. 449 (1941).

854 SEC Investor Report, note 28 supra, at 648. Of 197 accounts, only 2.4% of the reporting assets were registered under the Act. Id. at 646.

reserve funding the annuity. This, in essence, is the amount which, according to the probabilities at a particular moment, will be the total amount of payments eventually made under the contract. In a life insurance policy this amount is the death benefits. If we follow the principle adopted with regard to variable annuities, the voting rights of variable life insurance policies should be based on the amount of death benefits divided by the value of a unit.

Another basis for calculating voting rights is the amount of net premiums actually paid by the insured, as an index of his personal stake in the separate account. In answer, it can be pointed out that higher death benefits entail a liability for higher premiums. Besides, the aggregate amount of premiums which an insured pays is meaningless since each year some of it is used to cover actual cost of protection. If the criterion for voting should be the monetary stake, then the cash surrender value, the true savings of the insured, may provide a second alternative. It could be argued that this index is inappropriate because the cash surrender value does not represent the stake of the insured in the separate account, since at least in the first years of the policy the cash surrender value is eliminated or greatly reduced by the load. A third alternative is to calculate the number of votes as in state statutes applicable to voting policyholders of mutual insurance companies[855] and to participating policyholders.[856] The problem of finding a measure for determining voting rights is therefore not insurmountable.

A more difficult question regarding variable insurance policies is whether the right of a policyholder to receive the cash surrender value creates redeemable units in the sense of the 1940 Act. Further, does the right to cash surrender value convert the whole policy into a redeemable security? Finally, can the policy be classified as a periodic payment plan? These questions are important for determining whether, if the 1940 Act applies, the separate account is an open-end company.

If units representing cash surrender value are viewed separately from the whole policy, the separate account could be deemed to issue two types of units, non-redeemable death benefit units and redeemable cash surrender units. Since the account would then issue redeemable securities, it would be an open-end investment company. An exemption can be granted to the units of death benefits that, by definition, are payable only on death. It is arguable that cash surrender units are not redeemable because they do not in fact give to the holder a right to receive his proportionate share in a fund. But this argument was made with respect to variable annuities. Just as variable annuity units are not precisely a share in the fund, neither are cash surrender units.

Another objection is unique to variable insurance and is harder to answer. In order to receive the cash surrender value all the rights under

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[855] The measures used are varied. For example, each policy is entitled to one vote plus one additional vote for every $5,000 of insurance in excess of the first $5,000. Mass. Gen. Laws Ann. ch. 175, § 94 (Supp. 1971).

[856] N.Y. Ins. Law § 199.1 (McKinney 1966).

the policy must usually be surrendered.[857] If the policyholder is of advanced age these rights are very valuable. They can be replaced only at high cost, or, perhaps, not at all. Yet redemption under the 1940 Act seems to mean a right to receive the value of the units upon their surrender only;[858] otherwise the words "proportionate share" in the Act are meaningless. It should be noted that cash surrender value is during most of the life of the policy a fraction of what the insured paid as premiums, and that it is paid not with the view to accumulating earnings to be cashed at the appropriate time, but for the purpose of providing part of the death benefits at a later date when the level premium will purchase less than the face amount of the policy. The policy does not provide for repayment of cash surrender value. It provides for nonforfeiture of this sum. Cash surrender value becomes payable not because the policyholder surrenders his units for redemption, but because he defaults on payment of premiums causing the bulk of his rights under the policy to lapse. It is only then that the residue of his savings must be returned to him. It is submitted that a payment of cash surrender value, though technically a payment for surrendered units, is not a redemption of the units within the meaning of the Act.

Another approach supporting the redemption theory is that the policy is a periodic payment plan certificate[859] under which the insured makes periodic payments in order to secure the right to death benefit units and, upon default, to cash surrender value units. The policy must be redeemable by law, unless the Commission grants an exemption. The exemption from redemption will be granted in order not to undermine the insurance scheme, but the issuing company will remain an open-end management company.

The resemblance between payments on variable annuities and payments of premiums on insurance policies is superficial. A variable annuity contract in the pay-in period is pure savings. At the end of the pay-in period the contractholder has an option to cash his units and terminate his relationship with the insurance company without even entering into an arrangement that contains insurance components. In a life insurance policy the "periodic payments" are applied to insurance protection which becomes available immediately. The periodic payments of premiums do not represent accumulation of future benefits. They are payment for present protection of the whole amount of death benefits. The application of the 1940 Act definition of a periodic payment plan to an insurance policy is, to say the least, bizarre.[860].

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857 3A Appleman § 1752.

858 § 2(a)(32), 15 U.S.C.A. § 80a-2(a)(32) (1971).

859 § 2(a)(27), 15 U.S.C.A. § 80a-2(a)(27) (1971).

