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THE EXPANDING JURISDICTION OF THE SECURITIES AND EXCHANGE COMMISSION: VARIABLE ANNUITIES AND BANK COLLECTIVE INVESTMENT FUNDS

The Securities and Exchange Commission is presently attempting to assert jurisdiction over certain aspects of two industries traditionally exempt from federal securities regulation—insurance and banking.[1] The SEC claims that two recently developed investment vehicles—variable annuities in the insurance field and pooled funds of managing agency accounts in the banking field—are virtually the same as mutual funds, which are subject to SEC regulation under the Investment Company Act of 1940. (A mutual fund is essentially a fund (usually in corporate form), the participants' contributions to which are collectively invested in a portfolio of securities, each participation representing a pro rata interest therein.[2]) The SEC also asserts that participations in these new investment vehicles are "securities" as that term is defined in the Securities Act of 1933,[3] and thus should be registered under that act. In a related move, the SEC has taken the position that pension funds created under the Self-Employed Individuals' Tax Retirement Act of 1962[4] (popularly known as "H.R. 10"), when pooled by banks for collective investment purposes, are also "securities" subject to registration under the Securities Act, although the SEC has hesitantly con-

1 Bank securities and insurance policies (but not insurance company stock) are specifically exempted from the Securities Act of 1933, 48 Stat. 74, as amended, 15 U.S.C. § 77(a)-(aa) (1958 & Supp. IV, 1963) [hereinafter cited as Securities Act], by Securities Act §§ 3(a)(2), (8). Insurance companies and banks are specifically exempted from the Investment Company Act of 1940, 54 Stat. 789, as amended, 15 U.S.C. §§ 80(a-1)-(a-52) (1958) [hereinafter cited as Investment Company Act], by Investment Company Act § 3(c)(3).

The specific problems of variable annuities and bank collective investment funds were not covered in the recently completed *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963). Conversely, this comment will deal neither with the problems in the banking and insurance areas covered in the Special Study nor with the proposed legislation affecting those areas engendered by the Study.

2 An "investment company" is defined, *inter alia*, as an issuer which is engaged primarily in the business of "investing, reinvesting, or trading in securities." Investment Company Act § 3(a)(1). The typical mutual fund is technically a "diversified management investment company." Investment Company Act §§ 4(3), 5(b)(1). Mutual funds are of two types: "Open-end," where the shares are purchased from and redeemed by the fund itself, and "closed-end," where the assets and shares outstanding are fixed and the shares are traded on exchanges and over the counter. Open-end funds comprise the bulk of mutual funds today. For an excellent description of mutual funds and their operation, see Lobell, *The Mutual Fund: A Structural Analysis*, 47 VA. L. REV. 181 (1961).

3 Securities Act § 2(1).

4 76 Stat. 809, codified in scattered sections of the INT. REV. CODE OF 1954. This act extends certain tax advantages to self-employed persons who provide for their retirement by making contributions to a fund created for this purpose. The fund may be invested in insurance, variable annuities, investment company shares, or a trust of which a bank is trustee. The amount of the annual contribution which may be made to each such trust and which receives tax benefits is limited.

ceded that these funds are exempted from the Investment Company Act.[5] This comment will examine the validity of these claims and explore possible solutions to the controversies which they have engendered.

I. THE INVESTMENT VEHICLES INVOLVED

The variable annuity is basically a device whereby the purchaser makes periodic payments of fixed amounts over a period of years (the "pay-in" period), the proceeds of which, after certain deductions, are invested in a portfolio of securities. At each payment, the purchaser is credited with "units" representing his proportionate interest in this fund. The value of these units, and thus the number of units which can be purchased with a given dollar amount, will fluctuate, essentially depending on the investment results of the fund. During the pay-in period, the purchaser has the right to terminate the contract and receive the value of all units credited to his account, less certain termination charges. At the end of the pay-in period, the purchaser has the option of receiving a lump-sum payment representing the value of his units at that time or of receiving periodic payments for a fixed number of years or for the duration of his life (the "pay-out" period). If the program of payments for life is chosen, the number of units composing each periodic payment thereafter to be made to the annuitant is fixed at the beginning of the pay-out period. This is done by the same actuarial calculations which go into the fixing of the amount of periodic payments on a conventional annuity contract. Assume, for a simple illustration, that at the beginning of the pay-out period the purchaser has accumulated 2,400 units and it is actuarially estimated that he will live for twenty years. The monthly annuity payment to him will thus represent ten units. Each month he will receive the value, at the time the company makes payment, of ten units. The fluctuation in unit value is the *investment risk* assumed solely by the purchaser. The chance that he will live longer than twenty years, and so receive more units out of the fund than he put in, is the *mortality risk* assumed by the company selling the variable annuity contract.[6] Thus, a variable annuity contract contains both an investment, or "securities" feature, and also a traditional insurance feature. Variable annuities, first utilized in 1952,[7] were devised to avoid

