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Notes

Federal and State Regulation of the Variable Annuity

The variable annuity is presently subject to both federal securities regulation and state securities or insurance regulation. The author of this Note analyzes the present regulatory systems and concludes that, at present, no system alone, nor any combination of systems provides adequate protection for the interests of buyers and sellers of variable annuities.

The Supreme Court recently held[1] that the variable annuity[2] does not qualify for exemption as an "insurance policy" or an "annuity contract" under the Securities Act of 1933,[3] and that variable annuity companies are not exempt from the Investment Company Act of 1940[4] since they are not "insurance companies."[5] The

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

2. A variable annuity is a contract which does not provide customary fixed-dollar annuity payments. Rather, income varies according to the current value of a portfolio of common stocks in which the funds paid for the contract have been invested. Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 Ins. L.J. 357; Note, *The Classification and Regulation of Variable Annuities*, 42 Minn. L. Rev. 1115 (1958).

3. 48 Stat. 74 (1933), as amended, 15 U.S.C. §§ 77a-aa (1958). The act exempts:

> Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.

48 Stat. 76 (1933), 15 U.S.C. § 77c(a)(8) (1958).

The Court held that the companies involved were not issuing contracts of insurance, since in a variable annuity contract "there is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage." 359 U.S. 65, 73 (1959).

4. 54 Stat. 789 (1940), 15 U.S.C. §§ 80a—1 to —52 (1958).

5. The 1940 act exempts "any . . . insurance company." 54 Stat. 798 (1940), 15 U.S.C. § 80a—3(c)(3) (1958). An insurance company is:

> a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State.

54 Stat. 793 (1940), 15 U.S.C. § 80a—2(a)(17) (1958).

Since the Court held that for purposes of the act the companies were not issuing insurance contracts, their "primary and predominant business activity" could not be "the writing of insurance." Hence, the companies were not exempted from the 1940 act.

This Note distinguishes between two types of companies that sell variable annuieffect of this holding is to put the variable annuity under the regulatory jurisdiction of the Securities and Exchange Commission and to open the way for dual federal-state regulation of the variable annuity by the SEC and state insurance or securities administrators.[6]

The variable annuity raises peculiar problems of regulation because it is not strictly a form of insurance, nor is it strictly a security; it has aspects of both.[7] A variable annuity is marketed as an insurance contract[8] designed to enable the purchaser to secure, after retirement, a monthly income for life, the purchasing power of which will remain constant in spite of the effects of inflation.[9] The company invests the contractholders' funds in equity securities on the theory that changes in the value of the portfolio will correspond to changes in the cost of living.[10]

The purpose of this Note is to determine how the variable annuity should be regulated. The Note will first examine the various interests of buyers and sellers of variable annuities, and then analyze the capabilities of the three present regulatory systems—SEC, state securities, and insurance—to adequately protect these interests.

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ties: a company, such as the Variable Annuity Life Insurance Company, which specializes in the sale of variable annuity contracts is referred to as a *variable annuity* company, in contradistinction to an *insurance* company which sells variable annuities as well as "regular" insurance.

6. Much controversy has raged over whether the variable annuity is a security, a form of insurance, or something in between. *Compare* Haussermann, *The Security in Variable Annuities*, 1956 INS. L.J. 382 *and* Long, *The Variable Annuity: A Common Stock Investment Scheme*, 1956 INS. L.J. 393, *with* Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 INS. L.J. 357 *and* Day, *A Variable Annuity Is An Annuity*, 1955 INS. L.J. 775. *SEC v. Variable Annuity Life Ins. Co.* decided that, for federal purposes, the variable annuity is a security—at least until Congress speaks to the contrary. However, each state must decide for its own regulatory purposes how to classify the variable annuity. Three states have already classified it by statute. In New Jersey, the variable annuity may be sold by insurance companies, N.J. Laws 1959, ch. 122. Georgia and Kansas classify it as a security. GA. CODE ANN. § 97–102(i) (Supp. 1957); KAN. GEN. STAT. ANN. § 17–1261(e) (Supp. 1957). In Minnesota, the question has not been formally presented as yet, since no company has sought permission to sell variable annuities in the state. The Department of Commerce has informally decided, however, that if and when a company does seek permission to sell variable annuities in Minnesota, they will be regulated as securities. Interview With Assistant Commissioner of Securities, in St. Paul, Nov. 5, 1959.

7. See note 6 *supra*.

8. See the specimen policy appended to the district court opinion, SEC v. Variable Annuity Life Ins. Co., 155 F. Supp. 521, 529 (D.D.C. 1957).

9. See Johnson, *A Report On Variable Annuities*, 181 WEEKLY UNDERWRITER 610 (1959). In theory, as the dollar is devaluated by inflation, and prices rise, the dollar value of the variable annuity investment portfolio will rise correspondingly. The contractholder's monthly income will increase as a result of the higher value of the portfolio, thus enabling him to maintain his purchasing power in spite of higher prices. See Johnson, *supra* note 2.

10. *Ibid.*

I. The Interests of Buyers and Sellers

A. Buyer's Interests

The typical purchaser of a variable annuity is not in a position to protect his own interests. First, he is unversed in the finer points of selecting a contract to fill his particular needs. He lacks the specialized knowledge necessary to assure himself that he is being fairly treated. Second, the buyer is investing a relatively large amount of money in the contract over a period of many years. He probably will not become aware of any serious deficiencies in the contract, or realize he has misunderstood its provisions, until he is supposed to start receiving income, when it is too late to rectify the situation.

Since the buyer is not a capable judge of the adequacies of a variable annuity contract, he must rely on the salesman's judgment to a great extent. Therefore, the salesman must be competent; he needs a working knowledge of variable annuities, gained through special training, and an understanding of the special function they serve in providing a hedge against the uncertainties of the future.[11] The salesman should be required to demonstrate his competence by passing a comprehensive examination on the subject of variable annuities prior to being granted the privilege to sell them.