860 Even though an account funding variable insurance is not under present law an open-end investment company, it may have many of the characteristics of separate accounts funding variable annuities. It issues an unlimited number of policies. Its sales tactics and objectives are similar to open-end rather than closed-end companies, and competitively, they pose a threat to open-end rather than closed-end companies. This account

Another problem with respect to variable insurance concerns the application of Rule 22c-1 pursuant to the Act. The sales price of a security must be based on its "current net asset value."[861] It has been argued that the premiums, the sales price payable for variable life insurance, is based not on the net assets value but is arrived at with reference to actuarial principles depending on the age and health of the insured. Yet the same is true with respect to calculations of payments (pay-out period) of the variable annuity. There, too, the basic amount payable to the annuitant is calculated with reference to mortality tables. Payments funded by separate accounts may depend on factors other than the value of the assets of the account, but they are always affected by the value of the assets. This conceptual adjustment has been made with respect to separate accounts funding variable annuities. There is no reason not to have the same attitude toward separate accounts funding variable insurance.

In calculating the amount of the premiums there is the further question of how the amount of the load will be determined. Again, variable annuities can be a precedent. A projected number of years for making premium payments may be fixed by consent.

It has been argued that separate accounts funding variable insurance cannot be closed-end companies because insureds are not always equitable owners of the assets. It has been shown, however, that under the 1940 Act contractholders need not be equitable owners of the assets in the account.[862] Under state insurance laws contractholders may be entitled to rights similar to those of secured creditors that will satisfy the investment concepts and the definition of an issuer in the federal Act. Again, the provisions of section 23(b) of the Act, which forbid a closed-end company from selling common stock below current net assets value of such stock,[863] and Rule 23c-2,[864] which permits the company to call or redeem its outstanding securities (if less than all securities are called or redeemed, the call or redemption must be made by lot, on a pro rata basis), must be interpreted to include a security under which the basic amounts due are determined by insurance, not investment, arrangements. Section 23(b) will apply in the sense that the calculation of the value of the units must be based on the current value of the assets. The insurance company will not be able to take advantage of the permission granted under Rule 23c-2. But neither is it presently subject to redemption requirements of section 27(c)[865] in the pay-out period of annuities.

Thus, the separate account funding variable annuities has set the precedent for a method to solve most of the problems which might arise in connection with variable insurance.

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ought, perhaps, to be subject to the same regulation, with appropriate adjustments. This problem requires a legislative solution.

861 17 C.F.R. § 270.22c-1(a) (1971).

862 See p. 331 supra.

863 § 23(b), 15 U.S.C.A. § 80a-23(b) (1971).

864 17 C.F.R. § 270.23c-2 (1971).

865 § 27(c), 15 U.S.C.A. § 80a-27(c) (1971).

XI. Conclusion

This article is based on the existing law. The following is a discussion of what the law should be.[866]

A. *Purpose and Philosophy*

The law governing equity insurance products should afford purchasers the protection traditionally afforded by state insurance laws with respect to the insurance aspects of these contracts. In addition, the law should provide purchasers with substantially the same protection given by the federal securities acts to investors in investment companies. It does not necessarily follow that the same philosophy of regulation should be strictly adopted.

The provisions of the federal securities acts should be adjusted in order not to conflict with the insurance scheme of which the contracts are a part. The securities acts should not apply if the protection that they offer is not necessary because state insurance regulation provides adequate protection, or because a more convenient and suitable alternative is available.

The philosophies of federal securities acts and state insurance regulation with respect to the role that the investors and the regulatory agency should play in enforcing the law differ. Federal securities acts rely on, and strengthen the ability of, the public to evaluate the securities that are offered by investment companies, and the ability of security holders to make investment decisions and enforce the law. Therefore, the acts require disclosure, provide for voting power to investors, and give them a private right of action. The philosophy of state regulation is that the state regulatory agency is best equipped to evaluate insurance contracts and enforce the law. These different philosophies are also manifested in the attitude of the regulatory agencies towards the regulated industry. Long years of regulation produced at the state level an identification of regulatory agencies with the regulated industry and an informal procedure for solving problems. This does not mean that regulation is ineffective. The contrary may be true. But an industry used to exclusive regulation of this kind may find it difficult to accept regulation aimed at creating a new and different bargaining party.

In theory the paternalistic attitude of traditional insurance regulation could be applied to protect equity insurance contract purchasers. State insurance agencies or the SEC could be granted authority to regulate the investments in the separate accounts, to evaluate and oversee the investment advisory services rendered by the insurance company, and to provide a substitute for individual enforcement by contractholders. There is great danger in permitting government to make business decisions for the public on such a large scale. This method of securities regulation was rejected by Congress in favor of disclosure.[867] Even though the 1940 Act adopted a more direct regulatory approach, since disclosure was not effective in curbing

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866 The following is a general outline. The importance of detail has not been overlooked; but a detailed draft based on this outline merits a separate study.

