8-1-1957

Variable Annuity Is Not a Security

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A VARIABLE ANNUITY IS NOT A "SECURITY"

I. INTRODUCTION

The variable annuity is an annuity providing a life income, not of a fixed number of dollars, but of variable amounts keyed to an underlying common stock investment portfolio. The development of this new concept in retirement income planning may be traced directly to mankind's continuing search for greater economic security. The advocacy of variable annuities stems from the desire to avoid the dilemma in which many persons now retired on individual or group pension plans find themselves. Annuity incomes which seemed adequate when purchased years ago often fail to meet the buyer's needs of the present day, primarily because of the impact of inflation on the purchasing power of the dollar. For example, a person receiving a $2,500 pension in 1940 would, by 1951, have to receive $4,500 to have the same purchasing power. Consequently, existing types of fixed-dollar annuities have not been satisfying the retirement needs of the American public.

Where, then, can this security be found? It would apparently call for a retirement income which afforded a fairly constant amount of purchasing power. Maintaining such constancy may require more dollars in one year and fewer dollars in another. Variable annuities can help to provide such an income and thus bring that desired security closer to reality. Authoritative economic studies of the past seven decades indicate clearly that over the long term, the prices of a large group of common stocks went up and down as the prices of commodities in general went up and down, although they sometimes went in opposite
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Directions for short periods. Furthermore, the valuation of the common stocks generally fluctuated to a greater extent.¹

These studies likewise show that during this same period, if individuals could have used about one-half of their retirement savings to buy variable annuities based on common stocks and had put the rest of those savings into fixed-dollar annuities, the combined income from the two types of annuities would have provided a fairly constant amount of purchasing power, much more stable than either type of annuity would have provided by itself. The fixed-dollar annuity would have helped to keep the combined income from declining too drastically when the value of the common stock investments dropped while the variable annuity would have provided some protection against loss of purchasing power when prices rose. It is for this reason that many of the nation's leading life insurance companies have proposed that variable annuity contracts should be made available to those who want this balanced type of retirement income protection.²

¹ See Greenough, A New Approach to Retirement Income (1951), an economic report prepared for the Teachers Insurance and Annuity Association as background material for its College Retirement Equities Fund.

² Leaders in the insurance industry have emphasized repeatedly that insurance companies must provide new forms of coverage that will meet the ever-increasing needs of a changing economy. Speaking in support of variable annuities before the New Jersey Senate Business Affairs Committee, at a public hearing on June 22, 1956, Louis W. Dawson, President of the Mutual Life Insurance Company of New York, said:

"Now we live in what might be termed an 'age of improvement.' Like every other business, the life insurance business has a public duty to improve its products and services in every possible way, and to conduct reasonable experiments with that end in view. . . . Our business has always been willing to experiment and innovate in any way that offered a reasonable chance to benefit our policyholders and their families. And I think this very strongly, gentlemen, that we must maintain that progressive and open-minded attitude, if we are to serve future generations as we have served past generations."

Similar recognition of the need for, and the challenge to the insurance industry to provide new forms of coverage was well expressed by the retiring president of the National Association of Insurance Commissioners,
viously, it cannot be predicted with certainty that common stocks, and therefore, this combination of annuities, will continue to bear this same long-term relationship to prices in general, but there is good reason to believe that the relationship will be maintained.

There can be no disagreement as to the existence of the problem indicated or of the immediate need for a workable approach which will involve an adjustment in the method of providing retirement income. The fixed-dollar annuity alone cannot provide the needed protection and the public’s recognition of this fact is obvious from the drastic decline in the sale of such contracts. Nevertheless, there is a definite continued need for fixed-dollar annuities because no other type of contract can afford the recipient such solid protection against loss of income. The variable annuity contracts are not a panacea or a substitute for life insurance or fixed-dollar annuities, but rather they should be considered as a supplement to these existing types of pension contracts. In this sense, variable annuities are

Wade O. Martin, Jr., who, speaking at the 1952 meeting of the Life Insurance Association of America, said:

"... The best insurance that you could possibly have against further encroachment by the federal government is to provide new forms of coverage that will meet the ever increasing needs of a changing economy.

So, I urge you to make a determined effort at experimentation in new fields of coverage, in new policy forms. And whenever you find that you can enlarge your services, consistent with sound underwriting practices, make every effort to do it.”

Secretary of Health, Education and Welfare Marion B. Folsom, in a speech before the Life Insurance Association of America at New York on Dec. 14, 1955, made the same point:

"Although our strides have been great in the private pension field, there is a crying need today for a renewed display by the insurance industry of its traditional enterprise and ingenuity. Even with our advances, many millions of workers still lack sufficient protection. We need more and improved private retirement plans, and we need improvements in many plans already in effect.”

3 In 1956, the Prudential Insurance Company of America sold 559 annuities as compared with a peak year high of 8,834 in 1934; the Metropolitan Life Insurance Co. sold 194 annuity contracts in 1954 as opposed to a 1935 high of 3,975. All indications point to a similar experience on the part of the other companies.
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just one more tool available in the continuing search for economic security. To this date, the variable annuity contract is the only concrete, practical means available to obtain a life income which will correspond to changes in the cost of living and will grow in accordance with expansion in the nation's economy.

Despite its merits, the plan has met with considerable opposition. The mutual funds and others connected with the securities business view variable annuities as a potent source of competition, and have launched upon a "search for security" in a special sense, alleging that variable annuities constitute that type of "security" which under federal law is subject, in its sale and distribution, to regulation and control by the Securities and Exchange Commission. A refutation of this contention shall constitute the framework of this article.

II  OPERATION OF A VARIABLE ANNUITY

Presently, the general public cannot obtain annuity contracts on a variable basis, which will provide an income to continue for the lifetime of the annuitant, determined scientifically in accordance with actuarial principles of life contingencies, and which will liquidate a principal sum exactly over the uncertain period of the annuitant's lifetime, except from a few relatively new companies formed for the express purpose of marketing this type of contract. Despite this unavailability, a great deal of public interest has been generated in this type of contract.

Legislation on this subject, presently pending in New Jersey and approved by the New Jersey Department of Banking and Insurance, has two major objectives. The first is to authorize any New Jersey life insurance company
to establish a segregated account to be known as the variable contract account, the assets of which may be invested to a large extent in common stock and other equity securities. This authority is necessary only for the establishment of segregated investment accounts which will serve as a means of earmarking the variable annuity investments and providing a yardstick for evaluating units of purchase and payment. A company operating such an account would issue variable annuity contracts pursuant to its existing power to issue annuities. Under such variable annuity contracts, payments would vary in dollar amount so as to reflect the investment results of the variable contract account.

The second major objective of the legislation, possessing broader significance, is to provide the New Jersey Insurance Department with far-reaching control over contract forms, advertising, and sales methods applicable to variable contracts issued in New Jersey by a company of any state. This legislation would give the department authority to establish regulations for the sale of such contracts, specifically including, inter alia, requirements as to disclosure of the variable nature of the obligations to prospective annuitants. Under the proposed New Jersey legislation, mortality and expense assumptions would be guaranteed by the company and would not affect the variations in values and payments. The variable annuity, as a life insurance company product, is in the earliest stages of development. Undoubtedly, the traditional ingenuity of American business will lead to many different approaches, in manner of operation as well as in contract terminology. For example, it is possible that, as in the case of other life insurance company contracts, some variable annuity contracts may provide for participation in the form of insurance company dividends.

The term "expense" as defined in the pending legislation, N.J. Assembly Bill 13 (1957), may exclude some or all taxes, as stipulated in the contract. The rationale underlying this provision is the unpredictable nature of future tax legislation.
Furthermore, in some cases, the contract terminology, designed with special attention to the need for conveying the basic nature of the contract as understandably as possible, may be in terms of concepts that need not necessarily be used in the internal administration of the contracts. With the foregoing in mind, it may be helpful, for illustrative purposes, to consider one possible approach to a participating form of individual variable annuity contract, and the way in which such contract might read.

