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Insurance--Variable Annuity Held To Be a Security and Subject to Registration with SEC (SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65 (1959))

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adjudicating a State-created right solely because of the diversity of citizenship . . . is for that purpose, in effect, only another court of the State, it cannot afford recovery if the right to recover is made unavailable by the State nor can it substantially affect the enforcement of the right as given by the State." [29]

To allow the federal courts jurisdiction over foreign corporations when the state courts did not have jurisdiction would be allowing the federal courts to substantially affect the recovery of state-created rights. The Supreme Court when faced with the problem will probably follow the lead of the *Erie* and *Guaranty Trust Co.* cases and apply state law in determining jurisdiction over foreign corporations.

The conclusion of the principal case is not as sound as that of the *Shawe* case. Since it rejects the strict dichotomy between procedural and substantive law, it would seem that it should then accept the conclusion that since jurisdiction substantially affects the state-created rights, state law should be applied to determine jurisdiction. The reasoning in the principal case does not take into consideration the strong policy reasons for not allowing the federal courts to affect recoveries in cases involving state-created rights. The litigants enforcing state-created rights should have no greater right in the federal courts than they would in the state courts.

INSURANCE—VARIABLE ANNUITY HELD TO BE A SECURITY AND SUBJECT TO REGISTRATION WITH SEC.—Petitioner sought to enjoin respondent from issuing their variable annuity contracts [1] without

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[29] *Id.* at 108-09. *But see* Byrd v. Blue Ridge Rural Elec. Co-op., 356 U.S. 525 (1958). Outcome is not the only controlling factor. The Court here applies federal rules on presentation of facts to a jury. "The federal system is an independent system. . . . The policy of uniform enforcement of its state-created rights and obligations, see, *e.g., Guaranty Trust Co. v. York* . . . , cannot in every case exact compliance with its state rule. . . ." *Id.* at 536-38.

[1] The variable annuity is similar to the conventional annuity in the matter of premium payments, the annuitant making a fixed number of premium payments during his productive years. The fundamental difference lies in the matter of investment policy since most of the premiums paid under the variable annuity are invested in common stock. "Each premium payment, after the deduction for loading charges, is credited to the annuitant's account in the form of 'accumulation units.' The number of 'accumulation units' to be credited is determined by dividing the net amount of the premium payment by the current value of an 'accumulation unit.' . . . At stated periods thereafter, usually monthly, the basic unit value is adjusted dependent upon the current investment experience of the common stock portfolio. . . . The unit value is not affected by the mortality experience or current operating expenses of the program. These factors are assumed by the insurer who is compensated

first registering them under the Securities Act of 1933 [2] and complying with the Investment Company Act of 1940.[3] Respondent contended that it was engaged in the business of insurance, chartered by the Insurance Commissioner of the District of Columbia, and was therefore exempt from federal control under the McCarran-Ferguson Act of 1945.[4] The district court dismissed the complaint and the circuit court affirmed. On certiorari the Supreme Court of the United States reversed, *holding* that the variable annuity is a security and subject to federal regulation under the Securities and Exchange Commission.[5] *SEC v. Variable Annuity Life Ins. Co. of Am.*, 359 U.S. 65 (1959).

It would be constitutional to subject the variable annuity to federal control even if held to be insurance since it has been decided that insurance is interstate commerce.[6] Congress has, however, allowed the individual states to exercise their traditional control over insurance.[7]

Annuities are part of the business of insurance.[8] Conventional annuities provide for payments in fixed-dollar amounts and, as such, differ from payments under the variable annuity which fluctuate.[9] Payments of uncertain and fluctuating amounts have been held to be outside of the legal concept of the word annuity.[10] The dominant view is that any payment at periodic intervals may be termed an annuity regardless of the uncertain amount of the payments.[11] Also the insurance laws of the various states do not require annuity pay-

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by the loading charge." Note, *Regulation and Taxation of the Variable Annuity*, 33 ST. JOHN'S L. REV. 118, 119 (1958).

