THIRD SOUTH CAROLINA INSURANCE FORUM

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FEDERAL REGULATION OF VARIABLE ANNUITY ISSUERS

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Securities and Exchange Commission

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May I first express my pleasure for being invited to spend an all too brief period in the clearly gracious environment of South Carolina. While it has been my privilege to enjoy the warm receptions for which the South is deservedly acclaimed in several of your neighboring states, this is my first experience with South Carolina. This is regrettable for several reasons -- among them sentimental. I am told by my older relatives that our branch of the Conwill family had its point of origin in the United States in South Carolina. From here my great grandfather moved to Alabama and then to Mississippi where my grandfather was born. My grandfather moved to Texas, the birthplace of my father, and then to Oklahoma. My father went to Kansas, my place of rearing, and much to the distress of my father -- who considered himself an authentic Southerner -- I located in the Yankee territory of New York City. I compounded the error by marrying what would appear to be a certified Yankee -- a Maine girl.

We have, however, atoned somewhat for our sins by migrating slightly Southward to Washington. In fairness, I should add that the permanence of our atonement will depend upon the wisdom of the nation's electorate in maintaining a certain political administration in Washington. But in any event it is gratifying for me today to complete the circle, in a sense, and return to the area which my ancestors may have been unwise to leave.

Some of you were present when I spoke to the National Association of Insurance Commissioners in Montreal last June. You will recall that I then reviewed the functions of the Securities and Exchange Commission in the variable annuity area and submitted for consideration a method of regulation of issuers of variable annuities where, in our view, our Commission could carry out its statutory obligations without

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intruding into insurance regulation which is properly and wisely lodged within the states. I was expressing then, as I am now, views of the staff of the Commission rather than views of the Commission itself. Nothing has occurred since last June to alter the staff opinions I expressed in Montreal. Since then, however, three events have occurred of which you should be aware and which I propose to discuss with you this afternoon.

I

The first concerns my remarks in Montreal to the effect that the staff might be receptive to recommending to the Commission the adoption of a rule which would exempt from Investment Company Act application group deposit administration pension contracts where the employer's contributions would be deposited in a common fund of equity securities. Not surprisingly, the insurance industry, with its usual alertness, responded to my remarks swiftly. My airplane had hardly touched down at Washington's National Airport when I was deluged with calls from industry representatives who indicated, with admirable skill and diplomacy, but nevertheless in substance, "You said it; now do it."

We have done it. After numerous conferences with insurance industry representatives, extensive discussions before our Commission and release of the proposed rule for public comment pursuant to the requirements of the Federal Administrative Procedure Act, the Commission adopted what is now known as Rule 3c-3 pursuant to the Investment Company Act of 1940.

The effect of the rule is to exempt from the provisions of the 1940 Act any transaction by an insurance company involving group annuity contracts with an employer providing for the allocation of the employer's contributions to one or more separate accounts composed in whole or in part of equity securities. In order to qualify for the exemption the contract between the insurance company and the employer must:

(1) be made in connection with a pension plan of the employer which qualifies under the appropriate provisions of the Internal Revenue Code;

(2) provide for the future issue by the insurance company of guaranteed annuities payable in fixed dollar amounts to covered employees on their retirement to the extent of the employer's interest in the separate account;

(3) prohibit any employees' contributions from being placed in the separate account; and

(4) cover at least 25 employees.

Conceptually, for Investment Company Act purposes, one would be hard pressed to distinguish this type of group deposit administration contract from the structure of the conventional variable annuity. Like the variable annuity, many persons -- in this instance, employers -- are investing in units of a common fund of predominantly equity securities. Like the variable annuity contract holder, the employer -- not the insurance company -- bears the investment risk. And, from our point of view, the practical and legal status of the variable annuity contract holder is not significantly different from that of a shareholder in a conventional investment company. Why, then, did the Commission believe that an exemption of employer-insurance company group deposit administration transactions is consistent with the statutory duties imposed upon it by the 1940 Act?

There were several considerations. The basic thrust of the Investment Company Act is toward investor protection. It seemed clear that the usual employer participant in a group deposit administration contract will have the executive and expert talent available to protect adequately his interests in negotiating the terms of the contract. It is likely that the terms and consequences of his investment will be thoroughly understood by the employer and that a statutory prospectus complying with the federal securities laws would add little, if anything, to his knowledge. The employer will have a much higher degree of financial sophistication than the usual purchaser of an investment company share or a variable annuity. In short, the employer needs less investor protection.

In addition, it would appear that the basic security involved, that is, the share in the common fund created by the insurance company, will be privately rather than publicly offered. Presumably the contract negotiations will be vigorous and the contract terms may vary from employer to employer. The nature of this offering is considerably different than the widespread offering to individuals in the public at large of a variable annuity contract or an investment company share.