A person buying such a variable annuity would not receive a contract guaranteeing to pay him a certain number of dollars, as in the case of a standard or fixed-dollar annuity but, instead, would be credited with amounts which would be keyed to the value of the assets in the special account. When he became entitled to benefits, he would receive, for life, annuity payments which would vary in dollar amount. The value of the assets in the special account would be the yardstick for determining these dollar amounts. Distributions would be based upon actuarial application of mortality tables and would be within the scope of accepted responsibilities and functions of life insurance companies.

The variable contract account would be a separate account of the issuing insurance company, with the investments and liabilities clearly identifiable and distinguishable from the other investments and liabilities of the company. Except as might be otherwise specifically provided by any variable annuity contract, all amounts received by the company in connection with such a contract would be placed in the variable contract account, and all liabilities on such a contract would be set up in the account.

The individual variable annuity contract would specify a provision for insurance company operations, in actuarial terminology called the "loading," to be deducted from each consideration received and would further specify the
mortality assumptions to be used in determining annuity payments. It would also describe the essential features of the procedure to be used in determining the dollar amount of any variable benefits, such procedure to reflect only the investment results of the variable contract account. This procedure would provide for an "actuarial margin" to be deducted from investment results.

The insurance company would assume the risk that actual expenses might exceed the provision made therefor, or that mortality might be lower than provided for by the specified mortality basis. In such respects, the company position would be no different than under conventional fixed-dollar annuity contracts. Any divisible surplus arising under variable annuity contracts by reason of the margins provided, including the actuarial margin deducted from investment results, would be determined and apportioned by the insurance company, using suitable adaptations of conventional actuarial methods of life insurance company dividend distribution.

A "consideration unit" could be considered as the basic unit in which the contractual obligations of the insurance company would be expressed. In general terms, it partakes of the nature of a special currency defined in the contract for this express purpose. It would change in value to reflect investment income as well as capital gains and losses, both realized and unrealized, and would not be affected by expenses or mortality.

Since the value of a consideration unit would change in accordance with investment experience, it would be necessary to make periodic determinations of value. The frequency with which such evaluations should be made might vary for different purposes. In the case of variable annuity contracts issued on an individual basis, it might

\[\text{See note 4 supra.}\]
be appropriate to define the value as of the end of each calendar month. For this purpose, a simplified example will best illustrate the basic principles:

A. Assume that the variable contract account is established at the end of January, 1958, at which time payments totalling $1,000,000 are received under variable annuity contracts. Assume further that the value of a consideration unit as of January 31, 1958, is set at $10.

B. Purely for the purpose of analyzing the arithmetical computations involved, let us consider the oversimplified example of a month, February, 1958, where it is assumed that no funds are added to or taken out of the variable contract account and that at the end of February, 1958, the market value of the assets of the variable contract account is $1,010,000.

C. The gross investment factor for the month of February, 1958, would be determined in accordance with a procedure outlined in the contract, as follows:

\[
\frac{1,010,000}{1,000,000} = 1.0100
\]

D. Assume that the contract specified an actuarial margin of .001 to be deducted from the gross investment factor, on a monthly basis.

E. The net investment factor for the month of February, 1958, would be 1.0100 - .001 = 1.0090.

F. The value of a consideration unit as of the end of February, 1958, would be determined, as specified in the contract, as the product of the value at the end of January ($10) and the net investment factor for February (1.009), or $10.09.

The above example is simplified, of course. The contract would specify that the gross investment factor for any month would be determined by the insuring company by employing generally accepted accounting principles to analyze the investment experience of the variable contract account for the month, in terms of the number of dollars which, at the end of the month, result from one dollar remaining invested for the month in the variable
contract account. It would summarize the result of the monthly rate of capital gains and losses, both realized and unrealized, as well as investment income.

The accounting methods used to determine the gross investment factor would be similar to those used by most insurance companies to allocate investment results to a particular branch of the business. The gross investment factor for any month, being a purely investment factor, would not depend upon expenses or mortality. Thus the value of a consideration unit at any time would not be affected by expenses or mortality. In this way, then, the value of a consideration unit could be established as of the end of each month.

The individual variable annuity contract would provide that a fixed monthly consideration would be due on the first of each month, and provide further that a specified portion of each payment under the contract within the period allowed would be applied to credit consideration units to the contract at the end of the month in which the payment was due. The portion to be applied would represent the net consideration, after allowance for insurance company operations. For example, if a contract calling for considerations of one hundred dollars a month specified that seventy per cent of the consideration paid in February, 1958, would be applied at the end of the month to credit consideration units to the contract, then, based on the value of one unit determined as above, the number of such units credited would be 6.9376, determined by dividing $70 by $10.09. In a similar fashion, there would be determined the number of consideration units credited as a result of each additional payment.

Prior to the commencement of annuity benefit payments, actuarial dividends would arise from the excess, if any, of the specified provision for insurance company operations over the actual requirements, plus that portion of the speci-
fied actuarial margin deducted from investment results (taken arbitrarily above at the rate of .001 monthly for the purpose of example) which is not required for other purposes. Actuarial dividends declared might be applied to credit additional consideration units, unless some other treatment, permitted by the contract, was requested by the annuitant.

The dollar amount of the initial annuity payment would depend on the following factors: the current value of a consideration unit; the age and sex of the annuitant; and the type of annuity selected, e.g., life annuity, or life annuity with a ten year minimum period. The contract would contain tables of annuity factors based upon a mortality table and an investment increment assumption, and would describe the procedure to be followed in making the calculation. The initial amount of annuity so determined could then be expressed in terms of “payment units.” The number of payment units would depend on the then current value of the “payment index.”

The amount of the payment index would change only in accordance with investment results. To illustrate, assume that the payment index is set at $10 as of the initial date of operation, February 1, 1958; that the annuity factors assume an annual investment increment assumption of two per cent; and that the payment index is to be redetermined each month. Accordingly, the contract would provide that to determine the payment index as of March 1, 1958, a comparison would be made between the net investment factor for the month of February, 1958, and the assumed investment increment factor for one month, roughly one plus one-twelfth of two per cent, or 1.0016. On the basis of the figures shown above, this comparison would be 1.0090/1.0016 = 1.0074. In other words, during the month of February, the net investment results were seventy-four hundredths of one per cent better than
assumed. Hence, the payment index as of March 1, 1958, could be increased by seventy-four hundredths of one per cent above the amount paid on February 1, 1958. The calculation would be $10 times 1.0074 or $10.07. It should be emphasized again that this procedure is entirely independent of both the mortality experience and the expense experience.

To illustrate the principles involved, let us consider a male annuitant, holder of a variable life annuity age sixty-five at the time of conversion. For purposes of the example, it will be assumed that a total of twelve hundred consideration units have been credited to his contract by that time; that the then value of a single unit is $12.00; and that the current payment index at the time of conversion, is $10.50. The net annuity factor for a life annuity, male age sixty-five, assuming the 1937 Standard Annuity Table and a two per cent annual investment increment, is 6.92. That means that, on a fixed-dollar basis, $1,000 would provide a monthly annuity of $6.92. Assuming that the annuity factors are on that basis, the procedure to determine the number of payment units would be somewhat as follows:

(1) The value of the total consideration units is equal to 1,200 units multiplied by $12, the value of one unit, or $14,400.

(2) If applied on a fixed-dollar basis, the monthly payment would be 14.4 multiplied by $6.92, or $99.65.

(3) The number of payment units providing such a payment is determined by dividing $99.65 by the amount of the payment index, $10.50, and is found to be 9.49.

Thus, the conversion would provide 9.49 consideration units. Each current monthly payment would be 9.49 times
the applicable payment index.

Naturally, the actuarial basis for variable annuity contracts, including the provision for company operations, the mortality basis, and the margin deducted from the investment results, would be established on a scale presumed to be self-supporting. For example, if mortality losses are incurred, then to the extent possible, any surplus from either the expense provision or the investment margin would, of course, be applied as required, just as is the case in other areas of the life insurance business. Furthermore, in a multiple line company, if the resources of variable annuity contracts as a line of business became inadequate, then as is generally true, the corporate surplus would be available to overcome the deficit. Conversely, any surplus of the variable annuity line is a part of the corporate surplus for the purpose of meeting the needs of the other lines.

