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Divisional Reporting and the Insurance Company Exemption

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DIVISIONAL REPORTING AND THE INSURANCE COMPANY EXEMPTION

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INTRODUCTION

It is a long-standing rubric of federal securities regulation that the public investor must be afforded the fullest possible disclosure of all pertinent and material facts.[1] That philosophical tradition is evident in the new regulations and forms[2] promulgated by the Securities and Exchange Commission.

The new regulations affect a broad spectrum of companies, including those having securities traded over-the-counter and which are subject to the Exchange Act.[3] Companies which are exempted[4] from the provisions of the Exchange Act[5] are not, however, directly affected by the new reporting regulations. Companies operating in the multi-billion dollar insurance industry are the most significant exemption.[6] The extent to which the insurance company exemption is "conditional" will be examined hereinafter.

Basically, the regulations declare that, whatever the corporate structure, when a business enterprise conducts two or more operations, the success of each being more or less independent of the other, the public investor is not adequately informed as to the company's prospects and performance

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1 "Disclosure is and has from the outset been a central aspect of national policy in the field of securities regulation." SEC, DISCLOSURE TO INVESTORS, A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 10 (CCH ed. 1969) [hereinafter cited as THE WHEAT REPORT]. *See also* 1 L. LOSS, SECURITIES REGULATION 122-28 (2d ed. 1961).

2 *See* 1 CCH FED. SEC. L. REP. ¶ 7123, at 6202; ¶ 7192, at 6313 (1969); 2 CCH FED. SEC. L. REP. ¶ 27,303, at 21,303; ¶ 28,402-405, at 21,502-511 (1969).

3 Securities Exchange Act of 1934, 48 Stat. 892 (1934), *as amended*, 15 U.S.C. § 78*l*(g)(1) (1964).

4 48 Stat. 892 (1934), *as amended*, 15 U.S.C. § 78*l*(g)(2) (1964).

5 48 Stat. 892, 894-96 (1934), *as amended*, 15 U.S.C. §§ 78*l*(g), 78m, 78n, 78p (Supp. IV, 1969).

6 48 Stat. 892 (1934), *as amended*, 15 U.S.C. § 78*l*(g)(2)(G) (1964). The subsection (G) exemption does not exempt insurance companies whose securities are listed on a national securities exchange. However, very few insurance company securities are listed. *See* note 25 *infra* and accompanying text. Subsection (G) does not exempt insurance companies from the registration provisions of the Securities Act of 1933, 48 Stat. 74 (1934), *as amended*, 15 U.S.C. § 77a (1964), when the company undertakes a public offering of its securities in interstate commerce. The impact of the subsection (G) exemption is with respect to disclosure by insurance companies to the millions of existing shareholders and the public who purchase outstanding shares of insurance companies on the over-the-counter market. Improvement of investor protections in this area of the securities market place was a principal purpose of the Securities Acts Amendments of 1964. *See* notes 21 and 22 *infra* and accompanying text.

unless there is available to him the material information on each division or operation. In such companies consolidated reporting, particularly of financial operations, may in reality obfuscate more than disclose. The business of insurance companies fits precisely into this pattern. Yet, by reason of their exemption, the financial information which experience has established is essential to informed investment judgment, and which now will be available as to most companies, need not be provided by insurance companies to their shareholders or the public investor. This vast loophole in the investor protections provided by the federal securities laws is no longer (if, in truth, it ever was) tolerable.

INSURANCE IS BIG BUSINESS[7]

On December 31, 1968, the assets of life insurance companies in the United States amounted to $188.6 billion,[8] an increase of $10.8 billion during the year[9] as a result of the addition of $9.9 billion in "new" funds and a net increase of $898 million "in valuation of assets previously held."[10] Of this enormous sum, approximately 30 percent was held by shareholder-owned insurance companies.[11] These assets were invested in diverse securities.[12]

The Institute of Life Insurance further reports:

> Growth in the number of life insurance companies in the United States has been rapid since the end of World War II. At the end of 1945, there were 473 U.S. legal reserve companies in operation; by mid-1968, the number had nearly quadrupled, to 1,761. By the end of 1968, the number had reached an estimated 1,775.
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> From the beginning of 1950 to the middle of 1968, a total of 2,084 companies were added to the list of life insurance companies in business. The great majority of these were newly-formed companies. . . .
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> . . . Of the 1,761 companies in business at mid-year 1968, 1,605 or more than nine-tenths, were owned by stockholders.[13]

Additionally, by the end of 1966, 792 stock, property and liability insurers in the United States possessed assets of $31 billion.[14] During 1968, these companies wrote nearly $9 billion in premiums.[15]

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7 Insurance companies are of two types, *viz.*, mutual companies having no shareholders, and stock companies with equity ownership. This article is limited to consideration of shareholder-owned companies.

