9-1-1964

Legislation and Administration

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LEGISLATION AND ADMINISTRATION

Securities Regulation: Variable Annuities and Common Trust Funds for Managing Agency Accounts

The depression stock market crash spawned the entrance of the federal government into the field of securities regulation. The Securities Acts of 1933¹ and 1934,² along with the Investment Company Act of 1940,³ were the major legislative answers to the problems then existing. Today, modern institutions adapting to the current needs of investors have devised plans for commingling the funds of these investors in ways not contemplated when the federal acts were adopted. Two types of such institutions — insurance companies and banks — were seemingly granted broad exemptions from these regulations. The purpose of this Note is to investigate the recent controversies surrounding the application of these exemptions to individual⁴ variable annuity contracts issued by regular-line insurance companies and to bank commingled or common trust funds for their managing agent accounts.

I. Federal Legislation

Securities Act of 1933. This act⁵ is premised on the proposition that if the federal government requires full disclosure of pertinent information by the proposed issuer of a security, the prospective investor will be in a position to wisely compare and choose his risk-medium. The act's main provisions are those relating to registration⁶ and the prospectus,⁷ supplemented by the broad rule-making⁸ and enforcement⁹ authority vested in the Securities and Exchange Commission (SEC). It provides stringent civil¹⁰ and criminal¹¹ remedies for various types of fraud.

The act contains a broad definition of the term "security,"¹² including therein the term "investment contract." In SEC v. W.J. Howey Co.,¹³ the Supreme Court defined this latter term in the context of this act to mean, "[A] contract, transaction or scheme whereby a person invests his money in a common enterprise and

⁴ Group pension plans providing variable annuity benefits also present problems. As the SEC is currently dealing with them in its administrative capacity, they are excluded from the scope of this Note. See generally SEC Investment Company Act Release No. 3605, Jan. 7, 1963; Wall Street Journal, Apr. 14, 1964, p. 2, col. 3.
⁵ Supra note 1.

[A]ny note, stock, treasury stock, bond debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to purchase, any of the foregoing.
¹³ 328 U.S. 293 (1946).
is led to expect profits solely from the efforts of the promoter or third party . . . .”14 adding that it should be construed “so as to afford the investing public a full measure of protection.”15 But section 3(a) provides that the following are exempted securities:

(2) [Any security issued or guaranteed by any national bank, or by any banking institution organized under the laws of any State or Territory or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or Territorial banking commission or similar official; . . . 16 (8) 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.17

Investment Company Act of 1940. This act18 has been called “the most complex of the entire SEC series.” Motivation for Congressional action emanated from the widespread abuses19 prevalent in the “investment company”20 industry in the preceding years, as disclosed by an exhaustive series of SEC reports21 on which the act was based. It divides investment companies into three broad classifications: face-amount certificate companies, unit investment trusts, and management companies.22 Its extensive provisions, in addition to vesting broad rule-making authority in the Commissioner,23 contain requirements as to registration,24 detailed semi-annual reports which must be made to the SEC and the stockholders,25 composition26 and election27 of the board of directors, major changes in investment

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14 Id. at 298-99.
15 Id. at 298. The Court also pointed out that “form [should be] . . . disregarded for substance and emphasis . . . placed upon economic reality.” Id. at 298.
18 Supra note 3.
19 1 Loss, op. cit. supra note 1, at 152.
21 This term is defined in § 3(a) to include any issuer which —
(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
(2) is engaged or proposes to engage in the business of issuing face-
amount certificates of the installment type . . . ; or
(3) is engaged or proposes to engage in the business of investing . . . in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
22 See 1 Loss, op. cit. supra note 1, at 147 n.52.
28 Investment Company Act of 1940 § 16(a), 54 Stat. 813 (1940), 15 U.S.C. § 80a-16(a) (1958), designed to give the investors a voice in the management, provides in part that:
SECURITIES REGULATION

This Act defines the terms "company," "bank," and "insurance company," and then exempts from the definition of "investment company" the following:

- Any bank or insurance company;
- Any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian;

Despite these express exemptions, the SEC contends that a regular-line insurance company issuing individual variable annuity contracts, and a bank proposing to commingle its managing agency accounts in a common trust fund, must comply with these federal laws.

II. Controversy Over Variable Annuities

Background. The variable annuity is an answer proposed by some insurance

No person shall serve as a director of a registered investment company unless elected to that office by the holders of the outstanding voting securities of such company, at an annual or special meeting duly called for that purpose.