5 The SEC makes this concession in view of § 3(c)(13) of the Investment Company Act, which exempts "any employees' stock bonus, pension, or profit-sharing trust." *Hearings on Conflict in Federal Regulation of Common Trust Funds Before a Subcommittee of the House Committee on Government Operations*, 88th Cong., 1st Sess. 7 (1963) [hereinafter cited as *Hearings*]. See also Wall Street J., Dec. 26, 1963, p. 2, col. 3. Why the SEC makes this concession is not clear. It seems that the SEC could have argued persuasively that the exemption applies only to each separate pension trust individually, and that, when these various trusts are pooled, the resulting fund is not itself a "pension trust" and thus not exempted.

6 There is of course a reciprocal mortality risk, assumed by the purchaser of a straight variable annuity, that he may die before he has recovered his full 2,400 units in payments.

7 The first variable annuity fund was the College Retirement Equities Fund, which was established by a special act of the New York legislature and began operations in

paying annuitants in depreciated dollars, the theory being that returns from investments in common stocks would, over the long run, tend to balance the effects of inflation.[8]

A managing agency account is an arrangement pursuant to which a customer leaves money with a bank, directing the bank to invest it for him in the bank's discretion. The pooling of these accounts for investment purposes in a "common trust fund" is an innovation only recently made possible by a new regulation (Regulation 9) promulgated by the Comptroller of the Currency in April 1963.[9] (This regulation also permits the pooling of H.R. 10 pension funds.[10]) Congress had transferred authority over the trust activities of national banks from the Federal Reserve Board to the Comptroller of the Currency in September 1962.[11] Prior to that time, such trust activities had been governed by the Federal Reserve Board's Regulation F, which permitted the maintenance of common trust funds by national banks, but prohibited the use of such funds for "other than fiduciary purposes."[12] As a matter of practice, and apparently in deference to the foregoing cautionary language of Regulation F, managing agency accounts were not pooled.[13] Thus, because of the expense involved, banks were rarely willing to handle such an account amounting to less than 100,000 dollars.[14] With the newly permitted pooling of these accounts, much smaller amounts can profitably be handled.

1952. Morrissey, *Dispute Over the Variable Annuity*, 35 Harv. Bus. Rev., Jan.-Feb. 1957, pp. 75-76.

8 This theory may not be entirely valid. Some insurance spokesmen who oppose the variable annuity declare that past experience has not shown a true correlation between the cost-of-living index and common stock prices and that there is no assurance of any such correlation in the future. See *id.* at 77-78; Note, 1959 WASH. U.L.Q. 206, 207 n.16. For a good description of variable annuities and their operation, see Johnson, *The Variable Annuity: What It Is and Why It Is Needed*, 1956 INS. L.J. 357.

9 12 C.F.R. §§ 9.1-9.19 (Supp. 1964) [hereinafter cited as Regulation 9]. Section 9.18(a)(3) of Regulation 9 specifically permits the pooling of managing agency accounts for investment purposes. The terminology used in this section was amended slightly in February 1964. See note 35 *infra*.

10 Regulation 9, § 9.18(a)(2).

11 Act of September 28, 1962, 76 Stat. 668, 12 U.S.C. § 92(a) (Supp. IV, 1963). Since the Comptroller already had supervisory authority over the national banks' trust activities, it was believed that he should also have authority to regulate those activities; this was the sole reason given for the transfer of authority. 2 U.S. CODE CONG. & ADM. NEWS 2735, 2736 (1962).

12 Federal Reserve Board, Regulation F § 17(a), 2 Fed. Reg. 2976 (1937). The Board's conception of the limits of permissible "fiduciary purpose" use of common trust funds was made clear in a subsequent ruling which stated:

> "The Board intended that a common trust fund should be used merely to aid in the administration of trusts by a trust institution through the commingled investment of funds of various trusts. While the operation of a common trust fund might thus enable a trust institution to accept small trusts which it otherwise would be unwilling to handle, it was contemplated that trust guise or form should not be used to enable a trust institution to operate a common trust fund as an investment trust attracting money seeking investment alone and to embark upon what would be in effect the sale of participations in a common trust fund to the public as investments." 26 FED. RESERVE BULL. 393 (1940).