8 BEST'S INSURANCE REPORTS, LIFE-HEALTH vii (1969).

9 *Id.*

10 INSTITUTE OF LIFE INSURANCE, LIFE INSURANCE FACT BOOK 65 (1969) [hereinafter cited as 1969 LIFE INS. FACT BOOK].

11 *Id.* at 104.

12 *Id.* at 65-68.

13 *Id.* at 102-04.

14 A. MOWBRAY, INSURANCE 444 (6th ed. 1969).

15 Best, the industry statistical authority, reports that property liability insurers wrote $6,886,701,000 in premiums during 1968. BEST'S INSURANCE REPORTS, PROPERTY-LIABILITY xiv (1969).

Considered in the context of a discussion of the new SEC financial reporting requirements and the needs which they were framed to meet, the insurance company exemption appears as an anachronistic anomaly.

THE INSURANCE COMPANY EXEMPTION IN HISTORICAL PERSPECTIVE

From 1869[16] insurance companies had enjoyed a constitutional immunity from Congress' "commerce clause" powers. However, in 1944 the Supreme Court decided *United States v. South-Eastern Underwriters Association*,[17] an antitrust case, which held that Congress did *not* intend to exclude insurance companies from the provisions of the Sherman Act. Congress reacted quickly by enacting the McCarran-Ferguson Act,[18] which provides in pertinent part:

> (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, . . .[19]

Subsequently, in 1961,[20] Congress directed the Securities and Exchange Commission to conduct an investigation of the adequacy of investor protection under the existing securities laws. The Commission undertook the study and in 1963 presented its *Special Study Report* to Congress.[21] The *Report* recommended legislation which would extend proxy rule, insider trading and "registration" (the filing of certain information and periodical reporting of certain material information) requirements to a large number of companies which had theretofore been outside the provisions of much of the Exchange Act. All companies having securities traded over-the-counter, with 750 or more shareholders (reduced to 500 on and after July 1, 1966) and more than $1 million in assets were encompassed within the proposed legislation.[22] The recommendations of the *Special Study Report* were embodied in Senate Bill 1642.[23]

The Commission presented devastating arguments for the inclusion in the proposed legislation of shareholder-owned insurance companies.[24] The Commission found that almost all insurance company stock was traded over-the-counter and therefore was not and is not subject to the rigorous dis-

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16 *See* Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1869).

17 322 U.S. 533 (1944).

18 59 Stat. 33 (1945), 15 U.S.C. § 1011 (1964).

19 59 Stat. 34 (1945), *as amended*, 15 U.S.C. § 1012(b) (1964).

20 75 Stat. 465 (1961), *as amended*, 15 U.S.C. § 78s(d) (Supp. IV, 1962).

21 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. (1963) [hereinafter cited as SEC SPECIAL STUDY REPORT].

22 SEC SPECIAL STUDY REPORT, pt. 3, at 62-64.

23 S. 1642, 88th Cong., 1st Sess. (1963). "A Bill to amend the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, to extend disclosure requirements to the issuers of additional publicly traded securities, to provide for improved qualification and disciplinary procedures for registered brokers and dealers."

24 SEC SPECIAL STUDY REPORT, pt. 3, at 40-42.

closure requirements applicable to exchange-listed securities.[25] Moreover, a large percentage of the insurance companies which the Commission examined had outstanding stock with a market value of $10 million or more.[26] The Commission further reasoned:

> [I]nvestors in insurance companies are no different from those of other types of issuers in the investor-oriented protections they need. There is really nothing at all about State regulation of insurance companies — any more than about State regulation of public utility companies, for example — that differentiates these companies from all others in respect of the need for protection of investors as such.
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> The need for protection of investors in insurance stocks has been established. . . . State regulation of insurance companies, however thoroughgoing and salutary it may be, is not designed to protect investors; . . . .[27]

The proposed inclusion of insurance companies was vigorously resisted by powerful industry spokesmen.[28] Nonetheless, Senate Bill 1642 passed the Senate on July 30, 1963, without an exemption for insurance companies.[29]