29 Investment Company Act of 1940 § 13, 54 Stat. 811 (1940), 15 U.S.C. § 80a-13 (1958), requires such changes to be "authorized by the vote of a majority of its outstanding voting securities. . . ."


"Company" means a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not. . . . (Emphasis added.)


"Bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution or trust company, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 248 (k) of Title 12, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this subchapter. . . . (Subsection (D) omitted.)


"Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance . . . and which is subject to supervision by the insurance commissioner or a similar official or agency of a State. . . . (Emphasis added.)

38 Investment Company Act of 1940 § 3(a), note 21 supra.


40 The words of Mr. Justice Holmes should be recalled when construing technical statutory verbiage:

A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and context according to the circumstances and the time in which it is used.

companies to the problem posed by rising costs on the one hand and, on the other, the generally fixed retirement income of most people. A variable annuity is a contract which does not provide the traditional fixed-dollar annuity payments. Instead, income varies with the fluctuation in the current value of the securities portfolio into which the funds paid for the contract have been invested. Although individual variable annuity contracts may differ in insignificant features depending on the issuer's plan, their general nature may be summarized as follows:

The distinguishing feature of the variable annuity is that the annuitant's payments purchase units in a fund of securities, much as in the case of an open-end investment company. The accumulation in the annuitant's account is valued at maturity, and the insurance company promises to pay him thereafter not a fixed number of dollars monthly but the dollar value, fluctuating with each monthly payment as the value of the portfolio fluctuates, of the annuity units to which it is determined at maturity that the annuitant is entitled on the basis of capital contribution, age and sex. That is to say, the first payment after maturity is determined by reference to standard annuity tables, on the basis of an assumed net investment rate of a certain percentage per annum, but the figure thus obtained is converted into annuity units by dividing it by the then value of an annuity unit. Thereafter the number of annuity units held by the annuitant remains constant, but the dollar value of a unit and hence the amount of subsequent monthly payments fluctuate as the value of the portfolio goes up or down.

In 1959, the Supreme Court, in SEC v. Variable Annuity Co. (VALIC), decided that an individual variable annuity was a "security" within the meaning of the federal act because it "places all the investment risks on the annuitant, none on the company." The Court admitted that there was a mortality risk assumed by VALIC, but said as to this risk: "[I]t is apparent, not real; superficial, not substantial. 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."

Since Justice Douglas' opinion for the Court generically classified the variable annuity as a "security," there was no compelling reason to compare traditional state insurance laws with the federal securities regulations to determine which was more appropriate for these contracts. But he did observe that state laws regulating "annuities" as "insurance" pertained in the main to fixed annuities. The point is that in the case of fixed annuities the insurance company guarantees a fixed monthly payment, i.e., the investment risk is on the company. Therefore state insurance regulations are based on this premise — all they have to accomplish, with a paternalistic regard for the annuitant or insured, is that the contract is fair and that the company remains solvent to meet these obligations as they mature. These regulations thus deal mainly with capital and investment controls, statutory policy provisions, and licensing of companies and agents. Such protective de-
vices are inherently inadequate where a "security" is involved; the insurance company does not guarantee a fixed payment, and the investment risk is on the variable annuitant, not the company. Only the full disclosure and "corporate democracy" regulatory concepts embodied in the federal securities laws can adequately protect the investor's interest, prevent the abuses common to such investment funds, and at the same time leave the investment decision to an informed investor. Properly intermeshed with this investor protection standard is that of uniformity of regulation under SEC jurisdiction. Justice Douglas remarked:

It is apparent that there is no uniformity in the rulings of the States on the nature of these [variable] "annuity" contracts. In any event how the States may have ruled is not decisive. For . . . the meaning of "insurance" or "annuity" under these Federal Acts is a federal question.49

VALIC, the proposed ostensible issuer in this case, was regulated under the laws of the District of Columbia as an insurance company, but it was to sell only these variable annuities. This, at least implicitly, prevented the 1940 act's "insurance company" exemption50 from coming into operation, for such company's "primary and predominant business activity"51 must be the writing of insurance. With this reasoning, the Court held that the issuer of such contracts was subject to both the Securities Act and the Investment Company Act.