In other words, variable annuity contracts would have a relationship to the rest of the company's business very similar to that of contracts in a foreign currency. The company's obligations under the contracts in any such currency are not limited to the company's resources in that currency, but the payments made under such contracts are nevertheless payable only in the currency specified in the contract. Thus, in the case of a company domiciled in the United States, a mortality catastrophe under Canadian dollar contracts might involve obligations exceeding the Canadian dollar assets of the company. To honor its obligations, the company would draw upon its United States dollar resources, but would nevertheless pay under Canadian dollar contracts only the number of Canadian dollars for which it is obligated by contract. Fundamentally, this corresponds to the guarantees which the company would make under its variable annuity contracts.
III. A VARIABLE ANNUITY IS AN ANNUITY

At common law, an annuity was generally defined as "a yearly sum stipulated to be paid to another in fee, or for life or years, and chargeable only on the person of the grantor." However, because of continual expansion in general and judicial usage to incorporate new developments in the field, the word has undergone many changes in legal interpretation. The word no longer refers merely to a yearly or annual payment but is universally applied to any periodical payment, whether it be quarterly, monthly or at some other interval. As stated by Crobaugh, in Annuities and Their Uses: "In a strict sense the word annuity infers that the interval of payment is one year, but by gradual usage its meaning has been extended to include other exact recurring intervals of time, such as six months, three months or one month." Furthermore, it is now generally conceded that an annuity may be made a charge on real estate or on a specific fund, instead of being merely chargeable "on the person of the grantor."

The difficulty of assigning a precise definition to the term stems primarily from the existence of so many varieties of annuities. Life insurance companies are presently selling, or have sold, many different types of annuity contracts. There are life annuities, non-refund; life annuities, cash refund; life annuities, installment refund; life annuities, ten year guarantee (also known as life annuities, ten year certain); joint and survivor annuities (also known as last survivor annuities); survivorship annuities (also known as reversionary annuities); immediate annuities; deferred

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7 See Day, A Variable Annuity Is an Annuity, Ins. L. J. 775 (Dec. 1955), for a comprehensive study and analysis of this expansion in the meaning of the word "annuity."
8 CROBAUGH, ANNUITIES AND THEIR USES 25 (1933).
9 3 C.J.S., Annuities § 1 (1936).
10 See WEBSTER, NEW INTERNATIONAL DICTIONARY, 108 (2d ed. 1946).
annuities; and retirement annuities. There are also participating annuities and non-participating annuities. The very existence of this wide diversity demonstrates the extent to which the word has been adapted to new applications.

Yet, despite these expansions, modifications and qualifications of the term "annuity," some opponents of the variable annuity allege a lack of "certainty" in this type of contract. Adopting, without reservation, a will and trust case type definition of the term, it is contended that the test of an annuity is whether it provides for a certain, fixed-dollar amount to be paid the annuitant periodically commencing on the annuity date. Even if this contention were correct — and it is not — variable annuities would meet the test: variable annuity benefits are "fixed amounts" since they are definitely determinable on the basis of a rule and formula set out in the applicable contract. In this context the legal maxim, "that is certain which is, by necessary reference, made certain," is fully applicable.

A California case applied this principle in determining that an annuity, which had a variable feature, nevertheless provided a "certain specified sum." The testatrix had bequeathed an "annuity" to her sister-in-law in such an amount as would, when added to any "annuities" bequeathed to her by other members of the family, comprise a total "annuity" of $8,400 a year. Other beneficiaries claimed, by circuitous reasoning, that the testatrix was not using the word "annuities" in a technical sense and that all added income provided by changes in the wills in question reduced the gift to the sister-in-law, thus providing more for the other beneficiaries. It was contended that the sister-in-law's annuity was not a bequest of a "certain specified sum" because the amount she was to receive from the testatrix's will was not fixed, but was to be ascertained.

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by subtracting from $8,400 the amounts of annuities from other sources. The court rejected this argument, making reference to the maxim of jurisprudence, "that is certain which can be made certain," as incorporated in the California Civil Code,\textsuperscript{13} and held, that the sum in question was "certain" since it could be easily calculated.

This is not merely an isolated application of an outmoded principle. The Supreme Court of the United States applied the maxim in upholding the validity of a railroad charter provision attacked as indefinite and uncertain, prohibiting the imposition of any tax on the railroad which would reduce its dividends below eight per cent.\textsuperscript{14} Similarly, the Louisiana Court of Appeals held that a gasoline station lease, which called for a monthly rental based on a formula keyed to the number of gallons of gasoline sold, did not violate a statute requiring that rentals in leases be "certain and determinate," because the amount could be readily ascertained.\textsuperscript{15} Commenting on the inclusion of the maxim in a statute providing for accrual of interest from the day on which the right to recover damages "certain or capable of being made certain by calculation" vests in an aggrieved person, the Court of Appeals for the Tenth Circuit has said: "The effect of this provision is to say that that is certain and definite which by accepted standards of calculation can be made certain."\textsuperscript{16}

There are many cases which involve the interpretation of wills and trusts, as well as various tax questions, which include definitions of the word "annuity." The stereotyped definitions are used primarily as a guide for determining what the testator or settlor actually intended, generally

\textsuperscript{13} CAL. CIV. CODE ANN § 3538 (West 1954).
\textsuperscript{14} Mobile & O.R.R. v. Tennesee, 153 U.S. 486, 497 (1894).
\textsuperscript{16} Travelers Fire Ins. Co. v. Ranney-Davis Mercantile Co., 173 F.2d 844, 851 (10th Cir. 1949).
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the only issue in such cases, and it frequently will be found that the definitions have little bearing on the decision in the case. In these cases variable types of annuities seldom have been involved, so that no issue such as the one presently under consideration was before the court. In the few cases which have involved something approaching a variable annuity, the courts have not been deterred by the variable feature from designating the plan as an annuity. The most important consideration is the fact that the courts in these cases were not dealing with questions of corporate power of life insurance companies or their logical functions and responsibilities. As has been previously indicated, there has developed such a wide variety of annuity contracts issued by life insurance companies that it would be absurd to contend that the definitions of the term as applied in certain of the will and trust cases are binding on the insurance companies.

The demand for "fixed-dollar certainty" has not been echoed in current decisions and rulings which unanimously have held that an annuity plan providing for varying dollar payments is properly characterized as an annuity. The Teachers Insurance and Annuity Association of America (TIAA) obtained a ruling from the federal tax authorities with regard to its companion organization, College Retirement Equities Fund (CREF), a variable annuity plan which will be discussed more fully in a following section, to the effect that benefits payable under variable plans of the type here proposed, even without a mortality guarantee, are "amounts received under an annuity contract."
An Internal Revenue Service formal general ruling dated September 14, 1953, specifically states that a plan providing benefits varying with changes in the market value of the assets from which such benefits are payable will be recognized as a plan providing for "definitely determinable benefits" and such benefits will be recognized as "annuity" payments as those words are used in the Internal Revenue Code. This ruling upheld the variable annuity plan of the Long Island Lighting Company as a qualified pension trust.

The statutory definition of an annuity, as it appears in the New York Insurance Law stipulating the kinds of insurance which may be issued in that state, is as follows:

2. "Annuities," meaning all agreements to make periodical payments where the making or continuance of all or of some of a series of such payments, or the amount of any such payment, is dependent upon the continuance of human life, except payments made under the authority of paragraph one.

An interpretation of this section, and particularly of the words "periodical payments," was necessary in the case of In re Supreme or Cosmopolitan Council. The society operated what was referred to as a "Life-Annuity System," requiring each member to make an annual dues payment of at least $10, with excess amounts contributed as desired. Such excess contributions were deposited in a benefit fund invested in income-producing properties and the earnings from the fund were held in a separate account available for dividends, at the discretion of the executive committee, after payment of expenses. Death, resignation or three

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20 N.Y. INS. LAW § 46.