13 *Hearings*, app. B2, at 108.

14 *Hearings* 53.

II. THE VALIDITY OF THE JURISDICTIONAL CLAIMS OF THE SEC

A. *The Law*

Section 2(1) of the Securities Act of 1933 defines "security," in relevant part, as:

> "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit sharing agreement . . . investment contract, voting trust certificate, certificate of deposit for a security . . . or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing."

The language of this section is extremely broad, and both variable annuity contracts and participations in a common trust fund could fall within a literal construction of such terms as "investment contract," "certificate of interest or participation in any profit-sharing agreement," or, presumably, "any interest . . . commonly known as a 'security.' " Proponents of the variable annuity, however, pointed to certain statutory exemptions, noted above.[15] Section 3(a)(8) of the Securities Act specifically exempts from the act "any insurance or endowment policy or annuity contract or optional annuity contract." Section 3(c)(3) of the Investment Company Act unqualifiedly exempts any "insurance company" from the act's provisions. Finally, there is a provision in the McCarran-Ferguson Insurance Regulation Act, passed shortly after the Supreme Court had removed any constitutional doubt as to the federal government's power to regulate insurance,[16] which states that "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."[17] In 1959 the issue of whether variable annuity contracts are "securities" came squarely before the United States Supreme Court in *SEC v. Variable Annuity Life Ins. Co. of America* (the *"VALIC"* case).[18] The Court held, in a five-to-four decision, that variable annuity contracts are "securities" which must be registered under the Securities Act of 1933; furthermore, a company which deals solely in these contracts is not qualified for the "insurance company" exemption in the Investment Company Act of 1940, and so is subject to regulation under that act. The Court stated that such contracts are not "insurance" policies or "annuity" contracts within the meaning of the Securities Act's exemption, and that the company therefore is neither an "insurance company" within the meaning of the Investment Company

15 See note 1 *supra* and accompanying text. The proponents' arguments were thoroughly presented and discussed in SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959). See text accompanying notes 18-19 *infra*.

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

17 McCarran-Ferguson Insurance Regulation Act § 2(b), 59 Stat. 34 (1945), 15 U.S.C. § 1012(b) (1958).

18 359 U.S. 65 (1959).

Act's exemption nor engaged in the "business of insurance" as that term is used in the McCarran-Ferguson Act. The Court's reasoning was as follows:

> "[T]he concept of insurance involves some investment risk-taking on the part of the company. The risk of mortality, assumed here, gives these variable annuities an aspect of insurance. Yet it is apparent, not real; superficial, not substantial. In hard reality the issuer of a variable annuity that has no element of a fixed return assumes no true risk in the insurance sense .... [I]n common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts . . . ."[19]

The *VALIC* case left unsettled, however, the important question of whether a large insurance company, doing only a small portion of its business in variable annuities, could qualify for the "insurance company" exemption. The Investment Company Act defines the "insurance company" which it exempts as "a company which is organized as an insurance company, whose *primary and predominant* business activity is the writing of insurance . . . and which is subject to supervision by the insurance commissioner or a similar official or agency of a State . . . ."[20] The SEC has conceded that a company writing diverse forms of insurance qualifies for this exemption,[21] but there is another obstacle. The SEC claims that, when a variable annuity fund is set up, the *fund itself* is an entity separate from the insurance company and is the "investment company" and the "issuer" of the "security" interests in the fund. Under this "fund-issuer" theory, the fund itself must comply with the provisions of the Investment Company Act. That act clearly provides that an "investment company" may be "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not,"[22] but it gives no clue as to which entity—the corporation or the fund—should be considered the "issuer" of such an interest as a variable annuity.[23] Nevertheless, as a matter of common usage, "issuer" usually designates the person or entity against which an investor has some enforceable claim for a pro rata share of the assets owned by that person or entity. The holder of a variable annuity contract, if he does not outlive the actuarial prediction, has no claim against the assets of the company; rather he has a claim only against the assets of the variable annuity fund. In such circumstances it seems logical to treat the fund, rather than the company, as the issuer.[24] This "fund-issuer" theory creates a number of problems for

19 *Id.* at 71.