Finally, the offering is only in the context of a pension plan qualified under the Internal Revenue Code. Banks have been able to conduct essentially the same operation with employers free of Investment Company Act restrictions because there is a specific exemption available to them in the 1940 Act. In attempting to reconstruct the

legislative reason for exempting banks but not insurance companies in this type of pension funding, we concluded that the banks probably asked for it because they were engaged in this type of pension business at the time, and the insurance companies made no request because a funding vehicle involving substantial equity investments was not within the scope of their permitted business at the time. In fairness I should add that this conclusion was reached without finding any documented legislative history in its support. Had insurance companies been in this type of business in 1940 we assumed that Congress would have afforded them equal exemptive treatment with the banks. We hope and believe this is a responsible rationale. I will add that we do not have a closed mind on the restrictions imposed in Rule 3c-3. We are continuing to explore the subject as well as what can be done consistent with our statutory responsibilities in the self-employed retirement field where the recent Smathers-Keogh legislation has created possible new business vistas for insurance companies and other financial institutions.

II

A second recent event of interest is our institution of litigation against United Benefit Life Insurance Company of Omaha, Nebraska. It came to our attention that United Benefit was selling what it called a "Flexible Fund Retirement Annuity Policy" which might be characterized as a variation on the variable annuity concept. We invited them to cease selling, but our invitation was politely declined. The ultimate result was an injunction action by the Commission in the United States District Court for the District of Columbia where it now awaits trial. *

I consider it important to discuss this development with you this afternoon so that you in the insurance industry will be aware of and can anticipate probable staff positions if you plan to offer any form of variable policy to the public. Many companies have spent much time, money and energy in preparing variable programs in complete good faith without realizing they may encounter problems with our Commission. In most instances they are genuinely surprised and shocked when the staff interposes objections. In the hope that

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* Securities and Exchange Commission v. United Benefit Life Insurance Company, D. D.C., Civ. No. 3096-62 (Filed October 1, 1962).

it may be helpful to you in averting costly problems, I will discuss the United Benefit case as generally illustrative of positions you may encounter from the staff if you propose any program involving variable benefits. What I say, of course, may become moot, for we recognize that the legal problems are not without difficulty, and the ultimate judicial result could free variable plans from Commission jurisdiction.

The United flexible fund annuity arrangement differs from the Prudential and Valic type of annuity in at least two respects. While the net premium after deduction of sales and other charges is credited to a "flexible fund account" and the resultant dollars are invested largely in equity securities during the pay-in period, upon completion of the pay-in period the dollar value of the contract holder's interest in the flexible fund account is used to purchase for him a fixed dollar annuity. The annuitant's interest in the pool of securities would fluctuate with investment results only during the pay-in period. Thereafter he would have a conventional fixed dollar annuity obligation of United Benefit as to which we would assert no jurisdiction. In the Prudential variable annuity the annuitant would be at the risk of the investment experience of the equity fund during both the pay-in and pay-out periods. Accordingly, the staff asserted Investment Company Act jurisdiction over the Prudential investment fund in the pay-out as well as the pay-in period.

United's Flexible Fund Retirement Annuity Policy also involves what it characterizes as a guarantee of partial return of payments for those who discontinue prior to the maturity date of the contract. In brief, the discontinued contract holder would receive the higher of a given percentage of the premiums paid or the then value of his interest in the flexible fund account. The percentage starts low in the first year -- 25% of the gross premiums -- and graduates upward as the policy ages, but it never reaches as much as 95% of the gross premiums paid.

Like Prudential, United argues that its flexible fund account is not a separate entity but is merely the designation of an internal accounting mechanism of United, that if it is a separate entity it would not be subject to the 1940 Act, that the contract is merely another form of optional deferred annuity policy exempt from the Securities Act of 1933, and that in selling the policy it engages in business as an insurance company which exempts it from the 1940 Act. United also appears to claim that the _Valic_ decision of the Supreme Court * is not applicable to it by pointing to its partial

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* _Securities and Exchange Commission_ v. _Variable Annuity Life Insurance Company et al._, 359 U.S. 65 (1959).

repayment guarantee. This would seem to be an effort to take advantage of the "ceiling but no floor" phrase used by Mr. Justice Douglas in the course of the majority opinion. The argument seems to be that the Valic variable annuity had no "floor" because the interest of the annuitant could evaporate upon the occurrence of disastrous investment results. This cannot happen in United's flexible annuity arrangement, for the partial return of payments guarantee constitutes a "floor." The policy holder during the pay-in stage will receive something no matter how adverse the investment experience proves to be.

We believe these arguments miss entirely the thrust of the Valic decision and in part seek solace from words seized out of context. The point is not whether United is an insurance company as defined in the 1940 Act. The point is not whether there is a floor. The point is whether United has created a relationship which places the investor in the position of sharing the risk of investment performance of a common fund. We believe it has during the pay-in period and that those with interests in the flexible fund account are entitled to the protection of the 1940 Act. We also feel that all United has accomplished with the return of partial payment guarantee -- which, in our opinion, is more than a little illusory -- is to create a complication by introducing another security which may be subject to registration under the Securities Act of 1933.

