NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Montreal, Quebec, Canada

COMPATIBLE REGULATION OF VARIABLE ANNUITIES

Allan F. Conwill
Director, Division of Corporate Regulation
Securities and Exchange Commission

June 19, 1962

May I first express my appreciation for your gracious invitation to appear before you this morning. The invitation is particularly welcome because it affords the staff of the Securities and Exchange Commission the opportunity to present for your consideration the results to date of our extensive, if not exhaustive, search for a compatible method of state and federal regulation of variable annuity contracts and their issuers.

I am sure you are all familiar with the 1959 decision of the Supreme Court in Securities and Exchange Commission v. Variable Annuity Life Insurance Company, the so-called "Valic" case, where it was held that variable annuity contracts were securities subject to registration under the Securities Act of 1933 and that the companies issuing those variable annuity contracts were subject to regulation under the Investment Company Act of 1940.

Following the Valic decision, the Commission granted ad hoc relief to Variable Annuity Life Insurance Company and Equity Annuity Life Insurance Company, the two companies involved in the case, in order to avoid subjecting them to undue hardship and to permit them to continue in businesses established and operated for several years prior to the ultimate result of the litigation in the good faith belief that the Investment Company Act was inapplicable to them. The relief was in the form of conditional exemptions from the operation of some -- but by no means all -- of the provisions of the Investment Company Act.

I want to emphasize the purely ad hoc nature of this Commission action. The Commission was well aware at the time that the treatment afforded Valic and Ealic in no sense represented a satisfactory overall method of investment company regulation of variable annuity companies. The Commission recognized that it had the responsibility of exploring and developing a solution to a much broader problem, namely, how may the Commission carry out its statutory investment company regulatory responsibilities in a consistent manner without unrealistic burden upon the regulated companies and -- more important -- without intruding in areas properly within the scope of state insurance regulation. Accordingly, the Commission directed the staff of its Division of Corporate Regulation to conduct an extensive study of the problem. My purpose this morning is to suggest an approach developed as a result of that study which the staff believes contains the germ of solution and invite, indeed urge, your cooperation in working out the problem which, after all, is common to all of us. In presenting our approach to you I am of course expressing the views of the staff rather than the Commission, for the Commission has taken no action directed toward either approval or disapproval of the approach.

The problem is a real one and one which your commissions and ours have to live with. It is far more than a technical problem. It is one of substance. It involves the mutual accommodation of two substantially different philosophies of regulation. We cannot ignore the Congressional mandate of the Investment Company Act. Although we have exemptive powers under the Act, they are intended to be used sparingly and not in a way which defeats vital and inherent policies of the Act. We cannot, for example, grant an exemption if it would destroy those fundamental operating provisions of the Act which provide for stockholder control and which are grounded on the proposition that he who bears the investment risk must have a voice in the management and policy of the fund. We conceive this firm Congressional policy to be of special importance in the case of the variable annuity where the annuitant not only bears the investment risk but is locked into that risk for the remainder of his lifetime once he reaches the pay-out period. We must, therefore, find a method of preserving the important regulatory policies of the Act which will also preserve the state regulatory functions which are equally vital to you.

Before discussing our approach I should mention a pending proceeding before the Commission brought by The Prudential Insurance Company of America. I imagine that for several years Prudential has made no effort to hide from you gentlemen its intention to enter the variable annuity field. In that connection it has filed an application with the Commission for an order which in substance would declare the Investment Company Act inapplicable to Prudential, or, alternatively if the Commission should find the Act applicable, for certain exemptions which for practical purposes would remove Prudential from the major operating provisions of the Act. Prudential seeks to avoid the Valic decision by contending that it applied only to companies whose business consisted almost entirely of issuing variable annuity contracts. The staff opposed the Prudential application. Extensive adversary hearings were held, the case has been briefed and argued, and it is now sub judice before the Commission.

I mention the Prudential case only for the purpose of assuring you that my subsequent remarks are relevant no matter how the Commission may decide the Prudential case. Should the Commission decide adversely to Prudential, it is hardly likely that all interest in variable annuities will dissolve. Should the Commission decision be favorable to Prudential, the regulatory problem will not disappear. There will in any event remain issuers with structures similar to Valic and Ealic who will concentrate predominantly on the sale of variable annuities rather than insurance. We have had extensive conferences with many who propose to enter the field on this basis. Thus the regulatory problem must be resolved.