The salesman should present the facts about variable annuities in an accurate and understandable form so that the buyer may know exactly what he is getting for his money. The buyer should not be led to expect unrealistically high returns because a salesman was overly optimistic in predicting future market trends.[12] Nor would the salesman be treating the buyer honestly if he did not impress upon him the fact that monthly income could, and probably would, go down as well as up.[13]

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11. See note 9 *supra.*

12. It would be unwise, as well as unfair, to project past investment experience into the future to predict income. If a company were to use predicted long-run inflation as a selling point, it could find itself with many dissatisfied customers and a poor reputation, if the national economy took a deflationary turn. In its new variable annuity regulatory statute, New Jersey has prohibited projection of past investment experience into the future. N.J. Laws 1959, ch. 122, § 5(b).

13. The New Jersey statute requires that "any [variable annuity] contract . . . delivered or issued for delivery in this State . . . shall contain on its first page, in a prominent position, a clear statement that the benefits or other contractual payments or values thereunder are on a variable basis." N.J. Laws 1959, ch. 122, § 4.

If he purchases a "pure" variable annuity, the buyer takes the risk that he might receive *no* income. See SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 71 (1959). He might receive no income if the portfolio became substantially worthless. To avoid this risk, it is proposed to "balance" the variable annuity by using some of the funds paid in to buy a fixed annuity. See Johnson, *supra* note 2. The balancing would serve as a floor below which the monthly payments would not fall.

Along with being assured of a competent salesman, the buyer also has an interest in dealing with a company that uses fair business-getting methods, particularly honest advertising. The advertising should completely present the facts about variable annuities, describing the functions they serve and pointing out the risks as well as the advantages.

Most purchasers probably would not bother to read the entire contract, before or after signing. Even if the typical buyer did read the contract, it is quite unlikely that he would be able to understand it, or to determine his rights under it, because variable annuity contracts are replete with complex language such as "accumulation units," "annuity units," and "net investment factor."[14] Since the purchaser probably cannot adequately judge the quality of such a complex contract for himself, he has an interest in being assured that the contract conforms to reasonable standards of fairness.[15]

The purchaser of a variable annuity seeks a safe investment, but at the same time he seeks high earnings. The buyer's interest calls for a balance between safety, with the attendant low earnings, and the risks which accompany the possibility of high earnings. He would also be vitally concerned with having a solvent company on hand during the full period he expects to receive income.

B. Seller's Interests

Since the seller of a variable annuity is certain to be regulated in one manner or another, it has an interest in avoiding dissimilar or conflicting types of regulation. It would favor a system which would treat the variable annuity uniformly in all states. Likewise, the company should be given equal opportunity to compete with all other companies selling variable annuities, regardless of the system which regulates its activities. It would be unfair to subject a variable annuity company to one type of regulation while subjecting an insurance company selling variable annuities to a different

14. These terms are found in the variable annuity contract issued by the Variable Annuity Life Insurance Company, a specimen of which is appended to the district court opinion, SEC v. Variable Annuity Life Ins. Co., 155 F. Supp. 521, 529 (D.D.C. 1957).

15. For example, if the contractholder makes payments for a number of years and then misses a payment, he should not lose the benefits of the money he has already remitted. Also, the buyer should have some assurance that the greatest portion of the money he is paying in is being invested for his benefit, rather than having an unreasonable percentage of his payments siphoned off for "administrative expenses" and profit.

If protective clauses are not included in the contract itself, it is doubtful that the buyer could force inclusion of such clauses. It might never occur to him that he needs such protection; even if it did, he would find it difficult, if not impossible, to have the contract changed. See text accompanying note 43 *infra*.

type, since one or the other might be subject to stricter regulation.[16] The company would also be interested in operating under a regulatory system which would permit sufficient freedom of investment so that it could carry a large program of variable annuities. This would reduce average administration expenses, and permit a greater spreading of both actuarial and investment risks. In order to operate a large, diversified portfolio most effectively, and to apply the theory underlying the variable annuity,[17] the company would desire a substantial amount of freedom in making investment choices.

II. The Regulatory Systems

A. SEC Regulation

Federal regulation of the variable annuity falls within the scope of the Securities Act of 1933, which controls the issuance of securities to the public, and the Investment Company Act of 1940, which regulates the business of investment companies.[18]

Securities Act of 1933

Securities regulation is based on a philosophy of "full disclosure."[19] It assumes that if the prospective buyer has all the facts before him, he is in a position to make his own decision regarding the merits of a security, and can intelligently elect whether or not to buy. The SEC does not approve or disapprove any security; it makes no claims or guarantees about safety or earning power.[20] The buyer alone must decide whether the security is a desirable investment.