867 1 Loss at 121-28.

abuses of investment companies,[868] the ultimate decision regarding investments was left to security holders.[869] The Commission has never exercised its authority to establish standards for reasonable charges,[870] perhaps because it did not wish to become the final arbiter of a business decision. In any event, it is doubtful whether such a regulation will develop in all fifty states and even more doubtful whether the insurance industry would welcome it, on state or federal level.

The choice of a federal model is based on the successful application of this model for thirty years. It is difficult to measure the efficacy of regulatory systems. State insurance regulation has probably been more successful than federal regulation in ensuring the financial integrity of insurance companies. This area should therefore be left to the states. In choosing a regulatory model as well as the regulatory agency, past experience with regard to a particular subject matter should be considered.

The choice of the federal regulatory system is also based on the desirability of placing the insurance and investment industries on an equal competitive basis. It is recognized that equality is difficult to measure since the two industries are not subject to equal regulatory burdens, and do not sell the same products. The assumption that federal securities acts afford the only effective protection to investors in equity insurance products and the assumption that a more equal competitive position will be achieved by imposing the same regulatory system on the investment and the insurance industries, are therefore subject to rebuttal.

B. *Choice of Regulatory Agency*

The first question is who should regulate insurance equity products. Justice Brennan's concurring opinion in *Valic* and the Supreme Court's decision in *United* were primarily based on the grounds that state laws and their regulatory insurance agencies did not afford the purchasers of variable annuities appropriate investor protection. One can only speculate on what would have happened if, before the *Valic* decision, states had adopted, with appropriate changes, the provisions of the 1933 and 1940 Acts and applied them to variable annuities. The *Valic* decision may have been avoided. Even today, if states adopted the 1940 Act's regulatory philosophy and provided a comprehensive law governing the separate account and insurance equity products, variable insurance might be exempt from federal regulation.[871] Perhaps variable annuities will regain their insurance status. States cannot adopt a full regulatory scheme modeled after the 1940

[868] See p. 246 supra. The SEC is authorized by section 25(a) of the 1940 Act to give security holders an advisory report on the merits and disadvantages of a proposed reorganization.

[869] See p. 345 supra.

[870] See criticism of this position. Werner, Protecting the Mutual Fund Investors: The SEC Reports on the SEC, 68 Colum. L. Rev. 1 (1968).

[871] See Galston, The Regulation of Variable Annuities, ABA Section of Ins., Negligence & Compensation Law 348, 378-79 (1967), for unilateral regulation by the states; Johnson, "Why Not Individual Variable Annuities," Pension & Welfare News, Jan. 1967, at 42 (for concurrent SEC and State Blue Sky regulation).

Act with respect to variable annuities because the Commission is exercising identical powers over the same contracts. Identical concurrent state and federal regulation may render it impossible to carry on business. Full state investor regulation fashioned after the 1940 Act pattern can be put into effect only if the Commission refrains from acting while the states set out to show that they effectively protect insurance equity investors. In view of the number of people involved and the divergence among states it is doubtful whether the attitude of wait-and-see will be adopted. If the industry and the Commission agreed on a form of variable insurance policy that is not a security, state law may develop the type of regulation of equity insurance that can be substituted for federal regulation. It should be noted that even if the industry and the Commission agreed on the type of variable insurance policy that is not a security, the courts will be the final arbiters of this question. Once issued, every holder of such a policy may test the question in court. The substance of state regulation of these policies will be of paramount importance in determining whether or not the federal securities acts should apply to them.

An alternative method to enable states to retain and regain their exclusive regulatory powers over insurance equity products is a conditional exemption from federal regulation based on alternative effective state regulation, modeled after Section 12(g)(2)(G) of the Securities Exchange Act of 1934.[872] This section, by its own terms, does not apply to securities of an insurance company, if: (i) the insurance company filed and is required to file an annual statement with the agency of its domiciliary state, and the statement conforms to that prescribed by the National Association of Insurance Commissioners (NAIC), or in the determination of the state insurance authority the statement so conforms; and (ii) the insurance company is subject to regulation by the domiciliary state of proxies and similar documents, and the regulation conforms to that prescribed by NAIC; and (iii) with regard to short-swing profits of insiders, the domiciliary state provided regulation in "substantially" the same manner as that provided by section 16 of the Act.[873]

The first subsection raises no problems for the insurance companies and the states, but may be inadequate to achieve the goal of protection, since it leaves the entire area of regulation to NAIC. The second and the third methods would require the preparation of a model act. Yet the mere adoption of such a model act by a state may still not afford investors adequate protection. State courts might set standards that do not comport with federal standards. Administrative enforcement might be inadequate. Agencies that for decades have been enforcing a legislative policy aimed at preserving the solvency of insurance companies may not be able simultaneously to adopt and enforce the policy of investor protection of the federal securities acts.