20 Investment Company Act § 2(a)(17). (Emphasis added.)

21 Prudential Ins. Co. of America, SEC Investment Company Act Release No. 3620, Jan. 22, 1963.

22 Investment Company Act § 2(a)(8).

23 "'Issuer' means every person who issues or proposes to issue any security, or has outstanding any security which it has issued." Investment Company Act § 2(a)(21). The definition of "issuer" in Securities Act § 2(4) is similarly unhelpful.

24 It is conceded that, if the investor outlives his actuarial prediction, his claim becomes

the large insurance company, the principal one being that a key provision of the Investment Company Act requires that the directors of an "investment company" fund be elected solely by the holders of the securities in that fund.[25] In a recent proceeding, the SEC applied the "fund-issuer" theory to a proposed sale of variable annuity contracts by the Prudential Insurance Company.[26] Prudential, in light of the *VALIC* case, had agreed to register the contracts as "securities" under the Securities Act, but it claimed that it was exempt from the Investment Company Act. The SEC rejected Prudential's arguments that (1) the insurance company, not the fund, was the issuer; (2) the act governs only relationships organized in the form of some legal entity; (3) the term "fund" as used in the act was not meant to apply to such a "lifeless thing, incapable of action"; and (4) the act was not meant to apply to a "minor activity" of an already established company. The SEC's position that the fund did not qualify for the "insurance company" exemption was supported by the drawing of an analogy to the banking exemptions contained in the same statute. Although the Investment Company Act specifically exempts banks,[27] it nevertheless goes on separately to exempt common trust funds maintained by banks.[28] This statutory structure was held to raise a potent implication that Congress did not intend separate funds maintained by banks to be exempt unless a specific exemption for a particular fund was stated in the act; the SEC extended this implication to separate funds maintained by insurance companies. Prudential petitioned the Third Circuit for review, and, in January 1964 that court affirmed the position taken by the SEC.[29] Reviewing the legislative history of the Investment Company Act, the court decided that variable annuities partake of the nature of the investments which Congress was seeking to control. The court noted that Congress intended to make a functional, rather than an institutional, distinction, and that this intent was emphasized by the specific exemption for bank common trust funds.[30] Although the "fund-issuer" theory appears logically valid and has received the unqualified imprimatur of the Third Circuit, there

one against the company, since the company assumes the mortality risk. Thus the "fund-issuer" theory breaks down in regard to a particular variable annuity once the annuitant has outlived his actuarial prediction. However, the critical time for the categorization of an interest with respect to both the Securities Act and the Investment Company Act begins with issuance and continues as long as the annuitant's investment *risk* continues. Upon the annuitant's outliving of his actuarial prediction, he has recovered all of the units representing his investment; he is no longer taking an investment risk, and he no longer has need of the protection of the federal government. *Cf.* note 83 *infra.*

25 Investment Company Act § 16(a).

26 Prudential Ins. Co. of America, SEC Investment Company Act Release No. 3620, Jan. 22, 1963.

27 Investment Company Act § 3(c)(3).

28 *Ibid.*

29 Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3d Cir. 1964).

30 Mr. Justice Brennan has likewise stated that Congress was making a *functional* distinction in the Securities and Investment Company Acts. SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 76 (1959) (concurring opinion).

is still room for argument. The Investment Company Act specifically provides that, to qualify for the act's insurance exemption, a company need only be one whose "primary and predominant" business is insurance.[31] It could therefore be argued that Congress definitely contemplated the possibility of a company with a sideline in investment activities but nevertheless chose to exempt it.

The ultimate judicial fate of the "fund-issuer" theory in the insurance area will undoubtedly have an impact in the banking field, where the SEC is seeking to apply the theory to the newly permitted pooling of managing agency accounts. Since the Investment Company Act specifically exempts both banks and insurance companies when their businesses are predominantly banking and insurance, respectively,[32] the arguments for and against applicability of the theory would seem to be virtually the same in both areas. But, even assuming that the "fund-issuer" theory is applicable in the banking area, the SEC must dispose of another obstacle before it can assert jurisdiction over these pooled accounts under the Investment Company Act. This is the act's exemption, just noted, of "any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."[33] More specifically, the question of whether common trust funds of managing agency accounts are exempt will depend on whether these accounts are held by the bank "in its capacity as trustee." The Comptroller of the Currency interprets "trustee" as referring broadly to *any fiduciary capacity*, and he claims that, when a bank receives money to be placed in a managing agency account, it is acting in such a fiduciary capacity.[34] The SEC reads "trustee" in a much narrower sense, excluding not only the managing agency relationship, but even a revocable inter vivos trust of which the settlor is the beneficiary.[35] The SEC feels that such arrangements lack a

[31] See note 20 *supra* and accompanying text. Investment Company Act § 2(a)(5) contains a similar provision regarding banks. See note 32 *infra.*

[32] While the insurance company exemption depends on a "primary and predominant" test, note 31 *supra*, the banking exemption applies to a bank "a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers." Investment Company Act § 2(a)(5).