Thereafter, the industry associations, and particularly the National Association of Insurance Commissioners (NAIC),[30] obviously concerned by their failure to convince the Senate to exempt insurance companies, adopted a new approach in their lobbying efforts.[31] The arguments presented to the House were much more conciliatory, and much more candid than those presented by the industry spokesmen to the Senate committee. The House Report concluded:

> This committee amendment [exempting insurance companies] was adopted following testimony by a number of State insurance commissioners and representatives of stock insurance companies who unanimously opposed the subjecting of these insurance companies to the jurisdiction of the Securities and Exchange Commission in addition to the jurisdictions of the various State commissioners. . . . The basic objection advanced by these witnesses went not to the requirements for the protection of investors for disclosure but only to the jurisdictional question.
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> The State insurance commissioners through their organization, the National Association of Insurance Commissioners, testified that they recognized some

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25 *Id.*, pt. 2, at 547.

26 *Id.*, pt. 2, at 551.

27 *Id.*, pt. 3, at 41-42.

28 *Hearings on S. 1642, Before A Subcomm. of the Senate Comm. on Banking and Currency*, 88th Cong., 1st Sess. 228-41, 268-77 (1963). The Association of Casualty & Surety Companies and National Board of Fire Underwriters, *id.* at 228, American Life Convention, Life Insurance Association of America and Life Insurers Conference, *id.* at 268, National Association of Life Companies, Inc., *id.* at 275, Chamber of Commerce of the United States, *id.* at 277, were among the organizations opposing the inclusion of stockholder-owned insurance companies within the proposed legislation.

29 78 Stat. 565 (1964), 15 U.S.C. § 78*l*(g)(2)(G) (1964).

30 For a discussion and history of the NAIC, see Murphy, *The National Association of Insurance Commissioners* in EXAMINATION OF INSURANCE COMPANIES 47-56 (A. Straub ed. 1953).

31 PROCEEDINGS OF THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS 514-23 (1964) [hereinafter cited as PROCEEDINGS].

> validity to the contention in the commission's special study report that their procedures were primarily directed to matters concerning the protection of policyholders and to the need for some improvement in these procedures insofar as they relate to the protection of investors in the stock of these companies.
>
> The thrust of the testimony by these representatives of the State insurance commissioners was that they be given an opportunity to demonstrate their ability effectively to protect the investors as well as the policyholders. The committee amendment gives these State commissioners this opportunity to do so.[32]

Based on the representations and assurances of the NAIC,[33] a "conditional"[34] exemption for insurance companies was included by the House in the Securities Acts Amendments Act and remained in the Bill as it became law on August 20, 1964.[35]

THE SECTION 12 "CONDITIONAL" EXEMPTION

The exemption, not *quite* a total rejection of the Commission's recommendations, was made expressly contingent upon the insurance companies

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32 H.R. REP. No. 1418, 88th Cong., 2d Sess. 10 (1964).

33 A key argument of the NAIC to the House Committee was that:

> An NAIC Committee, under the chairmanship of Mr. Stafford Grady, insurance commission for California has recently developed also a "stockholders" information supplement which will become an integral part of the basic form for 1964 and later years.

Id.

It is illustrative of the power of the insurance industry lobbyists, and particularly the NAIC spokesmen, that they were able to convince the Congress to accept their assurance that this "stockholders' information supplement" would answer all of the Commission's well-made arguments for fuller investor disclosure, even though the House Committee apparently did not even have a copy or draft of the proposed form.

34 *See* THE WHEAT REPORT, *supra* note 1, at 210. The Commission's position that the insurance company exemption is "conditional only" is fully supported by the language of the exemption itself and the *Report* of the House Committee which adopted the amendment. The statement and clear qualification (warning?) that the amendment gives the state commissioners the "opportunity" to demonstrate their ability to protect effectively the investors is most significant. *See* note 32 *supra* and accompanying text.

35 48 Stat. 892 (1934), *as amended*, 15 U.S.C. § 78*l*(g)(2) (1964):

> The provisions of this subsection [regulating insider trading and proxy solicitation and requiring "registration"] shall not apply in respect of ——. . .
>
> (G) any security issued by an insurance company if all of the following conditions are met.
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> (i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.
>
> (ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.
>
> (iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 78*p* of this title.

being subject to proxy regulation in such form as the NAIC should provide.[36] In addition, it required that after July 1, 1966, insider trading be subjected to regulation by the domiciliary state "substantially in the manner" provided in the Exchange Act.[37] Thereafter, the NAIC proposed its "Stockholder Information Supplement, Schedule SIS"[38] as its device for proxy regulation, and each state adopted some type of insider trading law, thereby providing, to some degree, the investor protections the Commission had recommended to be included in the statute.