Justice Brennan, in a concurring opinion, stated that the test was "whether the contract falls within the sort of investment form that Congress was then [i.e., in 1933 and 1940] willing to"52 exempt from the federal regulations. He recognized that the variable annuity is a hybrid creation, but after comparing investor protection under the federal laws and under the "paternalistic" state insurance laws, he concluded that the variable annuity was different in kind from the insurance business exempted from these federal regulations.53 In his finding that this contract presented regulatory problems similar to those Congress was attempting to solve by these acts, a broad standard was espoused:

These [federal] controls may be largely irrelevant to traditional banks and insurance companies, which Congress clearly exempted; they were not investing heavily in equity securities and holding out the possibilities of capital gains through fund management; but where the investor is asked to put his money in a scheme for managing it on an equity basis, it is evident that the Federal Act's controls become vital.54

The dissenting opinion in VALIC, representing the views of four Justices, would leave variable annuity regulation to the states. While this would not foster uniform regulation, it was pointed out that if any inadequacies exist in state law protection of the variable annuitants' interests, we can expect the states to "adjust and develop their controls."55 At least one state, New Jersey, has attempted to do just this.56

The VALIC decision, on its three-year judicial journey to the Supreme Court, evoked much discussion, often critical;57 most commentators seemed to agree with the result finally reached.58
Present Controversy. Granting that the individual variable annuity is a "security," the VALIC decision did not reach the question of whether a regular-line insurance company issuing such contracts could take advantage of the Investment Company Act’s section 3(c) (3) exemption. Such a company would, unlike VALIC, have as its "primary and predominant business activity...the writing of insurance." This question has been recently answered. Prudential Insurance Company of America requested an order from the SEC declaring that its offer and sale of variable annuity contracts would not subject it, in whole or in part, to Investment Company Act. The SEC order recognized Prudential’s exemption, but held that the unincorporated Investment Fund, created out of the proceeds of the sale of the proposed contracts, is the issuer, and an investment company under the terms of the Act.

The SEC’s order was affirmed in Prudential Ins. Co. v. SEC. The court’s opinion adopted the Commission’s summary of the salient characteristics of Prudential’s variable annuities. They are similar to those in VALIC, and those described previously in this note, including: monthly purchase payments during the “pay-in” period, the net proceeds of which go into the “Investment Fund,” which is invested primarily in common stocks; monthly “unit” credits to the purchaser, the value of which fluctuates with the investment results of the fund; and after the normal (at least 15-year) “pay-in” period, guaranteed monthly payments during the annuity or “pay-out” period, based on the current value of a fixed number of units (based in turn on the purchaser’s accumulated units, an assumed annual investment increment, and actuarial computations) determined at the end of the pay-in period.

The Prudential court limited itself to the narrow question of “[W]hether the Commission made a permissible interpretation in concluding that the variable annuity program results in the creation of a separate, non-exempt investment company,” i.e., the Investment Fund. The term “company” is defined in the Investment Company Act to include “a trust, a fund, or any organized group of per-

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59 Investment Company Act of 1940 § 2(a)(17), cited note 37 supra, defines the “insurance company” in the § 3(c)(3) exemption, cited note 39 supra.

60 Prudential is a mutual life insurance company organized under the laws of New Jersey and subject to regulation by the N.J. Dept. of Banking and Insurance. At the end of 1962, with approximately 26 million policy holders, its total assets were approximately $18.6 billion, and it had in force contracts of insurance amounting to over $82.1 billion. Brief for Petitioner, Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964). The comparable figures at the end of 1963 were approximately 37 million, $19.8 billion, and $96.6 billion, respectively. Wall Street Journal, Feb. 25, 1964, p. 7, col. 2.


62 This is the Fund in which the purchaser holds units. It is managed by Prudential, and invested primarily in common stocks. This account is dedicated solely to the variable annuity contract holders and its assets will not be subject to claims of any other contract or policyholders of Prudential.

63 In a VALIC release, SEC Investment Company Act Release No. 2974, Feb. 25, 1960, the SEC had already expressed the theory that the holders of the variable annuity contracts (in VALIC), along with the proceeds of their payments, constituted an “investment company” separate from the issuer and subject to the Act. But since VALIC itself did not qualify for a § 3(c)(3) exemption, and hence had to register, separate registration of the fund was not required.