With regard to insider trading, section 12(g)(2)(G)(iii) of the 1934 Act

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872 15 U.S.C. § 78*l*(g)(2)(G) (Supp. 1969).

873 Id. § 78p.

requires a "substantially" similar manner of regulation, not only similar legislation. If this test is adopted, it will satisfy the investor protection requirement, but insurance regulatory agencies and the insurance industry might be faced with difficulties. If state courts did not follow in their interpretation of the model state statute the federal courts' interpretation of the identical federal statute, it is doubtful whether the substantially same manner test will be satisfied. Furthermore, even if the model act is drafted and passed with the consent of all interested parties, questions will arise as to the manner of its amendment and if it should follow changes in the 1940 Act. Finally, a conditional exemption does not eliminate concurrent state and federal regulation. Federal regulation will continue over equity insurance products and separate accounts of companies domiciled in states that do not adopt the model act.

Conditional exemption may have the one advantage of enabling states to show effective investor protection. It has many disadvantages.[874] Inherent in this solution is an undertaking by the states to follow and enforce a model fashioned upon a federal uniform standard through their own legislative and enforcement process. This solution should therefore be adopted only if states are prepared to make the federal courts the judges of the effectiveness of their regulation, and the insurance industry is willing to conduct its business in uncertainty as to whether or not at any particular moment the exemption exists.

The oft-heard arguments for exclusive state regulation are that concurrent state and federal regulation is burdensome, that traditionally insurance companies have been regulated by the states, and that Congress has approved of this tradition. As to the first argument, although unitary regulation is desirable, concurrent regulation is not unknown to insurance companies that sell their policies in more than one state. State insurance authorities do not always share the same policies or requirements, and many insurance statutes apply their own standards to foreign insurance companies, even though there is continued pressure for uniformity and a common philosophy of regulation. Finally, the last eight years have shown that concurrent regulation by state insurance agencies and the SEC is possible. It might be burdensome, but not to the extent of deterring the insurance industry from entering the variable annuities field. It was the absence of clear legal standards rather than the existence of two regulatory agencies that caused most difficulties.

As to the second and third arguments, states regulation of insurance business is predominant because state regulation throughout the last seventy years effectively protected the holders of conventional insurance policies. Therefore, the courts upheld state regulation and Congress did not

874 Loss, The Securities and Exchange Commission and the Insurance Business . . . Facts and Fancies, Address at a conference for young life insurance companies, "Trends in Life Insurance Regulation and Taxation," (Chi. Ill. 1966). For arguments in favor of this arrangement, see Jones, The Variable Annuity and the 1940 Act—An Uncomfortable Combination, 3 Conn. L. Rev. 144, 165 (1970).

find it necessary to act. When the McCarran Act was passed, Congress was faced with the choice of regulation by state insurance authorities or no regulation.[875] The Act expresses recognition of the effectiveness of state regulation of insurance and of the fact that there is no federal alternative to it. Variable annuities present the need for a different kind of regulation in which state insurance agencies have no special expertise and to which there is an effective alternative federal agency, the Securities and Exchange Commission.

An alternative to regulation by state insurance authorities of insurance equity products is regulation by state blue sky agencies. Again, had these agencies undertaken to protect effectively policyholders-investors, they might, perhaps, have been preferred over a federal agency. In the last eight years, however, most states exempted variable contracts from the regulation of state blue sky laws.[876] Further, concurrent regulation by nearly one hundred state agencies may be more objectionable than concurrent regulation by about fifty state agencies and one federal agency. Finally, the problem of ensuring effective adoption and enforcement by states of a model act without the alternative of federal regulation will remain.

The last alternative is exclusive federal regulation. This alternative can presently be dismissed as politically unrealistic and without merit.[877] Insurance equity contracts contain some insurance arrangement. The mortality tables, the rate of assumed interest and the calculation of reserves may vary from state to state, but in most cases they apply equally to fixed and variable products of the same type. Even if equity insurance contracts were a special brand of insurance that required uniform treatment on a national level, there is no federal agency that is equipped at present to deal with these insurance matters. Exclusive federal regulation might eliminate concurrent regulation over separate accounts and variable contracts, but will result in subjecting insurance companies to dual federal and state regulation with respect to their insurance business.

Concurrent regulation is therefore, at present, inevitable. Concurrent regulation might lead to exclusive federal regulation or to the development, on the state level, of the type of equity insurance regulation that will render

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[875] See p. 210 supra.