The conditions of the exemption made no provision at all for fuller disclosure to investors other than the fatuous requirement that the exempt company must file an NAIC annual statement[39] — at that time already a requirement in every state and a document which the Commission had persuasively contended was unintelligible to the average investor.[40] The entire exemption fails if the insider trading provisions of the domiciliary state are determined not to be "substantially" the same as those in the Exchange Act.[41] In June, 1964, the NAIC approved a model insider trading statute and urged its adoption by the legislature of each state.[42] The NAIC-proposed statute follows closely the provisions of section 16 of the Exchange Act.[43] The Exchange Act, however, applies to "any class of any equity security" while the state statute applies to "any class of stock." Unless the

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[36] 15 U.S.C. § 78*l*(g)(2)(G)(ii)(1964). Subsection (ii) does not specify a single guideline or direction. The form and manner of state proxy regulation was left completely to the discretion of the NAIC — the very group which had so doggedly contended that existing state regulation was fully adequate and which had so vigorously resisted any change whatsoever. This unprecedented and inexcusable abdication of Congressional responsibility virtually assured that the exemption would create at least as many problems and uncertainties as it might resolve. *See, e.g.*, notes 46, 47, 50 *infra* and accompanying text.

In a 1966 publication of the Subcommittee of the Public Regulation of the Business of Insurance Committee of the Section of Insurance, Negligence and Compensation Law of the American Bar Association, it was observed:

> It may not be desirable or feasible for an insurer to absorb another insurer through statutory merger or consolidation . . . [because of] technical obstacles to statutory amalgamation. . . . [Furthermore] there is wide variation among the states . . . [as to] alternative procedures . . . [to outright merger].

ABA, MERGER OF INSURANCE COMPANIES 175 (1966).

Clearly subsection (ii) did not produce uniformity among the states, and the differing laws of the several states still provide "alternative procedures" which enable the transfer of control of an insurance company without the burden of the "technical obstacles" of state insurance law and regulations.

[37] 15 U.S.C. § 78*l*(g)(2)(G)(iii) (1964).

[38] The form, known as the "SIS" (for "Stockholders' Information Supplement"), was in fact adopted by the NAIC and each state commissioner. A copy first appears in print as an addendum to the NAIC meeting on June 8, 1964 (nearly 13 months after the Senate had passed the bill with no insurance company exemption and just days before the House hearings). *See* PROCEEDINGS at 517-20. By 1969, every state had adopted some form of regulation of insurance company proxies. *See* THE WHEAT REPORT at 211.

[39] 15 U.S.C. § 78*l*(g)(2)(G)(i) (1964).

[40] SEC SPECIAL STUDY REPORT, pt. 3, at 40.

[41] 15 U.S.C. § 78*l*(g)(2)(G)(ii) (1964).

[42] PROCEEDINGS at 514-23.

[43] 48 Stat. 896 (1934), *as amended*, 15 U.S.C. § 78p (1964).

"equity security" coverage is "substantially" the same as "stock" coverage, the entire exemption may not be available.[44]

The net result of the insurance company exemption in the Securities Acts Amendments Act of 1964 was to increase, not lessen, the complexity of securities regulation of insurance companies, and to create a three-tiered regulatory structure — state, NAIC and federal. Overlooked, perhaps, in the states' rights arguments of the insurance industry for state regulation of their securities transactions, is the fact that insurance companies still remain subject to all anti-fraud provisions of the federal acts.[45]

SEC v. National Securities

An action brought by the Commission and culminating in an opinion by the United States Supreme Court in 1969 points up the confusion and inadequacy of the present system of regulation.