[33] Investment Company Act § 3(c)(3).

[34] *Hearings* 36-37. It is interesting to note that some leaders of the banking industry, not sharing the Comptroller's view, frankly admit that a managing agency account does not involve a fiduciary relationship. See *id.* app. B7, at 122.

[35] Letter from Allan F. Conwill, Director of the Division of Corporate Regulation of the SEC, to the author, March 26, 1964, on file with *Michigan Law Review*. See also *Hearings* 6, 36-37. In February 1964 the Comptroller amended § 9.18(a)(3) of Regulation 9, the section which permits pooling of managing agency accounts. That section now allows national bank funds to be invested collectively:

> "in a common trust fund, maintained by the bank exclusively for the collective investment and reinvestment of monies contributed thereto by the bank in its capacity as managing agent *under a managing agency agreement expressly providing that such monies are received by the bank in trust*." 29 Fed. Reg. 1719 (1964). (Amending language in italics.)

This amendment was apparently required by the Internal Revenue Service as a condition "bona fide fiduciary purpose." It should be recalled that the Federal Reserve Board's old Regulation F prohibited only the utilization of common trust funds for *other* than fiduciary purposes.[36] If, as the Comptroller contends, managing agency accounts are received in a fiduciary capacity, the banks' abstention from pooling these accounts under Regulation F is indeed difficult to explain.[37] As a matter of purely legal definition, the meaning of "trustee" cannot be pinned down, since the term "trust" is used by courts and lawyers in a variety of senses,[38] and the availability of the common trust fund exemption for such pooled accounts will therefore ultimately depend on a court's interpretation of the purposes of the Investment Company Act.[39]

The SEC is also claiming that interests in the pooled funds of managing agency accounts are "securities" required to be registered under the Securities Act, even though that act specifically exempts securities issued by a bank.[40] The SEC again applies its "fund-issuer" theory and claims that the fund, rather than the bank, is the issuer. Here the theory runs into difficulty because, under the Securities Act definitions, the list of entities which may be issuers does not include a "fund," although it does include a "trust."[41] But, even if the SEC prevails on its "fund-issuer" theory here, it must clear yet another hurdle before it can require registration under the Securities Act. That hurdle is the act's exemption of "transactions . . . not involving any public offering."[42] Common trust funds have existed for years, and yet, until the promulgation of the Comptroller's Regulation 9 in 1963, the SEC had never required participations in these funds to be registered under the Securities Act. Although the SEC has always considered these participations to be securities, it took the position that, as long as the "bona fide fiduciary purpose" requirement of the Federal Reserve Board's Regulation F was adhered to, there was no "public offering."[43] But, since the SEC believes that Regulation 9 has no requirement of a "bona fide fiduciary purpose" comparable to that of Regulation F,[44] the Commission fears that "merchandising," or a general public offer-

precedent to an income tax exemption for such funds. The favorable tax ruling, phrased in substantially the same language, appeared a few weeks later. Rev. Rul. 64-59, 1964 INT. REV. BULL. No. 8, at 12. This slight addition of language has not caused the SEC to alter its position. See Letter from Allan F. Conwill, *supra*.

36 See note 12 *supra*.

37 Except perhaps as an excess of caution which the Comptroller is now anxious to discourage.

38 1 SCOTT, TRUSTS § 2 (2d ed. 1956).

39 To be discussed in Part II-B *infra*.

40 Securities Act § 3(a)(2).

41 Securities Act §§ 2(2), (4). But even if this distinction causes a denial of SEC jurisdiction under the Securities Act, this is not crucial. If the SEC prevails under the Investment Company Act, under which a fund can be an issuer, it can still require a Securities Act form of registration. See Investment Company Act § 8(b)(4).

42 Securities Act § 4(1).

43 *Hearings* 4; *id.* app. B18, at 167-68.