The Securities Act of 1933 provides that any security which is proposed to be publicly offered by using the channels of interstate commerce or the mails, must be registered with the SEC before it may be lawfully sold.[21] A registration statement containing detailed disclosures on matters concerning the general character of the issuer's business must be filed.[22] There is then a twenty-day waiting period, during which prospective investors may familiarize themselves with the proposed offering.[23] In addition to the filing of the registration statement, the 1933 act requires that prospective buyers

16. There is a distinct possibility that the two types of companies will be accorded different regulatory treatment. See text accompanying notes 49–52 *infra*.
17. See note 9 *supra*.
18. See generally, Loss, Securities Regulation (1951, Supp. 1955).
19. Davis, Administrative Law § 42 (1951).
20. See 48 Stat. 77 (1933), 15 U.S.C. § 77e (1958).
21. 48 Stat. 77 (1933), 15 U.S.C. § 77e (1958).
22. 48 Stat. 78 (1933), 15 U.S.C. § 77f (1958). All information required in the registration statement is set out in 48 Stat. 88 (1933), 15 U.S.C. § 77aa (1958).
23. 48 Stat. 79 (1933), 15 U.S.C. § 77h(a) (1958).

be furnished with a prospectus, which is a written offer to sell the security.[24] Since detailed information is required, the prospectus is usually a lengthy document, often running to fifty pages or more.[25] As well as providing machinery for full disclosure, the 1933 act also contains anti-fraud provisions[26] which afford civil relief by way of injunction[27] and criminal penalties for fraud in the sale of securities.[28]

Investment Company Act of 1940

The Investment Company Act of 1940 contains several classifications of investment companies.[29] A company selling variable annuities apparently falls within the classification of an "open-end management company."[30] All investment companies which make use of the facilities of interstate commerce or the mails must register with the SEC to lawfully transact business.[31] The information which must be filed is determined by rules and regulations of the Commission.[32] If the Commission thinks it necessary "in the public interest or for the protection of investors," the company must include in the registration statement its policy on such matters as borrowing money, issuance of senior securities, concentration of investments in a particular industry or group of industries, and portfolio turnover.[33] Advertising concerning the securities issued by the company must be filed before, or within ten days after, it is

24. 48 Stat. 77 (1933), 15 U.S.C. § 77e(b)(2) (1958).

25. Loss, Securities Regulation 159 (1951).

26. 48 Stat. 84 (1933), 15 U.S.C. § 77q(a) (1958), reads:

It shall be unlawful for any person in the offer or sale of any security by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

27. 48 Stat. 86 (1933), 15 U.S.C. § 77t(b) (1958).

28. 48 Stat. 87 (1933), 15 U.S.C. § 77x (1958).

29. See 54 Stat. 799, 800 (1940), 15 U.S.C. §§ 80a—4, —5 (1958). An investment company is one which engages "primarily in the business of investing and reinvesting in securities of other companies." Loss, *op. cit. supra* note 25, at 94.

30. See SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 85 (1959) (concurring opinion). An "open-end management company" is defined by the statute as one "which is offering for sale or has outstanding any redeemable security of which it is the issuer." 54 Stat. 800 (1940), 15 U.S.C. § 80a—5(a)(1) (1958).

31. Registration procedure and information requirements for investment companies are set out in 54 Stat. 803 (1940), 15 U.S.C. § 80a—8 (1958).

32. 54 Stat. 803 (1940), 15 U.S.C. § 80a—8(b) (1958).

33. *Ibid.* The section also prescribes other information which the Commission may require if it sees fit.

sent through the mails or channels of interstate commerce.[34] The act also contains capital requirements for investment companies[35] and detailed restrictions on their management practices.[36]

Protection of the Buyer's Interests

The Securities Exchange Act of 1934 provides for the federal registration of "brokers."[37] Although the definition[38] of "brokers" may be broad enough to include securities salesmen,[39] there are no requirements for special training or examination. Thus, a prospective purchaser would have no assurance that the person with whom he is dealing possesses even a minimum of competence to sell a complex variable annuity contract. Similarly, a buyer has no assurance that he will get the facts regarding the variable annuity in a form understandable to him so that he can make an intelligent choice to buy or not. The method of disclosing the facts is by prospectus, which is a useful tool for the experienced investor, but it would be ineffective for the typical buyer contemplating the purchase of a variable annuity. It would be unrealistic to assume that he would read such a lengthy, complex document.[40] He does not need, nor probably could he use, the detailed information found in the prospectus. Rather, the simple facts of the variable annuity, such as how it can fulfill his particular retirement needs, what he is getting for his money, and the risks entailed in getting it, are sufficient to enable him to make an intelligent choice.

Although the prospectus itself is ill-adapted to present the facts in a manner useful to most people, the usable facts may accompany the prospectus.[41] To assure that the buyer will have access to understandable facts, such additional explanatory material in plain language should be a requirement for variable annuities, rather than a mere option.[42]

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34. 54 Stat. 826 (1940), 15 U.S.C. § 80a—24(b) (1958).

35. 54 Stat. 817 (1940), 15 U.S.C. § 80a—18 (1958).

36. See, *e.g.*, 54 Stat. 822 (1940), 15 U.S.C. § 80a—21 (1958), which deals with loans by management companies. How these restrictions affect variable annuity companies is illustrated in SEC Investment Company Act Release No. 2908, Aug. 20, 1959. The SEC ordered a hearing on the applications of two variable annuity companies to be exempted from certain provisions of the 1940 act. The Release discusses the provisions from which the companies sought exemption.

37. 48 Stat. 895 (1934), 15 U.S.C. § 78*o*(a) (1958).

38. "The term 'broker' means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank." 48 Stat. 883 (1934), 15 U.S.C. § 78(c)(a)(4) (1958).

39. See Loss, *op. cit. supra* note 25, at 723.

40. See text accompanying note 25 *supra.*

41. See 48 Stat. 75 (1933), 15 U.S.C. § 77b(10) (1958), Loss, *op. cit. supra* note 25, at 132.

42. The 1933 act does not *require* that explanatory material accompany the

Under SEC regulation there is a great deal of freedom to contract since the SEC cannot require that any specified terms be included in a variable annuity contract. As long as the contract does not perpetrate a fraud upon the buyer, the parties may include any terms they see fit, and are limited only by their respective bargaining positions. In dealing with a particular company, the buyer is at a definite disadvantage in seeking changes in contract terms. Since the contract is on a printed form which the agent may not have the authority to change, the buyer's only practical choice is to buy or refuse to buy.[43] Perhaps the exigencies of competition would force the various companies to include certain clauses for the buyer's benefit, but clearly this would not give as much assurance as a statutory or administrative requirement.