In 1966, the Commission challenged the adequacy of the protection accorded insurance company shareholders by seeking an injunction against a proposed insurance company merger which had been approved by the State Insurance Commission.[46] The Commission contended that the proxy materials, notwithstanding their approval by the Arizona insurance commissioner, were fraudulent and that, under the provisions of section 10(b) of the Exchange Act and SEC rule 10b-5, the federal court possessed sufficient power to issue an injunction. The insurance companies convinced the district court and the Ninth Circuit Court of Appeals[47] that by reason of the McCarran-Ferguson Act[48] the federal courts had no jurisdiction. The merits of whether the proxy solicitation was, in fact, fraudulent, were

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44 At first and superficial glance, "stock" (per the state statute) would appear to be more, not less, inclusive than "equity security" (per the Exchange Act). The NAIC model state statute does not define "stock"; nor does the Exchange Act. But the Exchange Act defines "equity security" very broadly:

> The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

48 Stat. 882 (1934), *as amended*, 15 U.S.C. § 78c (a)(11) (1964).

It would seem that convertible securities, such as convertible debentures, options and warrants, are all subject to the federal insider trading provisions and not to the state statute. If so, is this a "substantial" difference in the two statutes?

45 *See, e.g.*, Securities Exchange Act of 1934, § 10(b), 48 Stat. 891 (1934), *as amended*, 15 U.S.C. § 78j (b) (1964); Securities Act of 1933, § 17(a), 48 Stat. 84 (1933), *as amended*, 15 U.S.C. § 77q (a) 1964); SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1970). *See generally* A. BROMBERG, SECURITIES LAW: FRAUD — SEC RULE 10B-5 (1970). *See also* Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (D. Ind. 1968), 259 F. Supp. 673 (D. Ind. 1966).

46 SEC v. National Sec., Inc., 252 F. Supp. 623 (D. Ariz. 1966).

47 387 F.2d 25 (9th Cir. 1967).

48 59 Stat. 33-34 (1945), *as amended*, 15 U.S.C. §§ 1011, 1012(b) (1964).

never reached. The Supreme Court granted certiorari[49] and reversed.[50] The majority opinion, written by Mr. Justice Marshall, seeks to limit the scope of the decision, but while not expressly nullifying the McCarran-Ferguson Act as applicable to securities transactions, the Court's definition of a "securities transaction" as distinguished from "the business of insurance" reaches very much the same result. The decisions reached in *SEC v. United Benefit Life Insurance Co.*[51] and *SEC v. Variable Annuity Life Insurance Co. of America*,[52] where variable annuity insurance contracts were held to be subject to federal securities laws as being, in essence, "securities" as distinguished from "insurance,"[53] foreshadowed the result in *National Securities.*

Insurance company spokesmen presented arguments in 1963 and 1964 that state regulation could and would provide investor protection substantially equivalent to that of federal regulation, if the states were given the opportunity to do so.[54] The *National Securities* case, in microcosm, illustrates that the "opportunity" Congress extended has clearly not been met.

EVERY INSURANCE COMPANY CONDUCTS TWO DISTINCT BUSINESS OPERATIONS

Insurance is, as the industry rightly contends, a unique enterprise which is highly regulated by the states.[55] But in important respects — important from the standpoint of the shareholder and public investor — an insurance company has much in common with other businesses which operate on other people's money.[56] And the need to provide meaningful and understandable financial information to the public investor is every bit as significant in the insurance industry as it is in other industries which operate two or more diverse businesses.

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49 390 U.S. 1023 (1968).

50 393 U.S. 453 (1969). The case has been the subject of a number of notes. *See, e.g.*, 17 AM. U.L. REV. 554 (1969); 10 B.C. IND. & COM. L. REV. 1024 (1969); 20 SYRACUSE L. REV. 811 (1969); 47 TEXAS L. REV. 1238 (1969); 22 VAND. L. REV. 680 (1969).

51 387 U.S. 202 (1967).

52 359 U.S. 65 (1959).

53 Section 3 of the Securities Act of 1933 exempts from registration:

> [a]ny 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, or any State or Territory of the United States or the District of Columbia.

48 Stat. 75 (1933), *as amended*, 15 U.S.C. § 77c(a)(8) (1964).

54 *See* note 32 *supra* and accompanying text.

55 *See, e.g.*, 19 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 69 (1965); 2 G. COUCH, CYCLOPEDIA OF INSURANCE LAW 431-598 (2d ed. 1959); Kimball & Boyce, *The Adequacy of State Insurance Rate Regulation: The McCarran-Ferguson Act in Historical Perspective*, 56 MICH. L. REV. 545 (1958).

Life insurance companies evidently find the state regulation in Arizona most congenial. From 1951 to 1961, the number domiciled in Arizona increased from 4 to 116. *See* SEC SPECIAL STUDY REPORT, pt. 3, at 41-42. This number more than doubled from 1961 to 1969; by the end of 1968, Arizona had the largest number of domestic insurance companies (279) in the nation. *See* 1969 LIFE INS. FACT BOOK at 103-04. The *National Securities* case was a challenge to the Arizona regulation. *See* notes 46, 47, 49 *supra* and accompanying text.