I must make it quite clear that we are not laying before you a suggested solution which purports to be a finished product. To the contrary it is largely in the conceptual stage. If you find we are moving in the right direction, we would be hopeful for your active assistance in translating our concepts into a fully detailed and comprehensive plan of regulation.

I should also make it clear that our approach relates only to the conventional variable annuity offered to individuals. It is not being suggested in connection with the group deposit administration or flexible funding type of contract such as those contemplated by the recent New York legislation. While the staff of the Commission believes that group deposit administration contracts fall within the ambit of the Investment Company Act, we also feel that they may be sufficiently different from the conventional variable annuity to justify special treatment. For example, we recognize that the terms of many group deposit administration contracts will be separately and vigorously negotiated by firms far more financially informed and with far more professional advice available than the average purchaser of a variable annuity. In other words General Motors is in a better position to protect itself in negotiating the terms of a flexible funding contract than is the housewife in resisting a variable annuity salesman. For this and other reasons the staff has under serious study a conditional exemptive rule which it may recommend to the Commission.

At times during and after the Valic litigation we may have been over-inclined to analyze the variable annuity in terms of having either predominantly investment or primarily insurance characteristics. All thoughts of this one or the other theory have long since been abandoned. Its rejection occurred once and for all shortly after the arrival at the Commission of Professor Francis W. Coker, Jr., of the Yale University School of Law. Mr. Coker was retained as a consultant to the Commission to study in depth investment company problems. In that connection he has made valuable contributions to the staff's thinking on the variable annuity regulatory problem.

Our approach starts with the direct recognition that a variable annuity is neither solely an investment contract nor solely an insurance contract. As Mr. Justice Brennan stated in his concurring opinion in the Valic case:

> "It is rather meaningless to view the problem as one of pidgeonholing these contracts in one category or the other."

We fully accept his further observation that these contracts contain certain obvious elements of conventional insurance as well as plain elements of the traditional investment company. Furthermore we believe -- and our approach is premised upon the belief -- that the insurance and investment company elements can be segregated with sufficient precision so that the insurance elements may be regulated by state authorities with no intrusion by our Commission, and the investment company elements may be regulated by our Commission without interfering with the state regulatory functions.

May we examine for a moment the clear insurance elements. First and undeniable is the mortality guarantee. Here is a promise on which the insurance company alone is at risk. Here is a function where state regulation is vital, for the state commissioners have the experience and expertise necessary to control and evaluate the use of mortality tables, the computation of proper reserves and the propriety of the rates charged for this guarantee, to name a few. And may I here state unequivocally that we do not intend, nor do we have any desire, to intrude into state areas of insurance regulation. Not only do we know our limitations, not only is our workload sufficient to keep us active to a degree that one is tempted to recall wistfully those years before the variable annuity was invented, but I think you will also find that the Commission is and traditionally has been conservative. It well realizes and applauds the wisdom that long ago reposed the supervision of insurance functions within the states.

Other clear insurance elements are the disability waiver of premium insurance which is an integral part of the presently marketed variable annuities, insurance administration expense and a portion of the selling expense. In each of these instances the state authorities know precisely the nature and extent of regulation which public interest demands. It is not only sensible but mandatory that state commissioners be given precedence in these matters.

On the other hand, the unique investment risk of the variable annuity is not, in our opinion, an insurance element. Unlike the fixed dollar annuity, the insurance company makes no promise as to payment of an amount certain. As Mr. Justice Douglas observed in the _Valic_ case, the payment ". . . may be a lot, a little, or nothing." The annuitant alone bears the risk of loss or reaps the benefit of gain from the investments. It is this feature which makes the variable annuity attractive and saleable in a manner closely comparable to those features which are held out as attractive to prospective purchasers of conventional investment company shares. It is precisely this for which the Investment Company Act's protective provisions were designed. As to this segment we would be remiss in our Congressional mandate were we to fail to assert our regulatory jurisdiction.