The SEC, through its supervisory power,[44] can often coerce the issuer of a security to conform to the Commission's desires, such as by an amendment to the contents of the registration statement.[45] However, the supervisory power of the SEC does not seem strong enough to force a variable annuity company to incorporate fair provisions in the contract, because the coercive element is not nearly so strong as it is in the case of a traditional distribution. First, the time element is not so crucial because a variable annuity does not need to respond to market conditions that fluctuate hourly. It will not get "sticky," as will a "capital-raising" security, because it fails to be issued at the precise moment it is expected to appear. Second, even if a stop order were issued, it would not impair public confidence very greatly because the typical purchaser would almost never be aware of such a fact.[46]

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prospectus, although the prospectus itself "shall contain such . . . information as the Commission may . . . require as being necessary or appropriate in the public interest or for the protection of investors." 48 Stat. 79 (1933), 15 U.S.C. § 77j(c) (1958).

43. Even an executive who has sufficient authority to make changes in contract terms would probably be reluctant to make changes in a printed form just to suit the mood of a particular buyer.

44. The supervisory power of the SEC is discussed in 1 Davis, Administrative Law Treatise § 4.01 (1958).

45. If the SEC does not approve the registration statement as filed it has the power to hold up the security issue by a stop order proceeding. The twenty-day waiting period does not start running again until the Commission is satisfied. The SEC also has authority to accelerate the issue. 48 Stat. 79 (1933), 15 U.S.C. § 77h(b) (1958). The threat of a stop order, and the power to accelerate, are two effective coercive weapons used by the SEC when it desires additional information in the registration statement. The SEC may refuse registration if it appears that the statements made in the registration statement are incomplete or inaccurate, or misleading. 48 Stat. 79 (1933), 15 U.S.C. § 77h(b), (c) (1958).

46. When a "capital-raising" security is held up by a stop order, the prospective buyers lose confidence in the issue. It is then difficult to sell. See 1 Davis, Administrative Law Treatise § 4.01 (1958).

The SEC can prevent deceptive or misleading advertising regarding the sale of securities through its control over the terms of the prospectus, which is a form of advertising. Also, the antifraud provisions of the 1933 act have a deterrent effect on issuers who would use deceptive advertising practices, since it is a crime "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."[47]

The 1940 act does not contain investment controls.[48] Apparently a company may invest the funds of variable annuity contractholders in any securities it chooses. This contains an element of danger since a company might purchase too many speculative securities, thus imperiling the safety of the portfolio. Investment controls should be applied to assure the buyer that the investment portfolio will contain good grade stocks, on the average, and that the portfolio will be well-diversified to produce a steady income. A serious disadvantage of the 1940 act is that it probably does not apply to an insurance company selling variable annuities as a part of its overall program.[49] The buyer must look to state regulation alone to assure himself that such a company will remain sound.

Protection of the Seller's Interests

A company selling variable annuities might have difficulties in determining whether it must comply with the 1933 act alone, or the 1940 act as well. It is clear, as a result of the decision in the *Variable Annuity Life Ins. Co.* case,[50] that a company which specializes in selling variable annuities must comply with both acts. However, a company which sells insurance policies as well as variable annuity contracts cannot be certain whether it must comply with the 1940 act because, by its terms, the 1940 act apparently exempts an insurance company which sells variable annuities as only one element of its whole program. The question that must first be determined is whether writing insurance is the company's "primary and predominant business activity."[51] If the question is answered affirmatively, the company is exempt from the 1940 act.[52]

47. 48 Stat. 85 (1933), 15 U.S.C. § 77q(3) (1958). The requirement under the 1940 act that advertising must be filed with the SEC before it is used, see note 34 *supra*, would deter advertisers from putting extravagant claims in advertising material. See 54 Stat. 826 (1940), 15 U.S.C. § 80a—24(b) (1958).

48. *But see* 54 Stat. 807 (1940), 15 U.S.C. § 80a—10(f) (1958); 54 Stat. 809 (1940), 15 U.S.C. § 80a—12(d) (1958).

49. See note 5 *supra*, and text accompanying notes 50–52 *infra*.

50. 359 U.S. 65 (1959).

51. 54 Stat. 793 (1940), 15 U.S.C. § 80a—2(a)(17) (1958), quoted at note 5 *supra*.

52. An argument can be made, however, that if an insurance company uses a segregated fund for its variable annuity contracts this fund is subject to SEC regu-

Because of this doubt as to the exact coverage of the 1940 act, a company, although it has great freedom to contract and invest, cannot be assured of equality of regulatory treatment and equal freedom to compete, since a company regulated by both acts would be more closely supervised than a company having to comply with the 1933 act alone.

B. State Securities Regulation

Basically, state security, or Blue Sky, laws fall into three categories, each with a different approach.[53] Although some states use only a single type in their statutes,[54] most Blue Sky laws are a combination of the various types.[55] The simplest type is the anti-fraud statute, which generally provides that it is a misdemeanor to use fraudulent methods to sell securities.[56] A state officer is usually given power to investigate, and can enforce the provisions by injunction or criminal prosecution.[57]

The second type of statute requires that broker-dealers and agents must be registered.[58] The information required in the registration form varies from state to state. In some, such as New York, the registration requirements are little more than adjuncts to the anti-fraud provisions;[59] in others, such as Pennsylvania, the application for registration of agents must be accompanied by "evidence . . . establishing the good repute in business of the applicant. . . ."[60]

The third type of statute requires registration of the securities themselves.[61] But the usual Blue Sky law goes beyond the disclosure requirements of the Securities Act of 1933, since the adminis-

lation. The 1940 act definition of a "company" includes a "fund." 54 Stat. 791 (1940), 15 U.S.C. § 80a—2(a)(8) (1958). The segregated fund cannot be said to be "organized as an insurance company" since it is established for purposes of investing in securities with proceeds from the sale of other securities — the variable annuity contracts. Hence the fund would not qualify for exemption as an "insurance company." See note 5 *supra*.