56 L. BRANDEIS, OTHER PEOPLE'S MONEY (1914).

Every insurance company conducts business in two distinct fields which are, essentially, quite independent of each other, *viz.*, underwriting of risks and investment of assets.[57] Underwriting — that is, the assumption of specified risks upon issuance (or writing) of insurance policies or contracts — is the source of a substantial part of the income and profit (or loss) of every insurance company. Every insurance company also operates a securities investment business — a business wholly unrelated to its underwriting business, and one very similar to that of mutual funds and other investment companies. Yet, while the operations of investment companies are meticulously regulated by the SEC under the Investment Company Act,[58] on the other hand, the investment practices of insurance companies are not. This meticulous regulation of investment companies does not supplant, but is additional to, regulation under the Securities Act and the Exchange Act.

An insurance company may, and often does, operate its underwriting business at a loss, while investing its assets at a profit. The expertise, talent and managerial skills involved in underwriting are totally different from those necessary to the successful management of an investment portfolio.

A number of factors are important to an insurance company's underwriting business. The experience, training and performance of the agency force; the persistency[59] of the policies written; the ratio of acquisition costs to profitability of insurance written; the ratio of new business to renewals — all are elements which must be carefully considered in any evaluation of an insurance company. Entirely different factors determine the success (or failure) of an insurance company's investment business. Every state regulates the types and amounts of securities which may be purchased by insurance companies. These regulations are detailed. Nonetheless, the selection of a particular common stock, mortgage, bond, loan or other investment within the statutory categories, is entirely discretionary with management.[60] The skill and experience of those insurance company officials charged with managing investments are vital considerations to an

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[57] *Best's Insurance Reports* lists and rates both life and accident and health companies and property and liability companies separately by underwriting performance and investment performance. *See* notes 8 & 15 *supra*.

[58] The Investment Company Act of 1940, 54 Stat. 789 (1940), 15 U.S.C. § 80a-1 (1964). In section 1 of the Act, Congress expressed its "Findings and declaration of policy." Many of the reasons stated, from which Congress found that investment companies are "affected with a national public interest," appear equally true of and applicable to insurance companies. Insurance companies fall squarely within the definition of an "investment company," particularly as defined by subsection (3) of section 3(a), 54 Stat. 797 (1940), *as amended*, 15 U.S.C. § 80a-3(a)(3) (1964).

[59] Rates of voluntary termination of policies by policyholders vary considerably among life insurance companies. Each company's rate is influenced by many factors, including the types of policies written and the ratio of new policies to older ones in force with the company.

1969 LIFE INS. FACT BOOK 52.

[60] "There are considerable differences from company to company in the way life insurance assets are invested. . . ." *Id.* at 65.

insurance company shareholder or investor. Evaluation by the public shareholder or investor of these two distinct business operations of an insurance company poses informational problems no different than those which are encountered in evaluating a non-insurance company operating two distinct businesses.

THE CONVENTION STATEMENT AND SCHEDULE SIS DO NOT PROVIDE ADEQUATE INFORMATION

The Commission's new regulations will make available information from which the shareholder or investor can make an informed and balanced judgment as to the success and profitability of each division, business or product-line of most companies. Comparable information is just not available to shareholders and investors in insurance companies.

The insurance industry argues that such information is available; that the annual "convention" statement, which every insurance company must file with the insurance commissioner of each state in which it engages in business contains this information. These annual statements are public records and are, as the industry contends, indeed detailed. But the crucial question is whether these annual convention statements of insurance companies provide the shareholder and investor, in meaningful and understandable form, substantially the same information as the new regulations will elicit from non-insurance companies. Any analysis of the annual convention statement must answer that they do not.

The Annual Statement of Insurance Companies is a printed form copyrighted annually by the National Association of Insurance Commissioners.[61] The convention blank was reframed by the NAIC in 1951.[62] With minor changes, the 1951 form has been adopted by every state insurance commissioner and is in use today. Yet the NAIC does not list among its objectives the protection of insurance company investors,[63] and the convention blank reflects this limitation.