44 *But see* note 35 *supra*.

ing, of these managing agency accounts is inevitable.[45] Of course, the banks could restrict their availability to certain select customers, but, in the absence of a definite regulation and in view of the attractiveness of the lucrative mutual fund business, such self-restraint seems unlikely. The same fear of "merchandising" is behind the SEC's claim that interests in any pool of H.R. 10 pension funds of the self-employed must be registered under the Securities Act.[46] But the SEC's fears respecting these pension fund pools appear less solidly grounded. The pension funds must be set up under an elaborate trust arrangement with the bank,[47] and they are not terminable at will.[48] These restrictions preclude such a fund's developing into a mutual fund type of investment vehicle available to the general public, and they impart to the arrangement a "bona fide fiduciary purpose."[49] Indeed, it is questionable whether there is any distinction in substance between these pension fund pools and the old type of common trust fund set up under the Federal Reserve Board's Regulation F, about which funds the SEC had no complaint.[50]

B. *Analysis of Present Regulation*

As far as the letter of the law is concerned, the SEC's jurisdictional claims are probably valid (with a possible exception as to H.R. 10 pension fund pools). However, since that validity is somewhat less than clear-cut, an analysis of the existing regulation of these investment vehicles, in light of the purposes of the statutes involved, should be undertaken. The basic philosophy of the Securities Act is one of full disclosure—with the purpose of enabling the investor to make an intelligent appraisal of the risks involved before he commits his funds.[51] The Investment Company Act is similarly aimed at full disclosure,[52] but it seeks also to effect a number of

45 *Hearings* 8. For a recent statement of the SEC's position on what constitutes a "public offering," see SEC Securities Act Release No. 4552, Nov. 6, 1962. It should be noted that § 9.18(b)(5)(iv) of Regulation 9 prohibits advertisement of these collective investment funds. However, the SEC has pointed out that there are other methods by which their availability can be made known to the public (*e.g.*, dispersion through the private contacts of bank employees). *Hearings* 8.

46 *Id.* at 6-7.

47 The trust arrangement is outlined in great detail. INT. REV. CODE OF 1954, § 401.

48 No benefits may be paid to the self-employed person until he has attained 59-1/2 years of age. INT. REV. CODE OF 1954, § 401(d)(4)(B).

49 See text accompanying notes 42-43 *supra*.

50 Although there may be no difference between the two in terms of substantive structure, it is possible that the pension fund pools will far outstrip the old type of common trust funds in sheer size and number. This is because tax-deferred pension contributions are financially attractive, and large numbers of self-employed persons will probably wish to take advantage of this device. This factor, rather than any superficial distinction in the type of trust arrangements involved, is probably the main reason for the SEC's feeling that the protection of the Securities Act is needed where it was not needed before. See *Hearings* 6-7.

51 H.R. REP. No. 85, 73d Cong., 1st Sess. (1933); S. REP. No. 47, 73d Cong., 1st Sess. (1933); SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 77 (1959) (concurring opinion of Brennan, J.).

52 See, *e.g.*, the registration requirements of § 8.

other important purposes, the principal ones being connected with ultimate control of fund activities by the participants therein and the prevention of self-dealing by the directors, at the fund's expense, for the benefit of other enterprises with which they may be affiliated.[53] These purposes are accomplished by giving the participants the right to elect the directors of the fund[54] and to control changes in investment policy,[55] and by placing restrictions on the affiliations of the directors[56] and on transactions with affiliated persons and companies.[57] The legislative history of the Investment Company Act shows that it was drafted principally on the basis of reports submitted by the SEC after an extensive investigation undertaken at the request of Congress.[58] This history is of little help in determining whether Congress would have intended to include such investment vehicles as variable annuities and pooled managing agency accounts within the insurance and banking exemptions had these vehicles existed at the time. However, in describing the nature of the investment enterprises which Congress was seeking to control, the House Report quotes from the testimony of SEC Commissioner Healy, who stated that "essentially these organizations are large liquid pools of the public's savings entrusted to managements to be invested."[59] Moreover, in connection with the banking exemption, it is noteworthy that the Senate Report, in discussing the problems sought to be remedied by the legislation, stated that "commercial banks are in a position to dominate the board of directors and control the management of investment companies; and thus, when they are unscrupulous, to advance their own pecuniary interests at the expense of the investment companies and their security holders."[60]