53. Loss & Cowett, Blue Sky Law 19 (1958) [hereinafter cited as Loss & Cowett].

54. For example, New Jersey has a simple fraud statute. See New Jersey securities law, N.J. Stat. Ann. §§ 49:1–2, –4 (1955); Loss & Cowett 20.

55. *Ibid.* Minnesota, for example, incorporates all three types in its Blue Sky law. See Minn. Stat. §§ 80.07, .12–.131, .22–.23 (1957). In Loss & Cowett 39–41, Table A, the states and the type of law each uses are listed.

56. Loss & Cowett 21. See, *e.g.*, N.J. Stat. Ann. §§ 49:1–4, –25 (1955).

57. Loss & Cowett 21. See, *e.g.*, N.J. Stat. Ann. §§ 49:1–11, –12 (1955).

58. See Loss & Cowett 26–30. See, *e.g.*, Minn. Stat. § 80.12 (1957).

59. Loss, *op. cit. supra* note 25, at 27. See N.Y. Gen. Bus. Law §§ 352 to 352–b, 359e to 359ee.

60. Pa. Stat. Ann. tit. 70, § 34 (Supp. 1957).

61. Loss & Cowett 30–41. See, *e.g.*, Minn. Stat. § 80.07 (1957).

trator concerned may pass on the merits of the security.[62] An administrator may refuse to license a security and prohibit its sale if he has doubts as to its quality. Reasons for such a refusal could be, for example, bad faith of the issuer, insufficient information upon registration, or that the sale would be against "public interest."[63]

The most inclusive protection is afforded when all three types of statutes are incorporated in a state's Blue Sky law. Since Minnesota makes use of all three types of protection,[64] its Blue Sky law will be used for illustrative purposes.

Protection of the Buyer's Interest

A salesman must be licensed to sell securities in Minnesota.[65] The securities commissioner is given broad powers to grant or deny an agent's or dealer's license.[66] The Securities Division, by rule, requires "satisfactory evidence . . . of the trustworthiness . . . and . . . competency" of the applicant,[67] which "shall be in writing *or* shall be determined by oral or written examination before the Commission."[68] Although, in practice, an examination is not often used,[69] it is clear that the commissioner could require an examination on the subject of variable annuities as a prerequisite to licensing, if he thought it necessary to protect investors.[70]

Close supervision is exercised to prevent fraudulent practices. Applications for registration are examined, and if the commissioner "is of the opinion that the securities are fradulent [*sic*], or . . . that the sale thereof would work a fraud or deception on the purchasers," he may deny the application.[71] Similarly, the registration of securities presently outstanding may be revoked for fraudulent practices.[72] The administrator may conduct an examination of the books and records of the issuer of securities, so that he may better determine whether the sale of the securities would work a fraud on investors.[73] Thus, the buyer is assured that the contract itself will not be fraudulent. He is also protected against fraudulent, high-pressure sales tactics since the Securities Division, by rule, considers it fraudulent

62. See Loss & Cowett 35–36. See, *e.g.*, Minn. Stat. §§ 80.08, .11 (1957).
63. See Loss & Cowett 31–36. *E.g.*, N.H. Rev. Stat. Ann. § 421:27 (1955).
64. See note 55 *supra*.
65. Minn. Stat. § 80.13 (1957).
66. See Minn. Stat. § 80.13 (1957).
67. Minnesota Securities Laws, Rules and Regulations, Rule III(a) (1959).
68. *Ibid.* (Emphasis added.)
69. Interview With Assistant Securities Commissioner, in St. Paul, Nov. 5, 1959.
70. See Minn. Stat. § 80.13 (1957).
71. Minn. Stat. § 80.08 (1957).
72. Minn. Stat. § 80.11(2) (1957).
73. Minn. Stat. § 80.11(1) (1957).

"for any dealer, broker or agent, in offering or selling securities, or in making or offering to make any transaction in securities, knowingly to make or furnish any untrue or misleading statement, either oral or written, of a material fact, or to omit to state a material fact."[74]

If the advertising of the company issuing the securities contains an offer to sell, or renders advice regarding the securities, it must be filed with the Securities Division before it may be disseminated through the ordinary channels to the public.[75] Because of this provision, companies use "tombstone ads," which are no more than descriptions of the security.[76] No advertising of any kind is permitted if the securities have not been registered in Minnesota, or with the SEC under the Securities Act of 1933.[77] Such provisions furnish the prospective buyer with adequate protection against unfair or misleading advertising.

The Blue Sky law does not offer sufficient protection to assure a fair contract. There are no statutory requirements that specific clauses be inserted for the buyer's benefit. The administrator seemingly has sufficient discretionary power to require that specific clauses be included in the contract before it will be granted approval on application for registration, since he may deny registration for "good cause appearing" to him.[78] If registration were denied, the company would have to comply with the commissioner's demands or forgo the sale of the contracts in Minnesota. However, in practice, registration is not denied for lack of specific clauses in investment contracts.[79]

The Blue Sky law does not prescribe capital structure requirements for investment companies such as a variable annuity company, but the Commission does makes an inquiry into the financial status of the company when determining whether registration of the securities should be denied or revoked.[80] If the company seems to be operating on a "shoestring," the security will not be registered.[81] An examination of a company's financial status would seem to be as effective as an initial capital structure requirement. However, the Blue Sky law does not provide sufficient assurance that the company will remain sound. It prescribes no investment controls, but permits the company to make investments as it chooses.