21 In re Supreme or Cosmopolitan Council, 193 Misc. 996, 86 N.Y.S.2d 127 (Sup. Ct. 1949); see also, formal New York Attorney General's opinion cited in the above case, 1947 REP. ATT'Y GEN. 214.
years' dues delinquency resulted in an individual's account being prorated among the other members of his "birth year class," with consequent increase in their future annual income distributions. The society was not licensed to do an insurance business and the Superintendent of Insurance sought to liquidate it under provisions of the New York Insurance Law, maintaining that it was not necessary for a plan to promise fixed amount payments in order to constitute the selling of annuities within the meaning of section 46 of the Insurance Law. Sustaining the position of the insurance department, the court stated:

... The Court agrees with the Attorney General's statement that "The words 'periodical payments' [in the statutory definition of annuities] do not necessarily entail only fixed sums payable on specified dates. The annual division and distribution of the Dividend Fund above described would seem to be properly so designated."

The New York Insurance Department took a similar stand in response to an inquiry by the Teachers Insurance and Annuity Association of America regarding the College Equities Retirement Fund, advising that the fact of variation in amounts of periodic payments does not prevent the payments from constituting an annuity. CREF, therefore, as its act of incorporation provides, is subject to the supervision of the New York Insurance Department. The department has approved CREF contract forms and certificates which repeatedly refer to the variable benefits plan in terms of "unit-annuity."

22 N.Y. INS. LAW § 40(1).
23 In re Supreme or Cosmopolitan Council, 193 Misc. 996, 86 N.Y.S.2d 127, 130 (Sup. Ct. 1949).
24 An informal ruling received by the Association from the N.Y. Ins. Dept. See address by G. Johnson, An Experiment with the Variable Annuity, PROCEEDINGS, ASSOCIATION OF LIFE INSURANCE COUNSEL 1952-53, at 637. Indicative of the widespread acceptance of the term "variable annuity" is the fact that CREF, throughout its latest annual report, uses such term in preference to its earlier standard, "unity-annuity."
A recent Canadian case,\textsuperscript{25} decided by the High Court of Justice of Ontario, required construction of a will involving an annuity with variable dollar benefits. While decisions in will cases are not decisive in determining the corporate powers of life insurance companies, the case is of interest in showing the repeated use by the court of the term "variable annuity" and the appositeness of this phrase in describing this type of plan. Pertinent portions of the opinion contained the following language:

This problem arises as a result of the second codicil to the testator's will, which has a very elaborate provision substituting a variable annuity to Alfred Warwick Rogers in place of the definite one of $10,000 provided for in para. 14 of the testator's will. . . . [I]t sets up certain machinery which depends on the Dominion Government's Cost of Living Index. Unfortunately, in precise terms this index no longer exists. It was replaced in 1952 by a somewhat similar index called "Consumer Price Index". . . .

Reading further, it is quite clear that the testator was substituting, for the fixed annuity, a variable annuity which is weighted to Alfred Warwick Rogers' advantage in case the cost of living rises, and which is liable to be reduced if the amount calculated according to the testator's direction is out of line with the income being received by the testator's other two sons from any companies controlled by the trustees of the estate. It was urged by counsel for Alfred Warwick Rogers that those provisions as to the reduction of the annuity were void and unenforceable as being repugnant to a definite vested gift of income in the beneficiary. . . .

It is to be observed that this provision for Alfred Warwick Rogers, as altered by the codicil, does not vest any definite sum of income in him but lays down, as it were, a procedure by which the trustees are able to calculate the amount they should pay him in any given year and all that vested in the beneficiary, in my view, was the right to receive such annuity to be calculated by the trustees in accordance with the rather com-

\textsuperscript{25} Re Rogers, 4 D.L.R. 422 (1955).
plex procedure laid down by the testator in the codicil. ... What the testator has done is to give an annuity to Alfred Warwick Rogers which, in certain circumstances, is to be calculated according to certain definite directions which he has given. If a further situation arises where one of the other sons is enjoying a smaller income from the testator's companies than the Alfred Warwick Rogers annuity, the trustees are then given the discretion to reduce the annuity of Alfred Warwick Rogers, presumably to a degree that is comparable with the income which the other sons are receiving from the companies in question. In my opinion the testator was entitled to make this direction.26

Variable annuity legislation presently pending in New Jersey, which would recognize that such contracts may be issued by life insurance companies under their existing power "to grant, sell or dispose of annuities," has received the approval of that state's Department of Banking and Insurance.

Further recognition of the fact that the issuance of variable annuity contracts comes within the existing legislative authority of life insurance companies to write annuities is evidenced by the District of Columbia Insurance Department's licensing of Variable Annuity Life Insurance Company, July, 1955, and The Equity Annuity Life Insurance Company, July, 1956, to engage in such business under its supervision and regulation. The Arkansas Insurance Department has also licensed the Participating Annuity Life Insurance Company, Aug., 1954, and the Variable Annuity Life Insurance Company has been licensed to do business in West Virginia (Sept., 1956), Kentucky (Feb., 1957), and Arkansas (May, 1957).

It is well established that in the interpretation of statutes the words used should be given a meaning which will further the purpose of the legislature. It is fair to say that legislatures, in authorizing the writing of annuities, have

26 Id. at 428-29, 431-33.
intended to facilitate the promotion of security for retired persons. Having in mind the effects of past inflation and the strong possibility that there may be a recurrence it is reasonable to conclude that for true security in retirement it is appropriate to make available something more than income in dollars and to attempt to provide a reasonable retirement income in terms of current purchasing power. Furthermore, it is desirable that a retirement income contract be available which offers to retired individuals an opportunity to participate in the economic growth of the country. Under such circumstances, any restricted definition which would limit or circumscribe accomplishment of the statutory purpose should be rejected.

IV. A SUCCESSFUL VARIABLE ANNUITY PLAN

The variable annuity principles now in operation apply to about 100,000 individuals in the United States. Furthermore, two life insurance companies outside the United States, one in Great Britain and one in the Netherlands, offer variable annuity contracts.

The first variable annuity plan in this country, the College Retirement Equities Fund, was created in 1952 by the New York Legislature, acting upon the recommendation of a commission composed of educators and leading businessmen, for the purpose of providing educators, policyholders in the Teachers Insurance and Annuity Association of America, with an annuity which would respond more flexibly to changes in the economy and thus furnish constant purchasing power.

Teachers Insurance and Annuity Association is a non-profit legal reserve life insurance company, founded in

28 DeWaerdy, Rotterdam, Netherlands.
1918, and incorporated under the laws of the State of New York. Its policyholders represent some 650 educational institutions, and the company provides for these policyholders the ordinary type of guaranteed fixed-dollar retirement income. The idea of CREF was developed by the trustees and officers of the company after painstaking study, in response to a widespread demand for an attempt at protection from the depletion of a fixed-dollar retirement income by an inflationary economy. Participation in the plan is purely voluntary for the individual but, since 1952, more than 25,000 college teachers and staff employees have joined the program. Funds are invested exclusively in common stocks and its assets presently total well over thirty million dollars.

Under the two part program, which affords the annuitant a balanced income, part from CREF, determined by the value of the fund’s common stock holdings, and part from fixed-dollar income provided by TIAA, the educator may, for instance, pay five to ten per cent of his annual salary in premiums, to which the participating institution normally adds a like amount. He is permitted to designate either a quarter, a third or a half of his annual premium for CREF participation. The portion allotted results in credit of accumulation units to the contract at their current value under a continuing program of monthly revaluation. Thus, where the unit value rises, fewer units are credited, and when it drops, more units are credited for the same consideration.