65 Id. at 384-85.
66 359 U.S. 65, 81-87 (1959) (described in Brennan’s concurring opinion).
67 326 F.2d at 386.
sons whether incorporated or not.\textsuperscript{68} The court, in rejecting Prudential’s argument that the act regulates only identifiable business entities with some sort of internal organization, relied primarily on one small portion of the exhaustive SEC reports on which the act was premised, wherein reference was made to the following type of management investment company:

\begin{quote}
An agency relationship between the individual contributors to the fund and the management upon whom they confer substantially a power of attorney to act as agent in the investment of the moneys contributed. The group of individual investors is not a legal entity but rather constitutes in essence a combination of distinct individual interests.\textsuperscript{69}
\end{quote}

The contention was also advanced that Prudential was the “issuer” because it, not any amorphous entity, assumed the mortality risk. This was rejected because the annuitant’s interest is solely in the Fund. The fact that this mortality risk is more fiction than true risk appeared when:

\begin{quote}
The actuary for Prudential testified that the deductions provided for in the contract would be more than adequate to satisfy the annuity obligations. Hence, the annuitant’s interest in the general assets of Prudential is, at best, de minimis.\textsuperscript{70}
\end{quote}

To defeat the relationship theory, Prudential also argued that adequate state regulation was the basis for the insurance company exemption.\textsuperscript{71} But the court also rejected this, stating that VALIC “holds unequivocally that adequate state regulation of insurance is immaterial when variable annuity contracts are being considered under a Federal statute.”\textsuperscript{72} This generalization may be too broad, applied to the facts of the Prudential case. While at the time VALIC was decided there were no state regulations which were deemed adequate, Prudential proposes to operate under the subsequently adopted New Jersey laws\textsuperscript{73} specifically designed for regulation of variable annuity situations.

\textbf{Conclusion.} Whether the VALIC Court would have considered these new state regulations “adequate” is now academic. It is conceivable that such a finding by Justice Brennan, \textit{i.e.}, that the issuer was regulated under state laws similar to the federal provisions for disclosure and investment control, would have changed the result in VALIC.

But even assuming that the New Jersey variable annuity laws would meet the “adequacy” standard, it is submitted that the Prudential court reached the right result. This is the only course which affords uniform, nondiscriminatory treatment to all proposed issuers. It is the only way each investor can be afforded the same protection. Not that uniformity is an end in itself; indeed, it is not embodied in traditional state regulation of insurance. Rather, uniformity here would be a means of guaranteeing the very essence of investment protection sought by Congress in the securities laws. If regulation of the variable annuity were left to each of the fifty states, the potential investor in what is basically a “security” could not make the intelligent, informed choice contemplated by Congress. In addition to comparing the prospectuses and reports furnished him by issuers situated in different states, he would need to research the individual states’ laws to compare the content and form of required disclosure; he would also have to investigate the states’ investment and management control regulations. These should all weigh in his ultimate choice, as well as his later decision on whether to stay in the fund. Obviously the typical investor in such contracts would find this impossible.

It would also be impractical to expect the Supreme Court to determine the adequacy of each state’s new laws on a case-by-case basis; however, even if adopted, this would not eliminate the discrepancies which may be expected in the judicially-approved laws. Add to this the varying degrees of administration and enforce-

\textsuperscript{68} See statute cited note 35 \textit{supra}.


\textsuperscript{70} 326 F.2d at 387 n.5.

\textsuperscript{71} Brief for Petitioner, pp. 27-31, Prudential Ins. Co. v. SEC, 326 F.2d 383 (3d Cir. 1964).

\textsuperscript{72} 326 F.2d at 388.

\textsuperscript{73} See statutes cited note 56 \textit{supra}.
ment which may be expected in the separate states, and the very problem Congress sought to eliminate reappears. A uniform state act for regulation of variable annuity contracts would be helpful, but hardly to be expected. Nor is it needed, for we already have such legislation under experienced administration in SEC regulation.

One of the principal drafters of the Securities Act of 1933 recently noted that the "annuities of duly regulated insurance companies" exemption was never intended for variable annuities.\footnote{Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 46 n.24 (1960).} He favored SEC regulation, but added that:

considering and contrasting the essence of variable annuities and bank commingled managing agency accounts, and looking to their practical ramifications, can a different conclusion be advocated? [I]f the sale of variable annuities had been a flourishing business of insurance companies in 1933, they would in all probability have been specifically exempted. Such is the political power of life insurance.\footnote{Ibid. (Emphasis added.)}

On the subject of bank commingled managing agency accounts, similar questions of intent, ifs and probabilities come into play.