74. Minnesota Securities Laws, Rules and Regulations, Rule VII (1959).

75. MINN. STAT. § 80.18 (1957).

76. Such an advertisement is not an "offer to sell," nor does it "render advice" concerning the securities.

77. MINN. STAT. § 80.18 (1957).

78. MINN. STAT. § 80.08 (1957).

79. Interview With Assistant Securities Commissioner, in St. Paul, Nov. 5, 1959.

80. *Ibid.* See MINN. STAT. § 80.11(1) (1957).

81. Interview With Assistant Securities Commissioner, in St. Paul, Nov. 5, 1959.

Protection of the Seller's Interests

Even assuming the variable annuity were to be regulated under the Blue Sky laws in every state, a seller could not presently be assured of uniformity of regulation, because of lack of uniformity among the laws of the several states.[82] However, under the Blue Sky laws, as under SEC regulation, companies have a great deal of freedom in their business activities due to lack of restrictions on contract provisions and their freedom to invest funds as they please. The different types of companies selling variable annuities would be regulated similarly regarding their sales of variable annuities, since both types of companies would have to register their securities and comply with the other facets of the Blue Sky laws.[83]

C. Insurance Regulation

Insurance regulation is designed to assure the buyer that the company will be able to meet its financial obligations as they mature.[84] It is administered in a paternalistic spirit, on the assumption that the buyer is not able to adequately protect his own interests.[85] Insurance regulation exists in all states.[86] Some states have more comprehensive laws than others, but in broad outlines the statutes are much alike. They make use of such devices as licensing of companies and agents, capital and investment controls, and statutory policy provisions.[87]

Protection of the Buyer's Interests

Although insurance agents must be licensed in all states,[88] some

82. See Loss & Cowett 39–41, Table A.

83. The Minnesota Department of Commerce will apparently treat variable annuities the same as any other securities. They will not receive special regulatory treatment. Interview With Assistant Securities Commissioner, in St. Paul, Nov. 5, 1959.

From the aspect of practical administration the typical Blue Sky law is not so inclusive as it appears to be. The statutes generally exempt insurance companies or securities issued by them. *E.g.*, Cal. Corp. Law § 25100(h) exempts "any security issued by a company organized for the purpose of transacting an insurance business, the issuance of which is subject to authorization by the Insurance Commissioner."

Also, from a practical standpoint, the enforcement of the usual Blue Sky law is greatly hampered by the fact that enforcement agencies are understaffed and agents underpaid. See Loss & Cowett 57–62. But insurance commissions are not free from this problem, see Kimball & Hansen, *The Utah Insurance Commissioner: A Study of Administrative Regulation In Action*, 5 Utah L. Rev. 429, 434–36 (1957). Nor is the SEC — its staff has been reduced almost 60% since 1940, mostly due to successive budget cuts. Loss, Securities Regulation 388 n.11 (Supp. 1955).

84. See Patterson, Essentials of Insurance Law 2–3 (2d ed. 1957).

85. *Ibid.*

86. *Id.* at 1.

87. Not all control devices are used in all states, nor do all control devices apply to all types of insurance in all states. See notes 98–114 *infra* and accompanying text.

88. Patterson, *op. cit. supra* note 84, at 45.

states do not have a statutory requirement of an examination as a qualification.[89] As yet, only one state expressly requires an examination on the subject of variable annuities,[90] but, in many states, it is apparently within the discretion of the insurance administrator to require that this subject be included in the examination if he thinks it is necessary.[91] If a salesman must demonstrate his competence before a license is issued, the state has an effective tool to assure that only competent salesmen are licensed. It is clear, however, that in a state where a license is given almost as a matter of course, the buyer cannot be assured of a competent salesman.

The agent's business-getting methods are regulated by statutes which prohibit "twisting"[92] and misrepresentation.[93] In Minnesota, for example, the tactics of the agent are regulated by an unfair practices act.[94] It is a misdemeanor to procure payment of, or an obligation to pay, an insurance premium by fraudulent representations.[95] It is also deceptive practice to misrepresent "the terms of any policy issued or to be issued or the benefits or advantages promised thereby or the dividends or share of the surplus to be received thereon. . . ."[96] Thus, a salesman could not be too optimistic about the future income from the variable annuity contract, since he could not honestly represent what that income would be. The statute also prohibits the dissemination of any form of advertising which is "untrue, deceptive, or misleading."[97]

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89. *E.g.*, the insurance code of Missouri contains no provisions requiring an examination as a qualification for a license. See Mo. Ann. Stat. §§ 375.010–.920 (1952). However, even in states which have no specific statutory requirement, the commissioner usually has a great deal of discretion, and may require some type of examination to obtain a license. For example, the commissioner in Wyoming must be satisfied that the applicant is "worthy and competent" before the license will be issued. Wyo. Comp. Stat. Ann. § 52–303 (1945).

90. New Jersey requires an examination on the subject of variable annuities before a salesman may be licensed. N.J. Laws 1959, ch. 122, § 3. The provision applies to those already licensed to sell insurance as well as to new applicants. West Virginia, by rule, requires an examination. See note 91 *infra*.

91. This falls within the commissioner's discretionary power to determine the scope of the examination. *E.g.*, "No person shall be licensed by the commissioner as an insurance agent or solicitor if the commissioner shall be satisfied that the person is incompetent or unqualified to act as an insurance agent or solicitor. . . ." Minn. Stat. § 60.68 (1957). In West Virginia, the commissioner requires an examination on the subject of variable annuities, for experienced as well as inexperienced insurance salesmen planning to sell the variable annuity. Official West Virginia Ins. Dept. Reg. 56L–2, Governing the Sale of Contracts on a Variable Basis, August 29, 1956.