[876] See, e.g., Ala. Code tit. 28, § 4(5)(1)(g) (Supp. 1969); Alas. Stat. § 21.42.370(j) (Supp. 1970); Ariz. Rev. Stat. Ann. § 20-651 I (Supp. 1970); Ark. Stat. Ann. § 66-3523(i) (Supp. 1969); Del. Code Ann. tit. 18, § 2933(h) (1968); Ga. Code Ann. §§ 56-1038(h), -1040(n) (1971); Hawaii Rev. Stat. § 431-563(d) (Supp. 1970); Idaho Code Ann. § 41-1939 (Supp. 1969); Ill. Stat. Ann. ch. 73, § 857-51(c) (Smith-Hurd Supp. 1971); Kan. Stat. Ann. § 40-436(*l*) (Supp. 1970); La. Rev. Stat. Ann. § 22-1500J (Supp. 1971); Me. Rev. Stat. Ann. tit. 24A, § 2537(11) (1969); Minn. Stat. Ann. § 61A.20 (Supp. 1971); Mo. Ann. Stat. § 376.309.6 (Supp. 1971); N.C. Gen. Stat. § 58-79.2(r) (Supp. 1969); N.D. Cent. Code § 10-04-05.3 (Supp. 1971); Laws of Ohio bk. I, § 3911.011(c) (1969-1970); Okla. Stat. Ann. tit. 36, § 6061(*l*) (Supp. 1971); Pa. Stat. Ann. tit. 40, § 506.2(j) (Supp. 1971); R.I. Gen. Laws Ann. § 27-32-7 (1969); S.D. Comp. Laws Ann. § 58-28-31 (Supp. 1971); Tenn. Code Ann. § 56-319 (1968); Tex. Ins. Code art. 3.72, § 1 (Supp. 1971); Utah Code Ann. § 31-13-31(8) (Supp. 1967); Wash. Rev. Code Ann. § 48.18A.070 (Supp. 1970); Wyo. Stat. Ann. § 26.1-367(h) (1967).

[877] See Jones, note 874 supra, at 164-65.

federal supervision unnecessary. This last possibility is theoretical. Besides, the time has come for federal regulation of insurance in matters that are of national concern, along the lines of the development by the SEC of federal corporation law. Insurance is no longer a purely local matter.

There is no escape from the burdens of experimental regulation which the insurance industry and the staff of the Commission have carried. The staff has accomplished the complex task of laying the foundation for regulation of a unique hybrid product. The establishment of a new department in the Securities and Exchange Commission may facilitate the conclusion of this effort in a detailed legislative proposal.[878] It may also lay the foundation to the regulation of insurance in specified areas that are of interest to policyholders throughout the nation.

C. *The Model Act*

Assuming that equity insurance products will remain subject to state regulation with respect to insurance matters and federal regulation with respect to investment matters, and assuming that special legislation is needed to clarify problems, what should this legislation provide? The policy decision must first be made of whether the 1940 Act should continue to apply to separate accounts or should be amended to accommodate this new form of insurance-investment vehicle.

The advantages of continuing to apply the 1940 Act, unamended, to the equity insurance contracts and separate accounts are that the SEC is familiar with the Act and its corporate-structure orientation, and that the application of the Act to competitors (mutual funds, insurance companies) enhances competition to the benefit of investors. This position has its weaknesses. By now some members of the Commission's staff have been exposed to insurance for more than ten years. Variable contracts contain insurance arrangements that are different from, and cannot be reconciled with, other investment arrangements. Insurance companies have to satisfy state law requirements that are different from those regulating conventional investment companies. Perhaps the most serious weakness is that by applying an Act that does not take these differences into consideration the insurance industry is placed at a competitive disadvantage, to the detriment of investors.

D. *Organizational Structure*

Regardless of the substance of regulation of separate accounts, how should they be organized? There is ground for arguing that the 1940 Act requires any investment company to be an independent organization, master of its own form and internal affairs.

The Act defines investment companies that are investment trusts in terms of their organization, and face-amount certificate companies in

[878] Some of the more difficult problems are hidden in these details. For example, the accounting practices of the Nat'l Ass'n of Ins. Comm'rs and those required by the Commission are not in accord. Jones, note 874 supra, at 172 n.51.

terms of their securities. The rest are management companies. These companies must have a board of directors that are defined as directors of a company or persons occupying a similar position. It can be argued that almost every provision of the Act presupposes an independent entity and that the Act must be interpreted to require that an investment company be organized in a form that is amenable to regulation. If this attitude be taken, state law must recognize the existence of the account for the purposes of doing investment business and not only for the purposes of applying to it the 1940 Act. The ideal would then be a model state or federal statute that recognizes accounts as sui generis corporations carrying on the business of an investment company. The corporate law governing the sponsoring insurance company may provide a model for the account, subject to the following exceptions. The "capital structure" of an account must be left to insurance laws. Accumulation units and insurance units (annuity units and other units covering payments that contain an insurance arrangement) should be defined. The powers of the account, the content of the Rules, the division of decision-making power between the board of the account and the contractholders, and which Rules may be amended by whom, should be spelled out. The dissolution of the account, separately or together with the insurance company, should be regulated. Most of the problems raised in connection with accounts will be solved by such state legislation.