III. Commingling Bank Managing Agent Accounts In a Common Trust Fund

Background.\footnote{See generally H.R. REP. No. 429, 88th Cong., 1st Sess. (1963).}

In general, common trust funds are funds maintained by banks or trust institutions for the collective investment and reinvestment of moneys from the personal trusts or estates of which the institution is fiduciary.\footnote{See generally BOGERT, LAW OF TRUSTS § 105, at 278 (4th ed. 1963): The bank or trust company purchases with the mingled funds of its trusts a large number of investments which are legal for all the participating trusts... and allots interests in the fund to the contributing trusts in proportion to the size of their payments.} Their utilization by banks subject to the Federal Reserve System was not sanctioned until 1937.\footnote{H.R. Doc. No. 476, 76th Cong., 1st Sess. 5 (1939).}

Before 1927, when the first common trust fund was established, trust law required that, without express authority to commingle in the trust instrument, the bank-trustee keep the funds of each trust segregated and "earmarked."\footnote{Ibid. See generally BOGERT, LAW OF TRUSTS § 105, at 278 (4th ed. 1963); RESTATEMENT (SECOND), TRUSTS §§ 179-80 (1959).}

This presented problems as to small trust accounts, not the least of which were high service costs and lack of adequate diversification. As the states began to pass enabling legislation for common trust funds,\footnote{See generally BOGERT, TRUSTS & TRUSTEES §§ 616-64 (general standards - state statutes), § 677 (includes copy of UNIFORM COMMON TRUST FUND ACT) (2d ed. 1960).} the Treasury Department's position that the business transacted by such funds was taxable as a corporation (in addition to the taxes payable by the beneficiaries) was upheld in the courts.\footnote{Brooklyn Trust Co. v. Commissioner, 80 F.2d 865 (2d Cir.), cert. denied, 298 U.S. 659 (1936).}

The need for federal tax exemption to avoid this double taxation being apparent, Congress in 1936 defined a common trust fund for tax ("association") exemption purposes as:

[A] fund maintained by a bank (1) exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian; and (2) in conformity with the rules and regulations... [formerly of the Board of Governors of the Federal Reserve System, now including those of the Comptroller of the Currency].\footnote{Int. Rev. Code of 1936, ch. 690, § 169(a), 49 Stat. 1708 (now INT. REV. CODE OF 1954, § 584(a), as amended, 76 Stat. 669-70 (1962)).}

The Board of Governors of the Federal Reserve System (Board) then amended Regulation F, providing in part:

\begin{enumerate}
  \item \textit{In general.}—Funds received or held by a national bank as fiduciary may be invested collectively in any Common Trust Fund established and maintained in accordance with the provisions of this section whenever the laws of the State in which the national bank is located authorize or permit such investments by State banks.
\end{enumerate}
As used in this regulation the term "Common Trust Fund" means a fund maintained by a national bank exclusively for the collective investment of moneys contributed thereto by the bank in its capacity as trustee, executor, administrator or guardian.

The purpose of this section is to permit the use of Common Trust Funds, as defined in section 169 of the Revenue Act of 1936, for the investment of funds held for true fiduciary purposes; and the operation of such ... funds as investment trusts for other than strictly fiduciary purposes is hereby prohibited. ...  

While this regulation only applied to banks under the Board's jurisdiction, the tie-in with the tax exemption made it imperative for any other bank which wished to operate such common trust funds to comply also.

From 1936 until 1962, while such funds were under Board regulation, the bona fide fiduciary-purpose standard was strictly applied, with few exceptions. A Board amendment in 1955 permitted collective investment of various employee benefit funds. The Board also permitted national banks to operate "managing agency accounts" under which advisory and management investment services were performed for individual customers; however, collective investment or commingling of such accounts was prohibited. The Board's concept was that common trust funds should be mere aids in trust administration; they were not to be operated as investment trusts to attract those primarily seeking investment management of their funds.

Since the SEC considered such funds exempt from the 1940 Act under the specific exemption in section 3(c)(3) and from the Securities Act of 1933 because there was no "public offering," the legislative history is important as it reveals the nature of common trust funds in the late 1930s. One of the SEC reports underlying the Investment Company Act provides that a survey was made of the commingled or common trust funds, since these constitute an investment vehicle akin to the investment company of the general management type. Other pertinent observations include:

The common trust fund, like the investment company, has for its purpose the procurement of an adequate diversified investment medium for the small investor. The fund, in substance, combines a number of small personal trusts or estates of which a bank ... is the trustee into one larger fund for common administration and managements by the bank ... in its trustee capacity.