92. "Twisting" is a means of inducing a policyholder, by misrepresentations or incomplete comparisons, to cancel his contract with company *A* and take out a substantially similar contract with company *B*. See Patterson, *op. cit. supra* note 84, at 41.

93. See *id.* at 40–43.

94. Minn. Stat. §§ 72.20–.35 (1957).

95. Minn. Stat. § 72.05 (1957).

96. Minn. Stat. § 72.23(1) (1957).

97. Minn. Stat. § 72.23(2) (1957).

Most state insurance laws have provisions dealing with policy content.[98] The standard provisions which must be included in certain types of policies are set out by the statute, in substance if not verbatim. These statutes typically require such things as a grace period,[99] a nonforfeiture clause,[100] and reinstatement.[101] Some states have standard provisions for annuity contracts,[102] while others except them from the standard provision requirements.[103] As yet, except in New Jersey,[104] statutory controls of policy provisions are not aimed specifically at regulating variable annuity contracts.

98. *E.g.*, MINN. STAT. §§ 61.30-.34 (1957).

99. *E.g.*, MINN. STAT. § 61.30(2) (1957). This statute prevents the policy from lapsing if the premium is not paid on the exact due date.

100. *E.g.*, MINN. STAT. § 61.30(8) (1957). This statute provides for procedures on lapse of a policy to assure the policyholder that the money paid in is not a total loss. This feature would be essential to protect the purchaser of a variable annuity.

101. *E.g.*, MINN. STAT. § 61.30(10) (1957). By this clause the policy can be put back in force within a certain time after lapse.

102. See, *e.g.*, ARIZ. REV. STAT. ANN. §§ 20-1219 to -1224 (1956) by which provisions similar to those found in the text accompanying notes 99-101 *supra* are required for annuities.

103. *E.g.*, MINN. STAT. § 61.38(1) (1957).

104. N.J. Laws 1959, ch. 122. The statute reads in part:

> 4. Any contract on a variable basis delivered or issued for delivery in this State, and any certificate evidencing variable benefits issued pursuant to any such contract on a group basis, shall contain a statement of the essential features of the procedure to be followed by the insurance company in determining the dollar amount of variable benefits or other contractual payments or values thereunder and shall state in clear terms that such amount may decrease or increase according to such procedure. Any such contract delivered or issued for delivery in this State, and any such certificate, shall contain on its first page, in a prominent position, a clear statement that the benefits or other contractual payments or values thereunder are on a variable basis.
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> 5. (a) . . . The commisisoner shall disapprove or withdraw approval of any such contract form, application or certificate if:
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> (i) such contract or application or certificate contains provisions which are unjust, unfair, inequitable, ambiguous, misleading, likely to result in misrepresentation, or contrary to law, or
>
> (ii) sales of such contracts are being solicited by any means of advertising, communication or dissemination of information which involves misleading or inadequate description of the provisions of the contract, or
>
> (iii) such contracts are being issued in disregard of reasonable regulations which shall be promulgated by the Commissioner of Banking and Insurance relating to the conditions which must be met at time of issue of an individual contract on a variable basis for balance whereby (A) provision made for income from contracts on a variable basis shall not exceed (B) provision made for income payable in predetermined dollar amount (in whatever form such provision is made, including, but without limitation to, annuities, pensions, social security or other contracts or plans providing for the payment of income over a period of time). . . .
>
> (b) Illustrations of benefits payable under any contract on a variable basis shall not involve projections of past investment experience into the future and shall conform with reasonable regulations promulgated by the Commissioner of Banking and Insurance.
>
> (c) No individual annuity contract on a variable basis shall be delivered or issued for delivery in this State unless it contains in substance the following

Insurance regulations contain provisions for maintaining minimum capital requirements[105] and strict investment controls.[106] The minimum capital requirements vary according to the type of insurance the company issues.[107] The investment controls are designed to achieve a sound investment program built mainly around safe, but low-yielding, debt securities.[108]

Investment controls are not restrictive enough in the sense that a company often is permitted to invest a greater percentage of its assets in one corporation than is consonant with safety.[109] For example, suppose a company, which may lawfully invest two per cent of its assets in one corporation, has common stocks of the variable annuity program amounting to ten per cent of its total assets. The company could then back twenty per cent of its variable annuity program with the stock of one corporation. This could prove disastrous if the corporation failed or had some poor years. Therefore, these controls would be better expressed as a percentage of the assets available for investment in the variable annuity portfolio, rather than as a percentage of total assets.[110]

Protection of the Seller's Interests

Insurance regulation does not permit the freedom of business activity that the SEC and Blue Sky systems do. But, from the insurance company's point of view, such restriction is not altogether undesir-

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provisions:

(i) that, in the event of default in the payment of any consideration beyond the period of grace allowed by the contract for the payment thereof, the insurance company will . . . make payment of the value of the contract, in accordance with a plan provided by the contract, commencing not later than the date contractual payments by the company were otherwise to have commenced in accordance with the contract;

(ii) that, upon request of the contract holder received by the insurance company at least 4 months prior to the date contractual payments by the company were otherwise to have commenced, the company will . . . make payment of the value of the contract, in accordance with a plan provided by the contract and selected by the contract holder, commencing as of the first day of the first month which is at least 4 month [sic] after the date of receipt of such request, unless another date of commencement is requested by the contract holder and agreed to by the company. . . .

105. *E.g.*, MINN. STAT. § 60.29 (1957). See PATTERSON, *op. cit. supra* note 84, at 23–26.

106. *E.g.*, MINN. STAT. § 61.11 (1957). See PATTERSON, *op. cit. supra* note 84, at 26–29.