The participant continues to acquire accumulation units until he reaches his retirement date. Dividends received from stocks held in the fund are credited to the contract holders in the form of additional accumulation units. When a member retires, his accumulation units are changed into retirement units, the exchange rate being determined by customary actuarial computations. The
retirement income values of the annuity units vary from year to year, depending on expenses, dividend experience, mortality experience, capital gains and market value of common stock investments. Under this procedure, since its creation, CREF has paid out monthly for each annuity unit $10 for the fiscal year 1952-53, $9.46 for 1953-54, $10.74 for 1954-55, and $14.11 for 1955-56.

As has been noted earlier, the New York Insurance Department which supervises CREF's operation has approved its certificate forms containing the phrase "unit annuity" in referring to the variable benefits plan, and has advised that the variation in amounts of payment does not prevent these payments from constituting an annuity.

In the preparation of the brief filed by the Teachers Insurance and Annuity Association of America with the Commissioner of Internal Revenue, which resulted in the ruling that a variable annuity constituted an annuity within the meaning of the Internal Revenue Code, opinions were solicited from a number of experts in the field. Six outstanding actuaries and economists expressed their opinion that a variable annuity is properly classified and defined as an annuity.

For example, the following opinion was given by Joseph B. Maclean, author of the standard treatise on life insurance:

In my opinion such an agreement is properly classified and defined as an annuity contract. The essential characteristic of a "life annuity" in my opinion is a provision for payments at stated intervals during the lifetime of the annuitant.

While annuity contracts, in general, specify the amounts of the payments to be made, a provision that the amount of each payment is to be determined at the date of payment on the basis of a specified rule or formula (so that the amount of each payment is, in fact, de-

29 See note 18 supra.
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termined by the terms of the agreement) does not, in my judgment, alter the fundamental character of the agreement as an annuity contract.

It will be noted that Mr. Maclean emphasized the fact that under a variable annuity proposal of the type here involved, the amount of each payment was to be determined at the date of payment on the basis of a specified rule or formula set out by the controlling agreement. Once again, that is certain which can be made certain.

V. WRITING OF VARIABLE ANNUITIES CONSTITUTES DOING INSURANCE BUSINESS

The proposed variable annuities will involve actuarial and mortality computations which are an appropriate part of the general powers of life insurance companies. As previously stated, the intention of the variable annuity program is to make available contracts which provide an income to continue for the lifetime of the annuitant determined scientifically in accordance with actuarial principles of life contingencies, liquidating a principal sum exactly over the uncertain period of the annuitant's lifetime. The actuarial considerations which must comprise the determination of this type of distribution with use of mortality tables are within the traditional functions and technical competence of life insurance companies. Aside from the emphasis on common stocks in the investment fund, the predominate feature in a variable annuity is an actuarial, risk-pooling feature. The granting of annuities on a commercial basis is essentially a life insurance company function.

Generally under a variable annuity contract, the company as a whole guarantees the mortality and expense aspects of the contracts, and the only contractual vari-
ations in dollar values of units and benefits is reflected from the investment results of the segregated account. The issuing company assumes the risk that the mortality of the group holding variable contracts may be less favorable than anticipated at the time the annuity is issued and further assumes the risk that the expenses of the operation may be greater than allowed for in the loading provided by the contract. Thus the outlined variable annuity plan amounts to something quite different than the mutual sharing by the participants of a mortality and expense risk. Since variable annuities are based upon mortality tables, and upon mortality guarantees, they come within the logical functions of life insurance companies.30

In most states issuance of annuities is recognized in the applicable statutes as one of the powers of companies selling life insurance.31 Illustrative of this is the Maine statute, which reads as follows:

All corporations, whether incorporated in this state or elsewhere, which issue contracts whereby such corporations, in consideration of a premium to be paid annually or otherwise, agree to pay an annuity commencing in the future, or a sum fixed or to be ascertained by given methods, are made subject, in relation to doing business in this state, to all the provisions of law relating to life insurance, including all provisions relating to taxation.32

30 This conclusion is emphasized by leading textbook authorities. See Cyzio, Your Insurance — Its Problems and Their Solution 128 (1938), where the author states: “Since both life insurance and annuities are based on the mortality tables, logically they come within the province of insurance companies.” See also Magee, General Insurance 738 (4th ed. 1953): “The annuity is not strictly a life insurance contract. It is, nonetheless, insurance. Fundamentally it distributes funds, together with earnings thereon, in such a manner that payments will continue during the lifetime of the annuitant.”


Normally the power to issue annuities is not set out in a separate subsection of the statutes authorizing the writing of various "kinds of insurance," but is included in the same subsection which relates to the power to sell life insurance. Section 70 of the New York Insurance Law is illustrative of such a plan. In a letter to the Superintendent of Insurance, the Attorney General of New York clearly pointed out the New York provision when he stated:

Section 70 of the Insurance Law provides in part:

§ 70. Incorporation. Thirteen or more persons may become a corporation for the purpose of making any of the following kinds of insurance:

1. Upon the lives or the health of persons and every insurance appertaining thereto, and to grant, purchase or dispose of annuities."

This section provides who may form a corporation for insurance purposes and proceeds to specifically enumerate in the subdivisions thereof the kinds of insurance which the corporation may make. The language in the first paragraph of the section "the following kinds of insurance" followed in subdivision 1 by the words "annuities" plainly indicates that the Legislature intended by the use of the word to designate an insurance.33

Later in this same opinion the importance of the mortality provision in determining whether a contract is an annuity is emphasized:

The fixing of the mortality table as the minimum standard for the valuation of annuities by the provisions of subdivision 5 of Section 84 of the Insurance Law presupposes the presence of the feature of mortality risk. So also does the provision for adjustment in the case of misstatement of the age of the person or persons upon whose life or lives the contract of annuity it based, as found in subdivision 4th of section 102 ½ of the Insurance Law. The mandatory character of this provision leads one to the conclusion that the Legislature contemplated

33 Insurance Department Ruling, N.Y. 4 (1931).
no annuity except one where the risk was dependent upon age.\textsuperscript{34}

It is also important to note that under the statutes of many states prescribing penalties for doing an insurance business without a license the statute includes reference to writing annuities.\textsuperscript{35} This is another recognition that annuities involving life contingencies are a logical function of life insurance companies and, aside from those issued by charitable institutions, they normally cannot be issued at all except by an insurance company. It is appropriate to point out that reference is made only to the sale of annuities to the public by a business organization established for that purpose and not the myriad contracts and arrangements that might be used by individuals dealing with their own affairs.

Despite what appears to be an overwhelming weight of authority to the contrary, occasionally it is contended that the variable annuity is not properly a life insurance company product; that the purchase of such a contract is simply an investment in common stocks, and therefore, that the variable annuity contract is a "security," the sale of which must be registered with and regulated by the Securities and Exchange Commission.

The variable annuity is not a security or an investment in common stocks. Spreading distribution of a capital amount and the earnings therefrom over a lifetime in accordance with scientific tables of mortality is a traditional function of life insurance companies. They are the only type of business organization which can use this annuity principle. Annuities are neither securities nor an interest in securities, regardless of whether the assets behind them are invested primarily in bonds and mort-

\textsuperscript{34} Id. at N.Y. 5

\textsuperscript{35} See e.g., N.J. Stat. Ann. § 17:17-12 (1939) which prohibits the unauthorized transaction of an insurance business in the state, specifically, "including annuities involving life contingencies. . . ."
gages and in lesser amounts in stocks, as at present, or primarily in stocks, as proposed for future variable annuity contracts. As an example of the numerous legal and practical differences between an “annuity” and a “security,” it should be pointed out that once the security is transferred, the transferor is out of the picture. However, if an annuity is assigned the transferee receives an annuity contingent upon the continued survival of the original annuitant. In the case of deferred annuities, as under the typical group annuity contract, receipt of any benefit payments is contingent upon the survival of the participating annuitant until the retirement date.

Nor are variable annuities similar to mutual fund shares. Mutual funds cannot legally use the annuity principal because they are not authorized to relate distributions to mortality tables. They do provide a diversified investment that permits getting in and out of the stock market at will. Variable annuities, on the other hand, are designed for long-term retirement planning purposes and, under the plan proposed by the Prudential company, an annuitant could not withdraw faster than over a period of three years before retirement.