The arguments against interpreting the 1940 Act as requiring an investment company to have separate existence, are based on the definition of a separate account in the 1970 Act and on the practice of the Commission and the staff in the past eight years. The definition of the 1970 Act ties the account to an insurance company and identifies it as an account established under state law. Presently and at the date of the passage of the 1970 Act accounts had no separate existence from the insurance company. The Commission and the staff considered accounts for many purposes as a department of the insurance company and permitted the insurance company to determine the organization of the account and the contractholders. The fact that the insurance company is required to execute the registration statement of the account under the 1940 Act together with the account is evidence of the doubts that the separateness of the account will be upheld when tested in the courts. On the other hand, there are a few instances in which the staff insisted on the independence of the account as a business entity, for example, with respect to income tax treatment. With these exceptions an account is treated, at present, as a regulated department of the insurance company, subject only to the express provisions of the Act. If this attitude be taken, federal law ought to be amended to permit the regulation under the Act of a department of the insurance company. This attitude would leave traditional insurance arrangements intact whenever possible, and perhaps achieve a more equal competitive positioning of the insurance and investment industries. It will lead to a more realistic view of the variable contract and perhaps to a more effective investor-policyholder protection. Even under this structure the account must be identified, as it is under the present insurance laws. The investment department of the insurance company, if not separately incorporated, must be identified in the same fashion.

E. *Applying and Adjusting the Provisions of the Investment Company Act*

Problems of structure aside, the main question is which provisions of the Investment Company Act should apply to separate accounts and what adjustments should be made for separate accounts.

1. Qualification of Companies and Custody of Assets

When state legislation traditionally affords contractholders similar protection, the 1940 Act provisions should not apply. Therefore, the provisions of the Act regarding qualification of an investment company to do business,[879] and the provisions regarding the custody of assets[880] and the establishment of reserves to ensure refund of load,[881] should not apply to insurance companies. In these matters state insurance laws have been effective and state agencies have the expertise. For the purpose of uniformity, a model act could establish objective qualification standards.

2. Reorganizations and Dissolutions

For the same reasons the provisions regarding reorganization and dissolution of investment companies and the intervention of the SEC in proceedings regarding reorganizations should not apply.[882] In the event of insolvency, purchasers of insurance equity products are afforded sufficient protection under state laws. On the other hand, contractholders' rights in the assets of the account should be clearly spelled out. Contractholders ought to be given, by law, a security interest in the assets of the account and priority over other policyholders of the insurance company. They should not have priority over third party creditors of the investment business of the account.

3. Load

Section 22(d) of the 1940 Act prohibiting deviations from the established load should not apply to insurance companies. There are good grounds for deleting the section altogether. But even if the section had merit, insurance companies should be excepted.[883] This section was aimed at curbing destructive competition among dealers, not at curbing competition between various investment products. Since insurance companies use their own sales force they do not compete with mutual funds for security-dealers' favors.

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879 See p. 268 supra.
880 See p. 318 supra.
881 See pp. 311-12 supra.
882 See pp. 380-83 supra.
883 See pp. 314-15 supra.

If Congress were concerned in this section with discrimination among purchasers, which is doubtful, the model act should contain a prohibition of unfair discrimination, similar to the prohibition in many state insurance laws.

The provisions of section 22(d) requiring specification of the components of the sales charge should apply. There is a great variation among insurance companies regarding their various charges. First, there are differences among charges for administrative expenses, mortality and expense guarantees, sales charge and advisory fees. In addition, some companies deduct administrative expenses from premium payments; others deduct administrative expenses from the assets in the account. A purchaser might find it difficult to compare the charges of one insurance company to another, let alone insurance companies and mutual funds. Since one purpose of section 22(d) is to enable a prospective purchaser to make this comparison, an itemized list of charges will not be adequate unless charges were standardized. The requirement of itemized charges may also be based on the fiduciary position of the insurance company investment adviser and on the part contractholders play in ratifying the underwriting contract. Perhaps the main reason for this requirement is that it may show the purchaser how much he is charged on a specified activity so that he can judge whether or not he is overcharged.