III

The third event occurred last week when the Commission released its decision in the Prudential case.* The result was disappointing for Prudential, for the Commission unanimously (Commissioner Frear not participating) rejected its basic contentions. Prudential has the right to appeal the Commission's decision directly to a federal court of appeals.

The Commission framed the issues simply as "do the variable annuity contracts constitute or include a relationship subject to the Investment Company Act and, if so, what are the consequences." For purposes of the opinion it assumed the desirability of the variable annuity as a retirement program, raised no question of the adequacy of

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* In the Matter of The Prudential Insurance Company of America (Investment Company Act Release No. 3620, January 22, 1963).

state regulation or Prudential's management and agreed that Prudential is an insurance company as defined in the 1940 Act.

The Commission held that the 1940 Act "designates the relationships to which it applies -- most vitally here, that of the contributor to a pool of equity capital managed and invested in securities at his risk. It applies to such a relationship in whatever form or by whomever created." On this and related analysis it concluded that while Prudential itself is not an investment company it is the creator of one. Where it creates a fund for investment and "sells equity interests in the fortunes of that fund" its insurance company exemption under the 1940 Act does _not_ carry over to the fund.

The fund is an investment company and the issuer of a security -- namely, the units of interest acquired by the variable annuity contract holders. That fund must be registered under the 1940 Act and its structure must be such that vitality and effect will be given to the substantive provisions of the Act, particularly those relating to investor control which carry out the fundamental thesis that "those at risk in investment funds should have ultimate voice in their management and policy."

Prudential's application first sought a Commission determination that it was entirely free of 1940 Act restriction on the insurance company exemption theory. In the event that the Commission did not agree, which it did not, Prudential sought alternative relief by requesting a long series of exemptions from various provisions of the Act. I will not attempt to list the exemptions. Suffice it to say that had all of the exemptions been granted, the practical effect would have been to sterilize the operation of the major provisions of the Act.

The Commission dealt with the exemption requests by denying those which it conceived to be vital to investor protection and granting those which will make a variable annuity operation by an insurance company feasible. It recognized that its decision meant that Prudential would have to reorganize its proposal before it could register its investment fund under the 1940 Act. In my opinion this reorganization would not change the basic concept of the Prudential variable annuity itself. Rather it would involve re-structuring the operational mechanics of the investment fund in order to enable it to comply with important provisions of the Act.

This, in brief, is the Prudential decision. It is appropriate to inquire whether the Commission has used it as a vehicle to advance

its jurisdiction in the variable annuity field. I think not. The decision is, in my opinion, entirely consistent with every prior position asserted by the Commission _qua_ Commission and before the courts. Indeed, had the Commission accepted the Prudential arguments it would have constituted a substantial retreat from its prior positions.

Certainly the opinion in no way suggests that the Commission intends to inject itself into insurance regulation. The opinion emphasizes the severable nature of the insurance and investment company elements of the variable annuity and the difference in the objectives, administration and impact of insurance and investment company regulation. And the opinion says unequivocally:

> "This Commission has not the qualification, much less any desire, to become involved in matters of insurance regulation."

May I carry this thought further with an administrative fact of life within the Commission. It may surprise some to learn that the total personnel in my Division devoted to Investment Company Act matters approximates the total number of state insurance commissioners. I mean actual commissioners and not their deputies and subordinates. And when I refer to my personnel I mean the total, including stenographers and clerks. We have no plans for a substantial staff expansion. In fact, for the next fiscal year our budget, if accepted by Congress, will add only three persons to my staff in this area.

The variable annuity problem alone demonstrates the nature of the difficult legal and practical problems with which we are repeatedly confronted. Furthermore, we have 722 registered investment companies for whose regulation we are responsible and whose papers we must process. We must direct an inspection program for these companies. We have rules to draft and problem areas to study with a view to determining the necessity for future legislation. I say this not in a bureaucratic effort to gain sympathy, but only to inquire -- under these circumstances how much insurance regulation could we effectively accomplish even in a single state?

When I spoke to you in Montreal as a member of the staff, I invited, indeed urged, cooperation between the state commissioners and our Commission in working out a compatible method of state and federal regulation of variable annuities. We believe it can be done, that it is in our respective best interests for it to be done. Since last week I think you have something more authoritative than a staff

invitation, and to me this is a far reaching consequence of the Prudential decision. The opinion is plain in its awareness of the different objectives of our respective methods of regulation. The opinion is clear in stating that these methods need not conflict. The opinion recognizes that we both have our functions, that our responsibilities do not overlap. To me it opens the door officially to the opportunity for rewarding cooperative efforts between the states and our Commission toward compatible regulation in this area. Again I urge your favorable consideration.