[2] 48 Stat. 78 (1933), 15 U.S.C. §77g (1958). Various information is required to be set forth in the registration statement. 48 Stat. 88-91 (1933), 15 U.S.C. §77aa(8) (the character of the business of the issuing company); (9) (capitalization of the issuer); (14) (the amount of remuneration paid to officers and directors of the issuer); (17) (the amount of commissions paid to underwriters for the sale of the securities); (25) (a balance sheet of the issuer); (26) (a profit and loss statement indicating also the probable source of the income) (1958).

[3] Investment companies are required to register with the Securities Exchange Commission and set forth in their registration statement their investment policy. 54 Stat. 804 (1940), 15 U.S.C. §80a-8(b)(1) (1958).

[4] "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." 59 Stat. 34 (1945), 15 U.S.C. §1012a (1958).

[5] Hereinafter referred to as SEC.

[6] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).

[7] 59 Stat. 33 (1945), 15 U.S.C. §1011 (1958).

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

[9] Note, *Regulation and Taxation of the Variable Annuity*, 33 ST. JOHN'S L. REV. 118, 120 (1958).

[10] Spellacy v. American Life Ins. Ass'n, 144 Conn. 346, 131 A.2d 834 (1957).

[11] *In re* Supreme or Cosmopolitan Council, 193 Misc. 996, 86 N.Y.S.2d 127 (Sup. Ct. 1949); SPURGEON, LIFE CONTINGENCIES 31, 68-78 (3d ed. 1947).

ments to be of fixed amounts.[12] The fluctuation of payments, therefore, does not cause a denial of the insurance status.

The value of the annuitant's contract under the variable annuity plan is determined by the value of the underlying common stock portfolio.[13] Such an interest in this common stock portfolio might come within the definition of an investment contract[14] and subject to registration under the Securities Act.[15] This investment portfolio taken together with its administration led the Court in the present case to conclude that this was within the province of an investment company and foreign to the business of a life insurance company.[16]

The underwriting of risk is another point considered by the Court in determining that the variable annuity contract does not meet traditional insurance concepts. The application of mortality tables and the assumption of the risk of longevity is definitely within the concept of insurance.[17] But, the basis of the variable annuity is the success of its common stock portfolio. The essential element of risk, therefore, is the fluctuation in the value of the common stock underlying the annuity.[18] This risk is assumed solely by the annuitant.

An important consideration as a result of this case is its impact on life insurance companies which decide to issue variable annuity contracts. This presents the possibility of dual control imposed by the SEC and the Insurance Commissioner of the individual state. Under the existing regulatory structure this dual control will result immediately in a classification and diffusion of responsibilities resulting in confusion as to jurisdiction and methods of obtaining compliance.[19] The procedural ineptitudes of any method of dual control would stem from the differences in the very nature and purpose of the two areas of control. Federal regulation depends upon disclosure to the public, thereby allowing it to be informed before making investment decisions. The whole philosophy behind the Securities Act of 1933 is full disclosure.[20] The Investment Company Act of 1940 requires even more information to be given to the public.[21]

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[12] See, *e.g.*, N.Y. INS. LAW § 46(2); N.C. STAT. ANN. § 58-72(2).

[13] Note, *Regulation and Taxation of the Variable Annuity*, 33 ST. JOHN'S L. REV. 118, 120 (1958).

[14] In SEC v. W. J. Howey Co., 328 U.S. 293, 298-99 (1946), the Court defined an investment contract for the purposes of the Securities Act of 1933 as ". . . a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits . . . , it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

[15] 48 Stat. 74, 78 (1933), 15 U.S.C. §§ 77b(1), 77f (1958).

[16] SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 81 (1959).

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

[18] Haussermann, *The Security in Variable Annuities*, 1956 INS. L.J. 382-83.

[19] *Compare* N.Y. INS. LAW §§ 20-36, *with* 54 Stat. 841-45 (1940), 15 U.S.C. §§ 80a-37-45 (1958).

[20] *E.g.*, 48 Stat. 78, 81, 88-91 (1933), 15 U.S.C. §§ 77f, j, aa (1958).