It is arguable that the only meaningful information for a purchaser is what is the aggregate amount of charges on his policy as compared to charges on policies of other companies. He can then compare and make an intelligent judgment. If the disclosure involved here were only for the purpose of enabling purchasers to compare charges, this argument would have been attractive. Unlike state insurance statutes, however, the 1940 Act regulates charges. Administrative expenses may not be excessive, investment advisory fees may not exceed those that may be charged by fiduciaries, and sales and administrative charges may not exceed a maximum of 9 percent. Whenever the Act permits private enforcement, disclosure is indispensible. Therefore, investment advisory fees must be separately disclosed. If administrative expenses are to be regulated by government, disclosure of itemized charges to contractholders may be dispensed with. Since it is doubtful whether the SEC or the industry is enthusiastic about rate-regulation by the Commission, there remains no alternative but to require itemized disclosure to enable contractholders and the courts to determine whether administrative expenses were excessive. The insurance industry would prefer to disclose only the sum of all charges. It has been argued that it is difficult to separate the sales load from other charges. As an alternative to itemized disclosure, it has been suggested that rates be regulated by NAIC and that SEC be represented in the association for the purpose of regulation.[884] The suggestion is unacceptable. Insurance agencies have

884 See Jones, The Variable Annuity and the 1940 Act—An Uncomfortable Combination, 3 Conn. L. Rev. 144, 168-70 (1970).

no expertise in regulating sales expenses. Besides, delegation of regulatory powers to NAIC may raise constitutional problems.[885] There is no substitute for the fiduciary duties of the insurance company to the contractholders. The charges must bear some relationship to services rendered. They should be itemized in order to permit a check on each item.

The limitations on sales charges in section 27 of the Act should apply to equity insurance. Section 27(d), permitting the contractholder to rescind the contract within 40 days from its date, should not apply to variable insurance and immediate single premium variable annuities. Adjustments in calculating the load can easily be made on the basis of premium payments or ultimate benefits. At present, rates are not directly regulated by state insurance laws. In order to avoid conflicts of authority in the future, the model act should provide that if state insurance laws treat a charge as a reserve, the charge should not be deemed a part of the load. All other charges except premium taxes and administrative expenses should be subject to the limitations on the load.

4. Redemption

An adjustment should be made in the redemption requirement, along the lines of existing exemptions. Redemptions should not be required with respect to the parts of equity insurance products that do contain an insurance feature. It is submitted that contractholders should be afforded added protection during a period in which they are locked into investment arrangement. They should, at any time, be permitted to exchange their equity insurance contracts for a conventional insurance contract of the same type, for which the same reserves are required for the particular holder.

5. Underwriting Contracts

The requirement of an underwriting contract should be waived.[886] However, the insurance company must continue to make an effort in good faith

[885] But cf. sections 12(g)(2)(G)(i) and (ii) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78*l*(g)(2)(G)(i) and (ii) (Supp. 1969) delegating to NAIC authority to prescribe the form of annual statements of insurance companies and to regulate their proxy material. The theory of unconstitutional delegation has not retained great strength. K. Davis, Administrative Law ¶ 2.17 (Supp. 1970). However, the regulation of rates cannot be delegated without some safeguards against arbitrary decisions. Id. Itemization of charges is necessary to provide such safeguards. But with itemization the advantages of NAIC regulation will disappear. On delegation of governmental powers to private groups, see id. ¶ 2.14; Frankel, The Governor's Private Eyes, 49 B.U.L. Rev. 627, 647 (1969); State v. Allstate Ins. Co., 231 Miss. 869, 97 So. 2d 372 (1957).

[886] The joint committee of the two major associations of the insurance industry prepared and submitted to the SEC in 1967 a Memorandum of Proposed Relief From Provisions of the Investment Company Act of 1940 for Insurance Companies with Separate Accounts Registered Under that Act, Finnegan & Garner, note 90 supra, at 118 n. 31. The committee proposed that the requirement for an investment advisory contract be waived. Management fees charged by the insurance company will be stated in the individual contracts. A majority of the contractholders can terminate the investment advisory services of the insurance company only upon the recommendations of the board of the account. On the termination the insurance company has the option to notify the contractholders that it will not perform the mortality and expense guarantees and

to sell the contracts unless the holders of a majority, or perhaps two-thirds, of the outstanding voting securities of the account agree to a cessation of the sales effort.

6. Investment Advisory Contracts

The insurance company renders investment advice to contractholders in their capacity as shareholders since investment risk is borne by them. Therefore, if the insurance company charges a fee for these services it can only do so on a contractual basis, unless the contractholders are deemed to be shareholders of the insurance company in which case the fees should revert back to the contractholders, through the account. The 1940 Act requires a written contract between the insurance company and the account specifying the fees and services rendered by the investment adviser. The adviser is a fiduciary with respect to the fees as well as its other duties. Contractholders have a right of action on violation of the contract and a right to terminate the contract with 60 days notice. The contract is reviewable every two years. Since a requirement of a contract between the aggregate of contractholders and the insurance company raises conceptual and practical difficulties unless the account is constituted as a body corporate, it has been suggested that in lieu of this contract, advisory fees will be stated in the individual variable contracts. An alternative retaining the protective measures of the Act, or providing an effective substitute for them without separating the account from the insurance company, may be desirable. However, the mere relegation of advisory fees to individual variable contracts does not afford an effective alternative.[887]