Common trust funds have not participated in any active program of advertising and solicitation for participants in their funds. In instances where there was any solicitation for business it was of an informal nature where the officers of the ... companies discussed with their clients the comparative advantages and disadvantages of particular investment media.

Participation in a common trust fund is restricted to trust estates of which the trustee is the bank ... which sponsors common trust funds. Furthermore, an individual trust estate may be commingled ... only if the instruments creating the individual trusts authorize not only the commingling of such trust estate with other trust estates in a single unit, but also permit investment in the type of assets in which the common trust fund is ultimately to be invested.

85 See, e.g., 25 Fed. Reg. 12479 (1960); Operation of Common Trust Funds as Investment Trusts for Other Than Strictly Fiduciary Purposes, 26 FED. RESERVE BULL. 393 (1940); 41 FED. RESERVE BULL. 142 (1955); 42 FED. RESERVE BULL. 228 (1956).
86 See statute accompanying note 39 supra.
89 Id. at 3.
90 Id. at 6.
91 Id. at 7.
This is, generally speaking, what the "common trust fund" looked like when it was exempted from the 1940 Act.

If any distinction is to be made between investment companies and bank common trust funds in the pre-Investment Company Act era, besides the Board regulation of the latter, it must be the active and broad merchandising of the former compared to the personal fiduciary element of the common trust fund. At any rate, the number of common trust funds rose from the 16 in existence in 1935 to 511 such funds in 327 trust institutions with total assets exceeding $3.5 billion at the end of 1961.92

Present Controversy. In September, 1962, authority over the trust powers of national banks was transferred from the Board to the Comptroller of the Currency.93 The only change made at this time was in the name: from Regulation F to Regulation 9.94 But in April, 1963, the Comptroller promulgated an amended Regulation 995 which now permits, in addition to the collective funds previously permitted under Regulation F, and where not in contravention of local law, the collective investment of funds held by a national bank as fiduciary:

(3) In a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent under a managing agency agreement expressly providing that such monies are received by the bank in trust; . . . .96

This regulation defines "managing agent" as:

![Image](https://i.imgur.com/3Q5J5JG.png)

The SEC immediately took the position98 that the commingling of such accounts would be indistinguishable from a mutual fund; therefore, the common trust fund, as distinguished from the bank, would be in substance a mutual fund investment company and the issuer of a security, subject to both the 1933 and the 1940 Acts.99 In view of the "bank" and "common trust fund" exemptions,100 the Comptroller strenuously argued101 that this "ectoplasmic investment company" theory,102 though it may apply in cases like VALIC and Prudential, is logically

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96 22 Fed. Reg. 1719 (1964), amending 12 C.F.R. § 9.18(a)(3) (Supp. 1964); the amended portion, in italics, was added after the controversy arose.
97 22 Fed. Reg. 1719 (1964), amending 12 C.F.R. § 9.1(g) (Supp. 1964); the amendment changed this section by adding the portion in italics and deleting the words which are in brackets, not however making any significant changes in the regulation as it had appeared before, other than the trustee-fiduciary requirement clarification.
100 See statutes in text accompanying notes 16 and 39 supra.
102 This was explained by the Comptroller to be a "novel legal concept" working to "attribute legal existence, as an entity, to one specific activity of a business otherwise exempt by describing as an investment company any amorphous group which is deemed to be functioning as an investment company." 1963 Hearings, supra note 101, at 35.
unpalatable, a distortion of congressional purpose, and totally unworkable in application as applied to these managing agent common trust funds.103

Fear of dual regulation appears to have prevented any bank from setting up such funds as of April, 1964.104 Nor is it known that any test case is pending.

A few of the basic tenets of disagreement can be mentioned, starting with the Securities Act of 1933. One is whether there is a “security” involved in the commingled managing agent trust fund, within the letter and spirit of the 1933 Act. The fact that the participation interests will be mere book entries, not evidenced by any assignable or transferable document or certificate, is advanced by the Comptroller to support a negative answer. But the broad language of the Act, along with the definition of “security” in the Howey case,105 support the SEC position that no written document as evidence of the interests is necessary.