The Commission observed that the convention statement "was designed for regulatory purposes and not for the information of investors . . . [and] is complex and detailed, and its interpretation requires the skills of a specialized financial analyst."[64]

In a recently published text on insurance company accounting, the author, himself an actuary, acknowledges:

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[61] *See* R. NOBACK, LIFE INSURANCE ACCOUNTING 311-39 (1969).

[62] *Id.* at 6-8.

[63] The object of this Association shall be to promote uniformity in legislation affecting insurance, to encourage uniformity in departmental rulings under the insurance laws of the several states, to disseminate information of value to insurance supervisory officials in the performance of their duties, to establish ways and means of fully protecting the interests of insurance policyholders of the various states, territories and insular possessions of the United States and to preserve to the several states the regulation of the business of insurance.

NAIC CONST. & BYLAWS art. 2 (1963).

[64] THE WHEAT REPORT, *supra* note 1, at 213.

> [T]o understand the financial statements, one should be familiar with the principles of both actuarial science and the accounting discipline, with the functions performed by life insurance companies, with the provisions of the contracts issued by them and with the requirements imposed by the Association Blank. . . .[65]

A number of items on the annual convention statement are uniquely "insuranceze" and virtually meaningless to one not privy to the esoteric usages. "Provision for experience rating refunds"; " 'Cost of Collection' on premiums and annuity considerations deferred and uncollected in excess of total loading thereon"; "Mandatory securities valuation reserve" — are all on the balance sheet. Aside from the complexities of the data called for, the form itself is physically formidable: 45 form pages, and when completed, often running to hundreds of pages, printed in the unwieldly size of 11½" by 18½". Clearly, this statement was not conceived for purposes of providing readable, understandable or meaningful information to the investor.

In 1964, the NAIC, obviously in response to the pending federal legislation, promulgated an additional form known as the "Stockholders Information Supplement (Schedule SIS)."[66] In marked contrast to the convention blank, Schedule SIS is brief, just five pages, half of which merely contain instructions.[67] Schedule SIS is nothing more than a series of interrogatories, supplementing the interrogatories in the convention blank, concerning the information supplied during the previous year and to be supplied during the coming year by the insurance company to its stockholders. The information which Schedule SIS suggests be included in the annual statement mailed to stockholders is modest.

Life insurance and accident and health companies must supply "a. Statement of Assets, Liabilities, Surplus and Other Funds; b. Summary of Operations; c. Surplus Account." Fire and Casualty Companies must provide "a. Statement of Assets, Liabilities, Surplus and Other Funds; b. Statement of Income — Underwriting and Investment Exhibit; c. Capital and Surplus Account." The companies must also include remuneration and securities ownership of officers. The detail (or lack of it), the form, and whatever else is disclosed or not disclosed to the insurance company shareholders, are left entirely to the discretion of insurance company management. The schedule permits, even invites, the presentation of "operations" in such a way as to obscure underwriting losses by offsetting them with investment profits in a consolidated statement.

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[65] R. Noback, *supra* note 61, at 3. The spokesman for the Association of Casualty & Surety Companies and National Board of Fire Underwriters had a "let-them-eat-cake" answer:

> If an interested investor is in any way puzzled by insurance company accounting methods, he can readily receive an analysis from one of the investment houses specializing in insurance stocks, and these analyses furnish such information in terms of SEC accounting procedures.

Hearings, *supra* note 28, at 231.

[66] Proceedings, *supra* note 31, at 514-16.

[67] *Id.* at 517-20.

Schedule SIS was a step, albeit a small one, toward providing more information to insurance company shareholders. But no one can contend that it provides information "substantially equivalent" to that which would be available to insurance company stockholders if insurance companies were not exempted from section 12(g) of the Exchange Act. Furthermore, if an insurance company discloses no more material facts than are required by Schedule SIS in connection with a sale or purchase of securities, or a merger, it may well incur extensive civil liabilities.[68]

The Commission remains dubious about the adequacy of insurance company information available to the public investor. The Commission study group recently proposed a "Rule 164 Qualified List"[69] which would permit public sale and trading of securities of certain companies without registration where adequate information about these companies is available to the public. Insurance companies are to be excluded from the proposed list because disclosure is not adequate.[70]

Possible Remedies

I am not one who believes that federal regulation is the answer to every business problem; far from it. But the states have utterly failed in the five-year "opportunity" period which they requested to advance any

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[68] *See, e.g.*, SEC v. National Sec., Inc., 393 U.S. 453 (1969); Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (D. Ind. 1968), 259 F. Supp. 673 (D. Ind. 1966).

SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1970), reads in pertinent part: "It shall be unlawful . . . to make any untrue statement of a material fact or to omit to state a material fact . . . in connection with the purchase or sale of any security." Rule 10b-5 has been the basis of a proliferation of recent cases. *See generally* A. Bromberg, *supra* note 45.

A number of 10b-5 cases have turned on the meaning of "material." Obviously, what is "material" in one factual matrix may not be so in another. Perhaps, the best definition, because of its being conformable to any set of facts, is that given by the Court of Appeals for the Second Circuit in List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965):

> The basic test of "materiality" . . . is whether "a reasonable man would attach importance [to the fact misrepresented] in determining his choice of action in the transaction in question." Restatement, Torts § 538(2)(a). . .

However broadly or narrowly the test of materiality is drawn, there can be no doubt that the Convention Statement and Schedule SIS omit a considerable number of extremely material facts and, further, that the facts as presented are so incomprehensible as to be misleading.

[69] The Wheat Report, *supra* note 1, at 206-15.

[70]
> [T]he Study estimates that there are at least 465 insurance companies with over 100 stockholders and at least 120 insurance companies with over 500 shareholders which are not subject to either the reporting or proxy requirements of the '34 Act.
>
> The annual financial information filed by such companies with state authorities (the convention statement) was designed for regulatory purposes and not for the information of investors. It is complex and detailed, and its interpretation requires the skills of a specialized financial analyst.

Id. at 212-13.

At least one commentator believes insurance companies should be included in the exempted list. *See* Throop, *Federal Regulation of Securities Committee Comments on the Wheat Report*, 25 Bus. Law. 39, 44-45 (1969).

significant improvement in protection for insurance company shareholders. Despite all the falderal about NAIC and state regulation being "substantially equivalent" to federal regulation, the only real protection and recourse available to the insurance company shareholder is provided by the *federal* anti-fraud laws.[71]

The need is real. The number of shareholder-owned insurance companies is sharply increasing,[72] while mergers of shareholder-owned insurance companies are also occurring more frequently.[73] Yet, one can survey the possible remedial courses only with considerable pessimism. There is the possibility, certainly the best course, that Congress will simply do what it should have done in 1964 and bring insurance companies under the Exchange Act by repealing the section 12(g)(2)(G) exemption. However, there is no reason to believe that the same powerful interests which opposed the 1964 Act would not again resist the inclusion of insurance companies. The proven clout of the insurance company lobbyists raises considerable doubt as to the possibility of legislative remedy.

Another possibility, which could prove to be a model of state and industry self-discipline, would be for the states, through the NAIC, to adopt meaningful investor-directed regulation. The NAIC has within its considerable authority the power to promulgate uniform state regulations requiring insurance companies to provide to their shareholders and make available to the public, in meaningful and understandable language, every material fact about those companies having publicly-traded securities. However, the NAIC is not and does not profess to be, an investor-oriented association; nor has it ever shown any desire to regulate in the interest of the shareholder or investor. It was only with the extreme reluctance and under the spur of impending federal legislation that it acknowledged, in 1964, that the Commission's arguments for further investor protections had any merit at all. The implementation by the NAIC of the section (G) conditions was, predictably, the least possible within the statutory limits. There is no reason to believe that the Association, like the leopard, will, or even can, change its spots.

Either of the foregoing possibilities is desirable; neither appears likely. Almost certainly, the resolution will be left to the federal courts. The Commission or private litigants may well seek judicial determination of whether state insider trading laws meet the test of the section 12(g)(2)(G)(iii) condition. A court ruling that the state regulation was not "substantially in the manner" provided in the Exchange Act would nullify the entire exemption and bring insurance companies under the Act. A proliferation

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[71] *E.g.*, SEC rule 10b-5, 17 C.F.R. § 240.10b-5 (1970).

[72] *See* SEC SPECIAL STUDY REPORT, pt. 3, at 40-42; 1969 LIFE INS. FACT BOOK 102-03.

[73] *See* 1969 LIFE INS. FACT BOOK 102-03.

of civil suits in the *Brennan* and *National Securities*[74] genre appears possible, even probable. It is certain, however, that the millions of insurance company shareholders and the public investor should no longer tolerate state regulation which provides neither meaningful information nor adequate protections.

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[74] *See also* Brennan v. Midwestern United Life Ins. Co., 286 F. Supp. 702 (D. Ind. 1968), 259 F. Supp. 673 (D. Ind. 1966).