[21] The Investment Company Act of 1940 requires certain information to

State insurance regulations, on the other hand, do not depend upon disclosure to the public,[22] because investment policy and practices are not relevant to the insured. Most state insurance statutes were designed basically to preserve the solvency of the insurance companies in order to guarantee the fulfillment of their obligations.[23]

As a result of the differences in purpose and procedure, it is recognized that any system of dual control would be of doubtful practicality.[24] There would be definite areas of conflict such as in the area of accounting procedures and forms, and taxation without any additional protection to the public. The SEC by requiring full disclosure and prospectuses does not guarantee the soundness of the investment nor in any way does it pass on the merits of the security.[25] It is unlawful to make any representations that the SEC has "approved" an investment. Therefore, the SEC can require that pertinent facts be set forth in the prospectus but it cannot require the public to read them. State insurance regulations, on the other hand, are not limited to disclosure. The state insurance departments pass not only on the form but also on the substance and the content of the insurance contract.[26] The protection under state insurance regulations is afforded, therefore, even to those people who refuse to read the contract.

To escape the impracticalities of dual control there is the expedient of forming subsidiary companies for the sole purpose of issuing variable annuities. This would entail additional expense which would be borne by the annuitant with no added benefits to him. Organizational and administrative problems would also be presented which would make such a plan cumbersome.[27] For example, in order for the subsidiary company to assume the risk of mortality

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be set forth in the registration statement. 54 Stat. 803 (1940), 15 U.S.C. § 80a-8 (1958) (requiring investment policies and operating policies to be set forth in the statement); 54 Stat. 808 (1940), 15 U.S.C. § 80a-12 (1958) (relating to trading practices and activities); 54 Stat. 811 (1940), 15 U.S.C. § 80a-13 (1958) (relating to changes in investment policy); 54 Stat. 817 (1940), 15 U.S.C. § 80a-18 (1958) (requiring the capital structure of the company to be set forth in the registration statement); 54 Stat. 821 (1940), 15 U.S.C. § 80a-19 (1958) (relating to dividend policy); 54 Stat. 836 (1940), 15 U.S.C. § 80a-29 (1958) (requiring the companies to make periodic reports to investors).

[22] The content of the insurance contract clauses are basic provisions of state insurance regulation. See, *e.g.*, N.Y. INS. LAW §§ 155, 159-61.

[23] See Funston, *The Case Against the Variable Annuities*, Dun's Review and Modern Industry, Oct. 1956, pp. 41, 42. Some states have, however, provided for protection against misrepresentation in their insurance statutes. See, *e.g.*, N.Y. INS. LAW § 127.

[24] See Day, *A Variable Annuity Is Not a Security*, 32 NOTRE DAME LAW. 642, 684 (1957).

[25] 48 Stat. 902 (1934), 15 U.S.C. § 78z (1958).

[26] Note 22 *supra*.

[27] See Kvernland, *Some Economic and Investment Aspects of the Variable Annuities*, 1956 INS. L.J. 373, 377.

and longevity, complicated reinsurance arrangements would be necessary. Similarly, any desirable balance requirements imposed as a matter of underwriting policy between variable annuity income and income from fixed-dollar sources would be difficult to achieve under the separate company approach. A practical consideration is the fact that the variable annuity should not be offered as the exclusive product of a particular company and therefore in competition with life insurance, but rather the variable annuity should be offered as a supplement to the flexible services of the life insurance company. Of course, there is the initial consideration of incorporating the subsidiary company and having to obtain certificates of authority to operate in states where the parent insurance company is already licensed to operate.

Another method of avoiding dual control would be sole federal regulation of the insurance industry. Although there is the power to regulate,[28] federal regulation of insurance would clearly violate the congressional belief expressly set forth in the McCarran-Ferguson Act, ". . . that the continued regulation and taxation of the several states of the business of insurance is in the public interest." [29] It is submitted, however, that since the success of the variable annuity varies directly with the investment experience and policy of the issuing company, the full disclosure policy of the federal regulations would make such information available to the public.[30] But the complex actuarial mathematics on which these contracts are based, the content of the contracts, the solvency of the issuing company are all singularly within the area of state insurance regulation.