The model act can provide that individual variable contracts should contain essentially the same information about advisory services as those contained in the present advisory contract, expressly or by reference. The insurance company can be expressly subject to fiduciary duties as an investment adviser. Contractholders may be given a right to sue in a class action on any breach of the advisory contract, both on state and federal

invite them to arrange for a novation of these guarantees with another insurance company. Alternatively, the company would liquidate the assets of the separate account attributable to the contractholders that have voted to terminate the contract. These contractholders can either receive a fixed annuity, if their contracts are in the pay-out period, or a lump sum or an immediate, or a deferred fixed annuity settlement, if their contracts are in the accumulation, pay-in, period. The contractholders who did not vote for termination of the advisory contract can continue their variable annuity contracts unless the assets in the account are reduced to a level which makes the account economically unfeasible, in which case the insurance company could treat them as if they too voted to terminate the contract.

This alternative may be unfair to the contractholders since at the time of their termination of the advisory services contract values might be very low. Contractholders may be forced to convert their contracts at the wrong time. Id. at 125-26.

887 The right to manage the account, like the right to terminate the contract has been called theoretical. Jones, note 884 supra, at 174. The fact that these rights are seldom exercised may be misleading. Their existence provides a deterrent to abuse. Congress chose recently to strengthen these rights, rather than dilute them or find a substitute for shareholder power.

cause of action. In lieu of termination and review contractholders might be granted the right to require the insurance company to engage a specified investment adviser at a specified fee, and follow its advice. Contractholders ought to be given additional power, not presently provided in the 1940 Act, to initiate changes in investment policies.

Contractholders should be deemed a special class of policyholders. Equity insurance contractholders should be a new type of participating policyholders with the right to manage exclusively the account through their elected board. The board should be composed of independent members, and following the 1940 Act provisions, the employees, officers, and board members of the account, as well as the employees of the investment department, must conform to the qualifications of the Act.[888] Since the reason for the unaffiliated directors is the influence of the investment adviser over the board of the account, if the insurance company did not charge contractholders either directly or indirectly, any fee for investment advice, the requirement for independent directors may be eliminated.

7. Liability

Contractholders should not be personally liable for the obligations of the account or the insurance company. The account should be charged by the insurance company with all liabilities arising from its investment business and from any decision of the board of the account. As to third parties the insurance company must be liable for all the obligations of the business of the account.

The position of contractholders with respect to investments of the assets in the account should be equated to shareholders, applying to them most of the provisions of the corporate law of the state of establishment, regardless of whether the insurance company is a stock company or a mutual insurance company. With respect to investment business, the insurance company's whole board as well as the board of the account must be responsible to contractholders as fiduciaries. This proposal is a departure from conventional insurance laws to the extent that they regard policyholders as creditors. Furthermore, contractholders should be given capacity to sue as a class, on violations of the model act, even though as policyholders they may not have this capacity.

8. Investments

The limitations of the 1940 Act on investments should apply in addition to any limitation under state insurance law. So should the limitations under

888 It has been suggested that state statutes ensure the integrity of insurance companies' management and prohibit self-dealing. Therefore, the provisions of §§ 9, 10, 12, 17, 21, 25, 27, 36, 37 and 49 of the 1940 Act are not necessary. See Jones, note 884 supra, at 170, 171. The shift of investment risk from the insurance company to the contractholders renders much of state regulation irrelevant, e.g., it results in conflict of interest raising a need for the protection of the 1940 Act.

section 17(d) with respect to transactions between the account, the insurance company, and other accounts. The Act should expressly leave to state insurance laws the question of reserves and whether or not these reserves should be placed in the account. However, the act should spell out the methods that the insurance company may use to calculate the investment performance of the account, and to value its assets. This provision should include a clarification of the tax treatment of investment business of the account. Finally, and most importantly, the disclosure requirements of the 1933 Act and the 1940 Act should apply to the insurance company. Forms should be designed to minimize duplication, for example, to permit registration of more than one account on the same form.

It is suggested that this model be used by state legislatures to regulate equity insurance products that the Commission does not consider to be securities. Since state agencies have traditionally regulated the substance of the insurance policy and insurance business, contractholders' management powers might, perhaps partially, be substituted by regulation. The advisory fee and charges for guarantees, if any, and the amount of load including front-end load, could be regulated. In addition, there should be full disclosure of these charges and fees, especially if they do not appear in a conventional insurance policy. In lieu of the independent directors in an investment company the terms and conditions of the equity insurance contracts might be reviewable periodically by the insurance state agencies. With respect to investment restrictions and limitations on speculative business practices, as well as the valuation of assets funding the reserves, state law can follow the Investment Company Act. The National Association of Insurance Commissioners has prepared a Model Variable Contract Regulation after which many state laws are fashioned. These regulations can be adjusted to adopt the substance of the model previously discussed.

It is time for legislation.

Boston University Law Review

VOLUME 51 | SPRING, 1971 | NUMBER 2