Another element of the variable annuity at which the Investment Company Act is plainly directed is the investment management expense as contrasted with insurance management and administration expenses. This would embrace all expenses related to the management of the portfolio of securities in which the annuitants have undivided interests, including the fees and charges for investment advice, brokerage commissions, bookkeeping, directors' fees and staff salaries. These expenses are borne by the annuitants, not the insurance company, pro rata to their respective undivided interests in the pool of portfolio securities. Accordingly, they should be subject to the regulatory concepts of the Investment Company Act.

Perhaps a simple way to phrase what we are suggesting is to say that control and regulation should follow the risk and the expense. Where the insurance company takes the risk and bears the expense, regulation should be within the province of the states. But where the annuitant is at risk and incurs expenses directly related to the risk, the Investment Company Act provisions should be considered. If these premises are correct, the natural question is -- by what method can the two forms of regulation be imposed compatibly and without mutual intrusion and duplication.

We can anticipate that the variable annuity idea will be presented in many forms. For example, I am sure that many of you have been presented with a variety of offshoot proposals in the conventional life insurance field relating to variable payment options. Perhaps the ultimate benefit will vary in accordance with a standard cost of living or other index. Suppose you were presented with a proposal to measure an annuity payment by the change in net asset value of shares of a well established investment company. If you believe variable payments should be permitted, would such a proposal pose insurmountable difficulties under your present state statutes and regulations? The insurance company would still be an insurance company subject as now to your exclusive regulation. And the investment company would remain subject to the provisions of the Investment Company Act. Would not such a proposal embody the substance of the variable annuity concept. If this analysis is correct, it would seem that there could be little logical objection to a further step of permitting an insurance company to incorporate a mutual fund. This incorporation would be a part of our approach.

We contemplate the incorporation by an insurance company of an "investment fund" as an open end management investment company. The fund, but not the insurance company, would be registered under the

Investment Company Act. The fund would not be an insurance company and would perform no insurance function. The insurance company may well wish to act as investment adviser to the fund, in which case it would enter into an advisory contract with the fund conforming to the requirements of Section 15 of the Investment Company Act. Shares in the fund would be purchased from time to time by the insurance company as required by its contracts with annuitants. The insurance company would hold the fund shares in a legally separate account for the benefit of holders of variable annuity contracts. This separate account may also be an investment company of the type known as a unit investment trust, but the staff would be prepared to recommend that the Commission grant appropriate exemptions of this technically separate investment company from the provisions of the Investment Company Act in order to avoid infringement upon state regulation of the separate account.

The variable annuity contract would be between the insurance company and the annuitant only. The fund would not be a party. The contract would provide for the charges of the insurance company in the form of a premium or premiums computed to compensate the insurance company for insurance sales and administration expense, the payment for the mortality guarantee and the payment for the disability waiver of premium insurance. It would also provide for a deduction for the sales expenses attributable to the investment features. The remaining net premium would be used for the purchase of shares of the investment fund at their then net asset value, and the contract would set forth the number of units or shares in the fund on the basis of which the annuity payments will be determined. The contract would contain provisions for a pass through vote of the fund shares; that is, the insurance company would vote the shares in the investment fund in accordance with the instructions of annuitants in proportion to their respective interests in such shares at the time of the vote.

We believe this approach can successfully segregate the investment elements of variable annuities into the investment fund which would exist and operate in compliance with the Investment Company Act. All elements other than the investment fund would be regulated by the state commissioners except that it would be necessary for that portion of the selling charges attributable to the purchase of fund shares to conform to the requirements of Section 27 of the Investment Company Act which, among other things, limits the amount of sales load permissible in periodic payment plans. The approach also presupposes that in connection with offers for the sale of variable annuity contracts there would be delivered to prospective purchasers a current prospectus conforming to the disclosure requirements of the Securities Act of 1933 and the Investment Company Act.

Since the shares of the investment fund would be held in the legally separate variable annuity account the insurance company would control the disposition of the shares. The insurance company's liability on its variable annuity contracts would be in terms of numbers of fund shares, and its reserves under state insurance laws could be computed and supervised in terms of numbers of fund shares. One way of handling this feature is that if the reserve should be high due to favorable mortality experience, the insurance company could remove some of the shares and either hold them or redeem them for cash at their then net asset value as it sees fit. If the reserve should be low, the insurance company would purchase additional shares at their then net asset value.