Dual control has been considered to this point with respect to the existing regulatory systems. Mutually shared control under new regulations would be the ideal solution. The variable annuity is a new concept [31] and new legislation is needed. New Jersey has shown the way with competent legislation in the field. This new legislation avoids the use of the term "variable annuity" and substitutes the term "contract on a variable basis." [32] Under this new legislation, a life insurance company is empowered to issue such contracts after obtaining approval of the State Insurance Commissioner.[33] The statute sets up protective provisions for the public providing for the licensing of agents,[34] contract clauses,[35] forms of advertising,[36] and

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[28] United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944).
[29] 59 Stat. 33 (1945), 15 U.S.C. § 1011 (1958).
[30] See Long, *The Variable Annuity; A Common Stock Investment Scheme*, 1956 INS. L.J. 393.
[31] See Long, *supra* note 30, at 396. The variable annuity began in 1952 with the establishment of the College Retirement Equities Fund by special act of the New York legislature, N.Y. Sess. Laws 1952, ch. 124.
[32] N.J. Sess. Laws 1959, ch. 122, § 1.
[33] N.J. Sess. Laws 1959, ch. 122, § 2.
[34] N.J. Sess. Laws 1959, ch. 122, § 3.
[35] N.J. Sess. Laws 1959, ch. 122, § 5(a), (c), (e).
[36] N.J. Sess. Laws 1959, ch. 122, § 5(a)(ii).

the avoidance of misleading projections of earnings.[37] Regulatory measures provide for the establishment of a segregated "variable contract account" [38] which must also reflect investment results.[39] Further measures provide for the maintenance of reserves,[40] and the filing of separate income reports [41] with the State Insurance Commissioner.

This legislation quite adequately establishes a state regulatory system to deal with the variable annuity contract.[42] Perhaps it could have included investment standards in order to protect the contract holder from extremely speculative investments. The National Association of Insurance Commissioners has recommended that such regulations include provisions limiting investment in the shares of any one corporation to three per cent of its total outstanding shares; prohibiting the purchase of shares in a corporation not meeting earning and dividend requirements; prohibiting the purchase of shares not registered on a national securities exchange; and prohibiting conflicts of interest between officers and directors of the insurer and the corporation whose stock is purchased.[43]

As a result of this decision, the SEC will undoubtedly draft measures for the regulation of variable annuity contracts. Under the disclosure philosophy which prevails in the SEC, issuing companies will probably be required to make known to the public by means of prospectuses their investment experience and policy.[44] Periodic reports to contract holders as well as to the SEC is also a probable requirement. These requirements would be in keeping with the nature of the variable annuity contract and will allow the public to be informed before making investment decisions. It is believed that currently operative insurance companies will be permitted to issue the variable annuity with the provision that a segregated account be maintained as is provided for in the New Jersey legislation.

The SEC regulations may end here. This would depend to a great extent on the protection afforded the public by state regulation of the variable annuity contract. Although as a result of this case the SEC has plenary power to control the variable annuity contract, the congressional policy to leave the regulation and taxation of insurance companies to the states might be the dominating consideration.

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[37] N.J. Sess. Laws 1959, ch. 122, § 5(b).
[38] N.J. Sess. Laws 1959, ch. 123, §§ 1, 2, 4, 5.
[39] N.J. Sess. Laws 1959, ch. 123, § 3.
[40] N.J. Sess. Laws 1959, ch. 123, § 6.
[41] N.J. Sess. Laws 1959, ch. 122, § 5(e).
[42] In many ways the legislation embodies the suggestions set forth in Note, *Regulation and Taxation of Variable Annuities,* 33 ST. JOHN'S L. REV. 118, 125-27 (1958).
[43] NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS, REPORT OF SUBCOMMITTEE ON VARIABLE ANNUITIES (1955).
[44] See 54 Stat. 803 (1940), 15 U.S.C. § 80a-8 (1958).