The crux of the matter is whether the section 3(a)(2) exemption for “any security issued or guaranteed by any national bank”106 will defeat SEC jurisdiction. The Comptroller says that this specific exemption would apply, and that a “bank” would be the issuer. The SEC interpretation is that this exemption applies only to securities directly issued or guaranteed by a bank.107 Thus, if we accept the relationship theory as applied to the Prudential variable annuity, it is the common trust fund, not the bank, which is the issuer. In reality, the investor's unit of interest is in the fund; there is no interest in, nor guarantee by, the bank entity.

The SEC must also meet the section 4(1) exemption for “transactions by an issuer not involving any public offering.”108 The Comptroller points to the investment-discretion of the bank, and the advertising and solicitation restrictions of Regulation 9,109 to show there would be no “public offering” involved. The SEC can counter with the realistic argument that the object of pooling many such accounts so as to compete with mutual funds necessarily implies solicitation of customers. The merits of either position should depend on the amount of active merchandising a bank may do under Regulation 9's permissive standard: “[S]uch material may be given publicity solely in connection with the promotion of the fiduciary character of the bank.”110 The Supreme Court, in SEC v. Ralston Purina Co.,111 stated that “[T]he applicability of § 4(1) should turn on whether the particular class of persons affected needs the protection of the Act.”112 If the common trust device for managing agent accounts is actively promoted to attract the smaller


104 Letter from Donald L. Benson, Director, Information Dept., National Assoc. of Securities Dealers, Inc., to the Notre Dame Lawyer, March 19, 1964, on file in the Notre Dame Lawyer office, states:

[N]o banks, to my knowledge, have as yet established activities along these lines. One bank in New York indicated they wished to proceed to commingle common trust funds but were waiting to receive a tax opinion from the Internal Revenue Service.

This tax ruling has been issued, favorable to the banks; see text accompanying note 118 infra.

105 See notes 12-15 supra and accompanying text.

106 See text accompanying note 16 supra.


108 See statute cited note 87 supra.

109 The administration regulations would be under 12 C.F.R. § 9.18(b) (Supp. 1964).


112 Id. at 125.
investor, there is little doubt that this type of person should receive the same protection, at least qualitatively, as when he invests in a nonbank sponsored mutual fund. But if another regulatory scheme, i.e., the rules and regulations of the Comptroller, provides sufficient protection, the “need” for SEC regulation under this act is illusory.

As previously stated, the Investment Company Act of 1940 exempts both banks and, “[A]ny common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian.” The managing agent common trust fund must be regarded as the investment company to uphold the SEC’s position. Even than, the SEC must distinguish in substance this fund from the exempted one, i.e., on the ground that the bank is not contributing thereto in its capacity as “trustee.” The only basis on which this can be done is to deny that the “trustee” concept in the statute includes the fiduciary responsibility of a managing agent because of the latter’s discretion to determine whether or not the account funds will be invested in a common trust fund. Assuming that Regulation 9 will not permit the use of such collective funds for purely speculative purposes, as the Comptroller claims, there is little reason to exclude this capacity from the trustee-cestui que trust relationship. It is submitted that the SEC report already discussed supports this interpretation. Considering the fact that the investor may withdraw and receive his pro rata share at the valuation date, which must be at least one every three months, there is little substantial difference between it and a revocable trust. It cannot be disputed that one of the SEC reports underlying the 1940 Act’s “common trust fund” exemption recognized that a bank is acting as a trustee even with “revocable inter vivos trust estates which have been created specifically for the purpose of participating in a commingled or common trust fund.”

Conclusion. It is submitted that these commingled managing agent accounts are a reasonable and minor extension of the Regulation F common trust funds, and that they too should be exempted from SEC regulation under both acts. There is no substantial difference between the managing agent funds and the trustee funds previously considered exempt — the fiduciary responsibility regulated by the Comptroller remains intact.

This interpretation appears to receive recognition in a 1964 Internal Revenue Service ruling, which announced that the proposed managing agent common trust funds will qualify as a “common trust fund” within the meaning of section 584 of the Tax Code, provided they are operated in conformity with the Comptroller’s rules and regulations. At least for tax purposes the bank is held to be contributing to the fund as a “trustor.”