VI. INSURANCE EXEMPTIONS UNDER FEDERAL SECURITIES LAWS

The controversy about variable annuities and the Securities and Exchange Commission involves two fundamental questions which will be discussed in this and in the following section. These are: (1) are variable annuities presently subject to the federal securities acts administered by the SEC and (2) if presently exempt, should variable annuities be made subject to such acts?

There are four federal acts, portions of which have some
application to this discussion: the Securities Act of 1933\textsuperscript{36} (hereinafter referred to as the 1933 act); the Investment Company Act of 1940\textsuperscript{37} (hereinafter referred to as the 1940 act); the Securities Exchange Act of 1934\textsuperscript{38} (hereinafter referred to as the 1934 act); and the McCarran-Ferguson Insurance Regulation Act\textsuperscript{39} (hereinafter referred to as the McCarran Act).

Basically, the 1933 act requires the filing of a registration statement and the issuance and delivery of a prospectus in connection with public sales of securities. Section 2(1) of this act, in material part, defines "security" as follows: "The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, . . . investment contract, . . . or, in general, any interest or instrument commonly known as a "security" . . . ." Section 3(a) of the 1933 act contains a clear and unmistakable exemption of insurance contracts, as follows: ". . . The provisions of this title shall not apply to any of the following classes of securities: (8) Any insurance . . . or annuity contract, or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . or any . . . officer performing like functions, of any state . . . ."

Initially, it is apparent from this act that annuities, when issued by an insurance company subject to the regulation of a state insurance department, have been specifically labeled by Congress as outside those classes of contracts which the 1933 act was intended to affect.

Emphasizing this intention, the House Report, commenting on this section, states:

Paragraph (8) makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.40

The underlying and avowed purpose of the 1933 act, as well as the other federal and state security acts, is the protection of the public through the requirement of full disclosure of all material facts bearing upon a purchase or investment. Where there was already an adequately supervised procedure of disclosure, further control was considered to be unnecessary and an exemption was given. Insurance and insurance companies, under the codes of the several states and the supervision of state insurance departments, are subject to the most exacting qualifications and disclosure requirements.

A careful scrutiny of available case law fails to disclose a single instance in which a life insurance annuity contract has been held by any court to be a security within the meaning of a securities law. On the contrary, in those cases where application of the various state “Blue Sky” laws was sought to be imposed upon insurance companies, the courts have consistently upheld the exemption of such contracts. In a very recent case the court stated that it did “not recall a single instance in which we have heard an annuity called a security either by the learned or the vulgar.”41 The court in this case stressed the importance of the “risk-sharing” element in an annuity, stating:

While annuities are sometimes called investments, that is not an apt characterization. Indeed, it is not unusual to hear a person say he is investing in a new suit or a new car, but the essence of such transactions is really quite different. An annuity is also quite different; what makes it essentially an annuity is that it is a form of risk-sharing. In life insurance, the risk from which protection is usually sought is that the insured may die young without provision for his dependents; in an annuity, the risk is that the annuitant may live long, outliving his means for his own support. To the extent that insurance or annuities are risk-sharing, they are certainly not investments. It is true that investment or other objectives can be combined in such plans, but they are not of their essence.\(^4\)

Similarly, in *Bates v. Equitable Life Assurance Soc'y*,\(^43\) it was held that contracts providing for periodic lifetime payments are not "securities" where the "... basis upon which the promised payments were to be met is founded upon actuarial computation based upon the experience furnished by authentic mortality tables. ..."\(^44\)

Where a policy holder sought to cancel two annuity contracts on the ground that the defendant had not complied with the Blue Sky law, the court in *Hamilton v. Penn Mutual Life Ins. Co.*,\(^45\) held that the contracts were not subject to such requirements, saying:

> These annuity policies, though not life insurance policies, are such as a life insurance company is authorized to issue and therefore are subject to the provisions of our statute regulating the business of life insurance companies, ... and not to the requirements, in this connection, of the Blue Sky Law.\(^46\)

Furthermore, the exemption of annuity contracts of the
fixed-dollar variety from the provision of the 1933 act has not been questioned. Conceivably, a variable annuity contract hypothecated upon an investment predominantly in bonds and other debt securities would likewise not be so questioned. Yet, throughout the controversy about the applicability of the 1933 act to variable annuities, there is apparently an assumption that relating such a contract to equity investments in some manner voids the exemption given to fixed-dollar annuities. This assumption is without justification.

The definition of "security" in section 2(1) clearly specifies that bonds are as fully securities as are common stocks. Nothing in the 1933 act can be said to emphasize or prefer one class of securities over the other. Neither is there any implication whatever in the law that section 3(a) (8) exempts annuity contracts only if they are keyed to debt security investments or that the exemption does not apply if such contracts are keyed to equity investments. In view of the pattern of state laws against which this federal legislation must be interpreted, an insurance company's authorized investment of its assets in one or the other class of securities should not distinguish the contracts which these investments sustain.

For many years prior to the enactment of the federal securities laws, the granting of annuities of any kind was specifically construed under state statutes to be a part of the life insurance business. Similarly, in many states the laws governing investments by insurance companies permitted extensive or unlimited investment of insurance company assets in common stocks. New Jersey, for example, has imposed no limit whatever on overall common stock investment by insurance companies since 1904, although under present law, investment by a life insurance company in the stock of any one corporation is limited to twenty per cent of any class of voting stock of such cor-
As a consequence, in these jurisdictions, life insurance companies have enjoyed the authority to issue contracts, including annuity contracts, keyed largely or entirely to common stock investments, although this authority may not have been extensively utilized.

It is proper to assume that Congress had full knowledge of the existence of these state laws regulating life insurance company investment powers, and the authority conferred by these laws at the time the 1933 act was passed and its exemption provided, for the court in Prudential Ins. v. Benjamin, in referring to the action of Congress in passing the McCarran Act, stated: "... Congress must have had full knowledge of the nation-wide existence of state systems of regulation and taxation [of insurance companies]..."

Nothing appears in section 3(a)(8) of the original 1933 act to the effect that an annuity contract, in order to qualify for the exemption, must guarantee a predetermined level of benefits or employ certain minimum assumptions as to mortality or investment results. In fact, no qualifications, restrictions, or requirements whatever are attached to the word "annuity" except that it must be a contract issued by a company subject to the supervision of a state insurance commissioner. According to the statute, it is this insurance department control, without regard to the characteristics of the annuity, which secures the exemption for the contract. Without such supervision, though the annuity might be eminently fair and desirable, the exemption would not apply. In view of this absence of qualification, there can be no logical reason for attempting to construe the exemption afforded as applying only to fixed-dollar annuities and not to variable annuities. This is especially clear when one considers that any mutual life insurance company

48 328 U.S. 408 (1946).
49 Id. at 430.
could obtain a variable annuity type effect with fixed-dollar annuities through the employment of extremely conservative investment projections, achieving variation through the payment of unusually large insurance dividends. Such a plan might be inequitable to those annuitants who purchased their contracts at different times, and would certainly be difficult to manage, yet it would qualify for the exemption of section 3(a)(8). The straight variable annuity approach, unencumbered by the subterfuge of unrealistic fixed benefit minimums dependent upon large insurance dividends for acceptability, is certainly a much more direct, understandable, and equitable procedure for attaining the desired result.

A construction of the term “annuity” so as to require a guaranteed minimum benefit constitutes alteration of section 3(a)(8) by impliedly adding standards and restrictions relating to the basic investment assumption of the annuity contract. There can be no more justification for this than there could be for a claim that section 3(a)(8) imposes standards and specifies tests for the mortality assumptions to be used with regard to the contract. Certainly, under a pretext of determining the applicability of the exemption, the Securities and Exchange Commission could not pass judgment on the basic mortality assumptions in an annuity contract. Neither is there any reason why the commission should judge the investment assumptions.

