# RECENT DEVELOPMENTS

## VARIABLE ANNUITY CONTRACTS SUBJECT TO S.E.C. REGULATION

*S.E.C. v. Variable Annuity Co., 359 U.S 65 (1959)*

The Securities and Exchange Commission (SEC) sought to enjoin the Variable Annuity Life Insurance Co. of America (VALIC) from issuing variable annuity contracts to the public without registering with the SEC pursuant to the Securities Act of 1933[1] and the Investment Company Act of 1940.[2] The Supreme Court held that variable annuity contracts are not contracts of insurance; hence, issuers of such contracts are subject to the federal registration requirements.[3]

The field of insurance was, by specific terms of the Securities Act, exempted from control by the SEC,[4] because, at the time of the passage of the Act, control of insurance was considered to be outside the scope of the commerce clause.[5] It was not until 1944 that insurance was held to be within the province of federal control.[6] Then, in 1944, the McCarran Act was passed delegating exclusive control of insurance to the states[7] to permit continued state regulation without federal interference.[8] If VALIC were to be exempted from federal control in this case, it would have to be because it was an insurance company within the meaning of McCarran. This the Court said it was not.

The variable annuity form of contract was devised in an attempt to provide a policy which would serve as a hedge against inflation. The variable annuity differs from the traditional fixed-dollar annuity in which each annuity payment is a fixed sum.[9] In a variable annuity policy, the annuitant pays premiums which are invested in common stocks selected by the company. The value of the annuitant's policy is expressed in terms of "units", each unit varying in value in proportion to the value of the stock owned. When the time for payment arrives, the number of annuity units is computed on the basis of the insurance mortality tables. The number of these units owed to the annuitant is fixed, but the amount of money paid

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[1] 48 Stat. 74 (1933), 15 U.S.C. 77a-77aa (1951).

[2] 54 Stat. 789 (1940), 15 U.S.C. 80(a) (1951).

[3] S.E.C. v. Variable Annuity Co., 359 U.S. 65 (1959).

[4] Securities Act, § 77c(8), *supra* note 1.

[5] Paul v. Virginia, 75 U.S. 168 (1869). Congress, in defining the term 'security' in the Securities Act, intended to include all interstate transactions which were the *legitimate subject* of its regulation of sale of securities, S.E.C. v. Crude Oil Corp., 93 F.2d 844 (1938).

[6] United States v. South Eastern Underwriters Ass'n, 322 U.S. 533 (1943).

[7] McCarran-Ferguson Act, 59 Stat. 33 (1945), 15 U.S.C. 1011-15.

[8] State v. Prudential Ins. Co., 224 Ind. 17, 64 N.E.2d 150 (1945).

[9] See "annuity" in general, 1 APPLEMAN, INSURANCE LAW & PRACTICE 83 (1941).

to the annuitant for these units fluctuates with the investment experience of the company. In other words, there is no guarantee that the company will pay any money. It promises only to pay the investment yield which will vary according to the success of the investment program.[10]

Although the variable annuity contract resembles a security in this respect, it has several features of insurance. For example, the mortality risk is assumed by the insurer, payments are made from both principal and income, and the amount of payment varies according to the age and sex of the annuitant.[11]

Having a combination of the features of securities and insurance, the variable annuity contract is a creature which defies exclusive categorization, although at least one state has held such a contract to be a security[12] and the description of a security set forth in several important cases would fit neatly.[13] As a result, it is necessary to examine the intent of Congress with respect to transactions of this nature in order to ascertain which type of control most adequately serves the protection of the public. It is at this point that the opinion of the Court becomes most meaningful.

The concurring opinion emphasized that SEC regulation of the variable annuity contract would provide better public protection than could be achieved by use of the state insurance boards.[14] The purposes of the two types of regulatory schemes offer the reasons.

First, the Securities Act was passed for the purpose of preventing fraud and other unfair practices with respect to the sale of securities.[15] SEC regulations require full public disclosure of details regarding securities so that an investor can intelligently appraise the risk involved.[16] On the other hand, state insurance regulation protects the public by insuring that the financial structure of the company remains sound. This is achieved through organizational restrictions and protection against im-

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10 See Johnson, *The Variable Annuity: What it is and Why it is Needed,* 1956 INS. L. J. 357. For a further discussion of the variable annuity contract see Haussermann, *The Security in Variable Annuities,* 1956 INS. L. J. 382; Long, *The Variable Annuity: A Common Stock Investment Scheme,* 1956 INS. L. J. 393; Schecther, *Variable Annuities: Boon or Bane,* 1956 INS. L. J. 764.

11 *Supra* note 10. See also notes, 12 SW. L. J. 514 (1958); 32 TEMP. L. Q. 121 (1958); 11 VAND. L. REV. 1453 (1958).

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

13 S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946); S.E.C. v. Joiner Leasing Corp., 320 U.S. 344 (1943); S.E.C. v. Payne, 35 F. Supp. 873 (1940).

14 See concurring opinion by Mr. Justice Brennan joined by Mr. Justice Stewart. The majority opinion by Mr. Justice Douglas emphasized the fact that the variable annuity contract places all the investment risk on the annuitant rather than on the insurer and, as a result, the insurer assumed no true risk in the insurance sense.

15 A. C. Frost & Co. v. Coeur D'Alene Mines Corp., 312 U.S. 38 (1940). LOSS, SECURITY REGULATION 83 (1951).

16 A.C. Frost & Co. v. Coeur D'Alene Mines Corp., *supra* note 15; S.E.C. v. Sunbeam Gold Mines, 95 F.2d 699 (1938). See also Annot., 85 L.Ed. 508 (1941).

pairment of capital.[17] In short, federal regulation of securities is aimed at disclosure of pertinent information concerning investment while insurance regulation is aimed at controlling the financial structure of the insurance company to assure policy holders of its solvency and its ability to meet its obligations.

Where the investor cannot be said to be a direct participant in the investment experience of the company, state regulations are adequate. Conversely, where the obligation to the participant is measured directly in terms of the success of the company's portfolio, control over the solvency of the investment company itself has little bearing on the success or failure of the participant's investment. In the case of the variable annuity contract, disclosure of investment policy provides better protection for the investor than state regulatory programs emphasizing financial integrity of the insurer.

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[17] 1 VANCE, INSURANCE (3rd ed. 1951).