Assuming the SEC’s strongest position as developed in the VALIC and Prudential cases, that the managing agent common trust fund is the issuer, these

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113 See, e.g., Judd, Common Trust Funds Under Regulation 9, 102 TRUSTS & ESTATES 569 (1963).
114 Statute cited note 39 supra.

The provisions of regulation 9 have been misunderstood by the Commissioner and by the investment company industry. That the regulation permits this slight relaxation of common trust fund regulations does not mean that it would permit anything which might be characterized as “widespread merchandising. . . .” (W)e will [not] . . . fail to administer our duties responsibly.

See generally 1963 Hearings, supra note 101, at 40, 49-50.
116 See text accompanying notes 88-91 supra.
120 See note 82 supra.
funds should be exempt from the Investment Company Act under the “common trust fund” exemption. The remaining problem is whether the Securities Act of 1933, which only exempts “any security issued or guaranteed by any bank,” regulates the activities of these managing agent funds. While the 1940 Act’s common trust fund exemption is not to be literally found in the Securities Act, the obvious reason is the relative inactivity of such funds in the early 1930s. No legislative history has been found to suggest that the few such funds then existing were even considered to involve the issuance of securities. But when the activity of such funds became more prominent, i.e., in 1940, Congress did exempt them from the Investment Company Act. Adequate regulation by the Federal Reserve Board, preventing the abuses the Act was concerned with, had to be one of the main reasons for the exemption. Since this was the basic rationale of the “bank” exemption in the Securities Act of 1933, it can be assumed that, to paraphrase what has already been said of variable annuities, if bank common trust funds (even of the managing agency variety) had been flourishing in 1933, they would in all probability have been exempted. Logic, also, seems to require the inclusion of these common trust funds in the “bank” exemption. To have the SEC regulate disclosure under the Securities Act and the Comptroller regulate disclosure and other practices under Regulation 9 is completely impractical; the result paid for by the increased burden, financial and otherwise, on the government, its taxpayers, and the banks involved, is overlapping jurisdiction providing essentially similar protection for the “investor.” It is submitted that the Comptroller’s regulations can adequately provide the protection for the class of persons affected; this qualitatively equivalent protection should also satisfy the “public offering” exemption standard of the Ralston Purina Co. case, previously discussed.

Furthermore, the controlling factors in the variable annuity cases are not present here. VALIC and Prudential involved a change in insurance concepts; traditionally, the emphasis was on a guaranteed payment with the annuitant having an interest in the company and adequate state regulation premised on such a secured position; the variable annuity presented a situation in which there was no such guarantee, no annuitant interest in the company, and antiquated state regulation unadapted to the new concept. With commingled managing agent accounts, bank concepts do not involve such radical change. The Regulation F “trustee” funds, always considered exempt, guaranteed nothing beyond the assumed fiduciary responsibility and operation under strict and informed regulation by the Federal Reserve Board. The proposed managing agent funds involve the same elements; they are no more and no less “issued or guaranteed” by the bank than the Regulation 9 funds. They too should be exempt from both acts.

Obviously, the most crucial basis on which to distinguish the different results advocated for variable annuities on the one hand and the commingled managing agent accounts on the other is one of policy, i.e., that in the case of the bank funds, adequate and uniform investor protection can be furnished without SEC regulation. Bank supervisors already investigate bank-trust fund activities; Regulation 9 provides these supervisors with specific provisions for managing agent funds. If Regulation 9 is deemed inadequate—the need for a more informative prospectus is a possibility—the Comptroller can amend it to adjust to the needs.

121 See text accompanying note 16 supra.
122 The following debate on the bank exemption is illustrative:
   Mr. CANNON of Wisconsin. Why should it not cover the securities issued by the bank?
   Mr. RAYBURN. Because the United States Government, through its examiners and State officials, is supervising these banks, and it has been complained that we are going into fields where we had no business.
77 Cong. Rec. 2942 (1933).
123 See text accompanying note 75 supra.
124 See text accompanying notes 111-12 supra.
On this basis, the Congress of the United States had before it several bills which would specifically exempt such funds from SEC jurisdiction and vest regulatory control in the Comptroller. Although one reason for the congressional interest is the unnecessary expense, legal uncertainty, and friction involved in the present conflict between two federal bodies, the bills also evince a conviction that the Comptroller, with statutory guidelines provided by Congress, can sufficiently provide the investor protection deemed necessary. Legislation, not judicial decision, might climax this controversy.

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