107. See, *e.g.*, MINN. STAT. § 60.29(2) (1957).

108. See the list of permissible investments for domestic companies. MINN. STAT. § 60.37 (1957).

109. The states generally permit from 1% to 5% of a company's assets to be invested in one corporation. *E.g.*, Tennessee permits a 2% investment in any one corporation. TENN. CODE ANN. § 56–217 (1955).

110. New Jersey solves this problem by requiring a segregated variable annuity account. See N.J. Laws 1959, ch. 123.

able, since it prevents unscrupulous companies from selling poor policies at low prices which tends to drive good insurance from the market.

Present insurance regulation in most states does not permit an insurance company to invest a large percentage of its assets in common stocks. In most states a company may invest about five per cent to ten per cent[111] of its "admitted assets"[112] in equity securities. However, extreme variations range from permitting no investments in common stock[113] to permitting a company to invest all of its assets in common stock.[114] In a state which permits an investment of five per cent to ten per cent of assets in common stocks, a company with small capital could not invest enough of its assets in common stocks to finance a large program of variable annuities. A large program is preferable because it would allow the company to spread the investment and actuarial risks over a greater area.[115] Expenses for administering a small portfolio would also be higher per dollar of securities purchased. A large insurance company, on the other hand, could carry a great number of variable annuity contracts. Even five to ten per cent of such a company's assets would be ample to finance a large program.[116]

III. Evaluation

It is clear that none of the present regulatory systems, standing alone, can do a completely adequate job of protecting the interests of both buyers and sellers. The SEC regulation does not assure the buyer of either a competent salesman or fair contract provisions. The facts need not be disclosed in a form understandable and usable by

111. *E.g.*, Ariz. Rev. Stat. Ann. § 20–536(C) (1956) (10%); Neb. Rev. Stat. § 44–310.02 (1952) (10%); Okla. Stat. Ann. tit. 36, § 1616 (1957) (5%).

112. "Admitted assets" are those which an insurer is permitted to include in determining its statutory solvency; not included are such things as good will, trade names, or the insurer's own stock. See Patterson, *op. cit. supra* note 84, at 26.

113. The laws of Colorado do not include common stocks in the lists of permitted investments for domestic life insurance companies. See Colo. Rev. Stat. Ann. §§ 72–2–8, –10 (1953).

114. The laws of the District of Columbia permit unlimited investments in common stocks, subject only to the provision that not over 1% of the company's assets may be invested in any one corporation. D.C. Code Ann. § 35–535(10) (1951).

115. If a small company were to use its 5% to 10% limit of permissible investment in equity securities to back its variable annuity program, it would be unfairly favoring the variable annuity contract holders at the expense of other classes of policyholders. The effect would be to decrease the dividends paid to regular policyholders because only lower-earning debt securities would be available to back the regular insurance program. Because of the possible unfairness, a segregated variable annuity account is preferable.

116. Total assets of United States life insurance companies amounted to $101,309,000,000 in 1957. 1958 Life Insurance Fact Book 64. Assuming an average of 5% of total assets as permissible investments in common stocks under present laws, life insurance companies could back with common stocks a $5,065,450,000 program of variable annuities.

the typical purchaser. In addition, the buyer cannot be assured of the soundness of the companies, nor can the respective companies be assured of equal opportunity to compete.

Blue Sky regulation is likewise deficient in that there is no requirement for examination of salesmen,[117] no investment controls, and no uniform system of regulation. Insurance regulation is deficient because, in many states, there are no provisions for standard policy terms for variable annuities, and because of the strictness of the investment controls.

Dual regulation of the variable annuity making use of the present regulatory systems would be little better than using one of the three systems alone. If SEC and Blue Sky regulation were combined, the buyer would still lack sufficient protection since he would have no assurance of a competent salesman and the seller would have to contend with the lack of uniformity among the various Blue Sky laws. If SEC regulation were combined with insurance regulation, the buyer would not be completely assured of a fair contract, and the seller would have little freedom to invest in equity securities. There is also a danger that the systems would conflict, particularly SEC and insurance regulation. For example, the Investment Company Act of 1940 requires that all registered management investment companies place and maintain their securities and investments in a bank or keep them in their own custody pursuant to the rules and regulations of the SEC.[118] At the same time, some state insurance laws require that a company transacting business in the state must maintain with the insurance commissioner specified amounts of cash or securities as a condition of doing business.[119] If the company is to comply with one law, it must be exempted from the other.[120]

There are three practical possibilities by which the variable annuity could be adequately regulated: 1) exclusive federal regulation; 2) exclusive state regulation; 3) dual regulation. If Congress decided to give the SEC exclusive jurisdiction over the regulation of variable annuities, it would also have to pass additional legislation to give the SEC adequate regulatory tools to protect the interests of buyers and sellers. If the states were to be granted exclusive jurisdiction to regulate, it would first be necessary for Congress to remove the variable annuity from the jurisdiction of the SEC. The states would then have to give a regulatory agency adequate tools to enable it to do a proper job. The best exclusive state regulation

117. Although Minnesota does not in practice require an examination of securities salesmen, see note 69 *supra*, several other states do. See Loss, *Developments in Blue Sky Laws*, 14 Bus. Law. 1161, 1164 (1959).

118. 54 Stat. 816 (1940), 15 U.S.C. § 80a—17f (1958).

119. *E.g.*, Minn. Stat. § 60.34 (1957).

120. See SEC Investment Company Act Release No. 2908, Aug. 20, 1959.

requires a uniform variable annuity act. An adequate dual system would result only if the states supplemented present SEC regulation by giving a state agency power to control the areas not covered by present SEC regulation. Again, a uniform system would be preferable to avoid conflicts between the legislation of sister states.