The payment of benefits keyed to investment results is a practice which has been long employed by life insurance companies. A common settlement option under life insurance contracts is one whereunder the proceeds of the policy are held by the company at interest. The rate of interest is generally specified as a stated percentage plus whatever additional amount the board of directors might allow. This additional amount is allowed only if it is justified by the company’s investment earning experience.
Over the years there has been a considerable variation in the actual amounts paid by any given company under this type of option.

As previously indicated, a life insurance company would assume risks in the issuance of variable annuity contracts because of the guarantee of mortality and expense assumptions. There can be no basis whatever for a contention that the assumption of an investment risk is a necessary characteristic of a life insurance company contract. In fact, there are issued many types of contracts, such as term policies and a large proportion of group insurance policies, which involve practically no investable reserves, and therefore have non-existent or negligible assumptions as to investment return.

Since the only standard imposed by section 3(a)(8) of the 1933 act is that the company must be subject to the supervision of a state insurance commissioner, it seems obvious that Congress intended to leave to such commissioner the determination whether a particular contract was properly designated as an insurance or annuity contract. There nowhere appears an indication that Congress expected that this determination would be either made or reviewed by the Securities and Exchange Commission or any other federal agency. The question of whether and to what extent risk was to be assumed by the company could be resolved only upon the basis of actuarial analysis of the assumptions underlying the contract and it would be absurd to assume that the SEC was supposed to attempt to make these endless determinations. The SEC historically has concurred in this conclusion, for there is no indication that it has ever attempted to pick and choose among contracts of life insurance companies on the basis of the presence, absence, or extent of risk assumption.

The most reasonable and workable interpretation of the exemption is that all such technical distinctions were to
be left to the determination of state insurance departments and that anything they might designate as an insurance or annuity contract comes within the exemption. It must be kept in mind that the exception is not applicable merely to the contracts of life insurance companies, but relates as well to the wide variety of contracts issued in the fire, casualty, marine and other insurance lines, some of which may involve little or no risk to the company. Certainly it was never intended that the SEC should attempt its own independent investigation as to the risk involved in all the endless complicated types of insurance contracts covering all lines of insurance.

The 1940 act relates only to "investment companies" and specifically provides that a company, organized as an insurance company and subject to the supervision of a state insurance department, is not an investment company if its primary and predominant business activity is the writing of insurance contracts.50

The language of this exemption from the definition of "investment company" became the basis of a suit for injunction by the Securities and Exchange Commission against the Variable Annuity Life Insurance Company. The complaint alleged that the company, whose business is devoted solely to the sale of variable annuities with additional life insurance features, was primarily engaged in the business of investing, reinvesting and trading in securities within the definition of an "investment company" contained in the 1940 act; that the VALIC contracts constituted investment contracts and certificates of interest or participation in a profit-sharing agreement within the definition of the term "security" contained in the 1933 act; and that consequently VALIC must first register with the SEC under both acts before proceeding with the sale of its contracts. The commission claimed jurisdiction be-

cause the company was organized and chartered and has its principal place of business in the District of Columbia.

The action is being defended on the basis that VALIC is a life insurance company, supervised and regulated by a qualified insurance department; that the exemptions from the federal securities acts apply; and that its contracts are insurance contracts.

Section 24(d) of the 1940 act states that the exemption provided by section 3(a)(8) of the 1933 act "... shall not apply to any security of which an investment company is the issuer." This section thus interrelates the provisions of the two acts in so far as they have a bearing on the insurance business. The 1940 act does not purport to list or refer to the various types of contracts which may be issued in the course of the "writing of insurance." The reference to insurance in section 2(a)(17) of the 1940 act is of the broadest and most general nature. In view of the aforesaid statutory interrelation, it follows that the writing of any contract which fits within the insurance exemption of section 3(a)(8) of the 1933 act constitutes the writing of insurance within section 2(a)(17) of the 1940 act.

In passing, it should be noted that, like section 3(a)(8) of the 1933 act, section 2(a)(17) of the 1940 act contains no standards, requirements, or qualifications to be met by "insurance," nor are there any specifications relating to investment or mortality assumptions, or other characteristics of any contract. Once again, there is no basis for assuming that the SEC was expected to analyze individually specialized contracts issued by insurance companies to determine whether and to what extent they qualified as "insurance." Rather this determination was intended to be left to the supervising state insurance departments.

The 1934 act, inter alia, regulates brokers and dealers selling securities, requires reports, and imposes controls upon companies whose securities are listed on national
securities exchanges. In view of what has been said with regard to the exemption of insurance company contracts under the 1933 act, it does not appear that the 1934 act would have any application to variable annuity contracts issued by a life insurance company.

VII. THE McCARRAN ACT

It is clear that none of the federal securities acts purport to regulate the "business of insurance." In fact, each of these acts specifically exempts such business from the effect of its provisions. In enacting the Securities Act of 1933, the act of 1934, and the Investment Company Act of 1940, Congress acted under the power afforded by the commerce clause of the federal Constitution. Under this clause, Congress may assume control of a particular phase of interstate commerce by specific enactment; it may decline to "occupy" an area through failure to take positive action; or it may specifically express an intention that control over a particular area be maintained by the state or states involved. The effect of either of the last two courses of action would be the same, but as to the business of insurance, the latter of the two courses was followed.

Section 2 of the McCarran Act provides:

(a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business,

(b) No act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: Provided, that after January 1, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known
as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.\(^5\)

Although insurance companies are thus susceptible to being made subject to both state and federal control, federal regulation under present congressional policy is limited to areas in which the states have not undertaken regulation. The acts specifically enumerated in the McCarran Act were inapplicable to insurance companies until January 1, 1948, and thereafter were applicable only to the extent that insurance was not regulated by state law. It will be noted that there is no enumeration of the various federal securities acts in section 2(b) and accordingly, as to these acts, section 2(a) applies with full force and effect to exclude their application under the familiar doctrine that *inclusio unius est exclusio alterius*.\(^2\)

VIII. **STATE V. FEDERAL REGULATION**

Just as there is no justification for contending that the sale of variable annuities comes within the purview of existing federal securities laws, there is no reasonable basis for making such sale subject to federal regulation. The laws presently regulating the insurance industry adequately assure the public of all necessary protections and they are far more effective controls than might be imposed by the SEC. The proposals advocating federal regulation seem to ignore completely the far-reaching and comprehensive regulation of insurance companies by state departments.

A prime example of this attitude may be found in a recent case\(^3\) involving a Texas corporation licensed to

\(^{52}\) State ex rel. Whall v. Saenger Theatres Corp., 190 Miss. 391, 200 So. 442, 446 (1941).
conduct an insurance business in fourteen states, including Texas. Asserting that brochures, distributed to agents outside of Texas and shown by them to prospective insureds, contained advertising material which was false, misleading, deceptive, and violative of the Federal Trade Commission Act, the FTC issued a complaint against this corporation. Noting that each of the states involved, except Mississippi, had statutes prohibiting the distribution within its borders of insurance advertising material which was false or misleading and that, therefore, such states fully regulated the business of insurance in this connection, the hearing examiner determined that the McCarran Act had removed FTC jurisdiction over such advertising and dismissed the complaint. By a three to two majority, the FTC on appeal reversed the examiner's finding and asserted jurisdiction. The Court of Appeals for the Fifth Circuit unanimously reversed, interpreting the McCarran Act to exclude FTC jurisdiction.54

As pointed out by the dissenting members of the commission and by the court of appeals, the commission decision did violence to the plain language of the McCarran Act limitation that "... the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law," and ignored the clear expression of congressional intent that the states continue to regulate the business of insurance. In so doing, the commission implied that the McCarran Act had no effect whatsoever, and, perhaps, questioned the power of Congress to exercise its control over certain areas of interstate commerce by consenting to state legislation.55

54 American Hospital and Life Ins. Co. v. FTC, No. 16132, 5th Cir., April 9, 1957.
55 See 32 Notre Dame Law. 319 (1957).
Aside from purely legal considerations, what is the practical valuation that might be placed on each of the alternative forms of control? It is a popular misconception that the Securities and Exchange Commission approves securities issues and thus in some sense guarantees to the buyer that he is making a good investment. Quite to the contrary, it is a criminal offense to make any statement to the effect that the SEC has "approved" a registered security and every prospectus must so state on its face. In reality, the SEC merely requires "full disclosure" by specifying that the prospectus reveal the pertinent facts concerning the security about to be issued. It makes no assertion whatever about the soundness of a particular security.