It should be made clear that the investment fund, though a separate corporation, would in no sense be a subsidiary of the insurance company. While the shares of the fund would be held by the insurance company with power to control their disposition, the power to vote them would rest in the variable contract holders. As a practical matter, barring unforeseen circumstances which would produce extreme disenchantment among a majority in interest of the annuitants, the insurance company would control the fund. But the power to eliminate that control or to change investment policies would be in the annuitants. This is vital in the application of the Investment Company Act. Deeply rooted in the policies and operative provisions of the Act is the concept that the fund shareholders -- those who bear the investment risk -- must have power to control the destiny of the fund. This is particularly important in the case of variable annuitants. In the conventional mutual fund a shareholder displeased with investment performance can always get out by redeeming his shares. A variable annuitant can only cash out during the pay-in period. Once the pay-out period commences he is locked in and his risk is frozen into the fund. There is more involved here than the honesty or integrity of the managers of his investment. Also involved is the wisdom of the managers and the right of the annuitant to have a voice in investment policy. Under these circumstances he must have the power to act should mismanagement or unwise management occur and with respect to investment policy.

I should add that our interest in subjecting the investment fund to Investment Company Act regulation does not imply a belief that state authorities should be excluded from regulation in this area. Any state regulation of the fund which does not impair application of the Investment Company Act would be satisfactory, indeed welcome. For example, a state commissioner may wish to impose requirements as to the quality of portfolio securities or eligibility requirements for directors of the fund. We would have no objection

to either. We would also look with favor upon thorough and searching periodic examinations by state authorities of the books, records, management and operations of the investment fund.

The insurance company, as well as such phases of the investment fund as may be deemed desirable, would be subject to the regulation of state authorities. Federal regulation would play no part in its organization, capitalization, reserve requirements, management or operations. The Investment Company Act would apply only in connection with its transactions with and relation to the investment fund and sales of variable annuity contracts. Examples of this application would be a restriction on the number of investment fund directors who are affiliated with the insurance company, election of the investment fund directors by the annuitants, annual approval by annuitants or the directors of the fund of the investment advisory arrangements with the insurance company, and restrictions on purchases and sales of property between the insurance company and the investment fund.

We are aware that effectuation of our approach will require legislative amendments in some states. We do not believe that any of the amendments would do violence to traditional concepts of state insurance regulation. Rather we feel that the amendments would be of a formal and technical nature, such as to permit the incorporation of the investment fund, provide for the separate account to hold fund shares and computation of reserves in terms of numbers of fund shares, permit the insurance company to serve as investment adviser for the fund and permit contract provisions under which the insurance company would vote shares in accordance with the direction of annuitants.

As to the amendments we would make two observations. First, quite apart from federal regulation, if variable annuities are to be sold at all somewhat comparable legislation will be necessary in some states. If the state commissioners believe the variable annuity is a desirable device to be available for purchase by the residents of their respective states, we would urge consideration of an amendment program which would permit effectuation of an approach of this nature. Second, no one to my knowledge has suggested that federal legislation would be an appropriate answer.

We do not suggest that we have presented you with a panacea. I have submitted to you only a framework, and I have not purported to cover all of its ramifications. There may be some problems, including federal tax problems, yet to be resolved. My point is, however, that we believe we can build from this framework. We are convinced that an approach of this nature is workable and that the problems can be resolved in a manner consistent with both your and our schemes of regulation. We would hope to have your help in their resolution.

Our staff will be available to confer with any of you in detail on our approach and on the general regulatory problem at such times and places as may be convenient to you. And perhaps it would not be inappropriate to request your Association to consider the possibility of the creation of a liaison committee to work with our Commission in this connection.

New investment and insurance concepts require a fresh approach. Neither you nor we can avoid the variable annuity regulatory problem. It is here, and each of us bears the responsibility to solve it. I believe it is to your interest and our interest to develop a solution which will not impair established methods of either state or federal regulation. We believe our approach sets the guideline toward such a solution which is practical and workable. We have worked long and hard on it, and we do not consider it unreasonable at this point to request your active participation in bringing it to fruition.