In a recent speech, SEC Chairman J. Sinclair Armstrong said specifically that, "... the Federal securities laws do not, and, I hope never will, give the Commission power to pass on the merits of securities." 56

At a "Fulbright Committee" hearing in March, 1955, Mr. Harold E. Wood, Chairman of the Board of Governors of the National Association of Securities Dealers, was asked about a particular SEC prospectus, and particularly whether he would call it a reasonable promotion. His reply, bearing on the effectiveness of SEC control, is most enlightening: "No; of course I wouldn't. Of course, that is all covered, Senator Fulbright, by full disclosure, and when the issue is registered with the SEC and there is a full disclosure, they are helpless and we are helpless to do anything about that." 57 Asked by the chairman whether this helplessness was a healthy situation, Mr. Wood replied that, "... if you do anything else, though, than required a full disclosure, you are getting into a paternalistic situa-

56 Address by SEC Chairman J. Sinclair Armstrong, Investment Bankers Association of America Meeting, November 26, 1956.
57 Hearings Before the Senate Committee on Banking and Currency, 84th Cong., 1st Sess., at 325 (1955).
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tion." One further pertinent comment made by Mr. Wood at this hearing was his statement that, "When you come to the question of prospectuses there is also the problem that people just do not read them." How effective, then, is a control and supervision whereunder any type of security may be sold so long as the "pertinent facts" are contained in a prospectus the potential purchasing public is not expected to read, the enforcing agency being then "helpless" to do anything further? What special protections are offered to the public under a system of regulation where the philosophy, as expressed to a congressional subcommittee by Mr. Keith Funston, President of the New York Stock Exchange, is to the effect that: "If some Americans refuse either to read or believe the true facts about an enterprise and persist in throwing their money away, then their losses are the price we must pay in a free society for the right to invest or speculate as we please."

The situation is much different when it comes to approval by state insurance departments of insurance policies and annuity forms. The pending New Jersey variable annuity legislation would give to the Department of Banking and Insurance the broadest type of regulatory power, not only over the variable annuity contract forms, but over advertising and sales methods as well. The Department would be required to pass, not only on whether the facts are disclosed, but on whether the variable annuity contract is just, fair, and equitable. In other words, it would pass on the substance and the content of the contract and not only on its form. Even people who "refuse either to read or believe the true facts" are protected by the state agency control.

There are, of course, more obvious reasons why state

58 Ibid.
59 Ibid.
control in this field must certainly be more effective and more satisfactory than federal control, and not the least of these is familiarity with the specialized subject matter. The state insurance departments have built up a vast wealth of experience and knowledge relating to the general insurance business and all forms of life insurance policies and annuities. In the particular field, the commissioners and their staffs are thoroughly familiar with the principles of sound annuity writing and are equipped to properly evaluate every aspect of this business. The complex actuarial arithmetic on which annuity contracts are based singularly illustrates the difference between a variable annuity and the type of contract with which the federal regulatory commission has training or experience. Moreover, if this is true about the individual contract, consider the group contracts on a variable basis covering qualified employee pension plans. The federal regulatory authorities are far less equipped to deal with that complicated specialized field of insurance.

Another fallacy in the argument that federal regulation is necessary becomes apparent in view of the fact that a big part of the “trusteed pension plan” competition which insurance companies face in the pension field is not subject in any way to the far-reaching regulation to which life insurance companies must submit in their group annuity operations. It seems incongruous that a trusteed variable annuity plan need not have to be regulated at either the state or federal level, but that if a life insurance company does the same thing, it must be regulated at both levels.

Aside from these distinctions in the efficiency, experience, thoroughness, and desirability of the two forms of regulation, certain other problems would arise under a system of dual control, which weigh strongly against the adoption of such a system. The likely creation of controversy and doubt as to jurisdiction and methods of forcing
compliance certainly cannot be said to recommend the controls suggested. For example, SEC jurisdiction might well result in conflict with state insurance regulation and taxation in the areas of accounting procedures and forms; control of company operation through required deposits against liabilities; premium taxes; disposition of earnings; maintenance of reserves; examination of insurance companies; content of policies; prohibitions against misrepresentation and discrimination; control of advertising and sales methods; and federal income taxation. Insofar as the requirements of SEC control would differ from the existing system of regulation prescribed by the state insurance departments so as to require two distinct procedures where possible, or the choice of one when necessary, as seen from the discussion of the McCarran Act,61 such assumption of control by the SEC would constitute a contravention of expressed congressional intent, as it appears in that act, by an administrative agency.

IX. Conclusion

It is not necessary to emphasize the current and continuing need for an economic tool designed to meet the problem presented by the impact of cost-of-living changes on long-term retirement plans. The life insurance industry as a whole has a responsibility to cooperate with the initiative, thrift, and self-reliance of the great mass of average wage earners in order to provide them with effective security plans. The variable annuity principle is singularly adaptable to this end, and in fact is the only workable approach to the problem which has yet been suggested.

61 See text, VII. The McCarran Act.
The complex and thorough system of state regulation grown out of years of experience has adequately and efficiently controlled the insurance industry to secure the maximum degree of protection; this same control will effectively be extended to the issuance and sale of variable annuity contracts. For both legal and practical reasons, there is no justification for intervention in this regulation by a federal agency.

Since the foregoing article was prepared, there have been several pertinent developments in the variable annuity field. The S.E.C.'s suit for injunction against VALIC went to trial on June 10, 1957.62 The National Association of Securities Dealers, Inc., was granted permission to intervene as party plaintiff and The Equity Annuity Life Insurance Company, whose situation is quite similar to VALIC's, has joined as party defendant. As of this writing, no decision has been rendered.

In West Virginia, VALIC successfully defended, against an ex parte action by the state securities commissioner, its right to do a variable annuity business in that state. Without any prior hearing, the commissioner by letter attempted to order VALIC "to cease and desist" the offering or selling of "securities" in West Virginia. VALIC immediately pointed out the illegality of the purported "cease and desist" letter, the identity of the issues in the S.E.C. v. VALIC case and the arbitrary rejection by the commissioner of all suggestions looking to an amicable disposition of the controversy. On February 8, 1957, VALIC brought suit for declaratory judgment. The judge of the Circuit Court of Kanawha County, West Virginia, on March 14, 1957, held that there was no statutory authority for the purported "order," concluded that there was nothing before him for judicial review, and dismissed without prejudice to such other action

as VALIC might determine should be taken. VALIC has, without further interference, resumed the sale of variable annuities in West Virginia.

The sufficiency of state systems of regulation in this area has been borne out in Connecticut. In the recent case of Spellacy v. American Life Ins. Ass'n, the Supreme Court of Errors of Connecticut has held that a fraternal benefit society may not, under the state law governing fraternals, issue variable endowment policies. While the decision would not be binding on an insurance company seeking a license to do a variable annuity business in that state, since it would not be a fraternal society, one cannot quarrel with the proposition that the decision was within the scope of state regulation. The laws of the several states as to the admission of foreign companies to do business, as well as the authority of domestic companies, are not identical and any insurance company must accept the necessity of qualifying under the laws of a particular state if it wishes to do business there. The state courts are the appropriate forums to decide the status of variable annuities under the various state statutes.

By unanimous vote in June, both houses of the Wisconsin legislature passed three bills (Wisc. S.196, S.401 and S. 491) which would incorporate a variable annuity program, on much the same basis as the C.R.E.F. plan, into that state's retirement system for state employees. These bills are presently before the governor for signature.

J. Edward Day*

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64 — Conn. —, 131 A.2d 834 (1957).

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