Given the foregoing indications of the intended scope of the acts and of the possibilities for abuse, the proper inquiry now becomes whether, in light of the statutory purposes mentioned above, present regulation of insurance and banking is sufficient to warrant the exemption of variable annuities and pooled managing agency accounts from the federal securities laws.[61] Insurance regulation today is conducted entirely by the states. In general, state insurance regulation is aimed at preservation of principal and production of a steady income so that the constantly maturing claims

53 The evils which the Investment Company Act was designed to prevent are listed in § 1(b).

54 Investment Company Act § 16.

55 Investment Company Act § 13.

56 Investment Company Act § 10.

57 Investment Company Act §§ 17, 21.

58 H.R. REP. No. 2639, 76th Cong., 3d Sess. 5-6 (1940); S. REP. No. 1775, 76th Cong., 3d Sess. 5 (1940).

59 H.R. REP. No. 2639, 76th Cong., 3d Sess. 6 (1940).

60 S. REP. No. 1775, 76th Cong., 3d Sess. 7 (1940).

61 For an analysis of present regulation in these two areas and its effectiveness in protecting the general shareholders of banking and insurance corporations (as distinguished from the holders of shares in special *funds*), see *Report of Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 3, at 35-42 (1963).

of policyholders can be met. This aim is accomplished by regulating the capital structure, requiring maintenance of proper reserves, and limiting the type of investments which may be made by insurance companies.[62] To the holder of a standard insurance policy the company assumes a *fixed obligation* which cannot be reduced by any dip in the stock market. Since the insured assumes no *investment risk,* disclosure is unnecessary for the protection of his interests. Likewise, the policyholder has no need to control the composition of the board of directors or the investment policy because, assuming the continued solvency of the company, his claim cannot be reduced by mismanagement or unwise investment policy. But, when the policyholder does assume an investment risk, as he does under a variable annuity contract, these factors take on a direct significance. Yet, under traditional insurance regulation, the prospective contract holder has no means of comparing the investment performance of several variable annuity funds, and, once committed, he is virtually helpless to prevent unwise investment policy or mismanagement of the fund. The company could remain solidly solvent while, at the same time, a stock market drop could leave the purchaser of a variable annuity contract holding nothing but a greatly devalued piece of paper. Thus, present insurance regulation is insufficient to warrant exemption of variable annuities from the protective strictures of the federal securities laws.[63]

Regulation of the banking industry has not traditionally been focused on shareholder protection; rather, the prime interest has been the protection of depositors.[64] As in the insurance industry, the main objective is the continued solvency of the institution. Regulation of the trust activities of national banks is now vested exclusively in the Comptroller of the Currency.[65] All regulation of common trust funds of pooled managing agency accounts is thus found in the Comptroller's new Regulation 9.[66] Although that regulation contains some minimum reporting requirements, it does not require that a prospectus be supplied, and even the information which

62 PATTERSON, INSURANCE LAW §§ 3-4 (2d ed. 1957). Since most states limit the portion of an insurance company's assets which may be invested in common stocks, one might suppose that this would prevent the establishment of a variable annuity fund, which is usually invested entirely in common stocks. But this is not the case with a company the size of Prudential. Suppose, for example, that state law limits Prudential's common stock investments to 10% of its assets. If in fact Prudential has only 3% of its assets presently invested in common stocks, it can set up a variable annuity fund invested solely in common stocks as long as the amount of the fund does not exceed 7% of the company's total assets.

63 Compare Kimball, *Regulation of Specialty Policies in Life Insurance,* 62 MICH. L. REV. 167, 226 (1963).

64 *Hearings* 9.

65 See note 11 *supra* and accompanying text.

66 Although the Comptroller has direct authority over *national* banks only, Regulation 9 actually affects *all* banks (state and national) which establish common trust funds. This is because INT. REV. CODE OF 1954, § 584 gives a federal income tax exemption only to those common trust funds which comply with the regulations governing common trust funds of national banks. It would be financially inconceivable to establish a common trust fund without such a tax exemption.

the investor can obtain upon request does not provide sufficient material for intelligent investment analysis.[67] Nor does Regulation 9 require that the participants in the fund elect its directors or control the investment policy. Since, in these and a number of other respects, Regulation 9 falls far short of the investor safeguards of the federal securities laws,[68] the fact of regulation by the Comptroller does not warrant an exemption from those laws.

III. POSSIBLE SOLUTIONS

A. *Judicial*

If the present jurisdictional controversy is settled in the courts—a solution strongly urged by the Comptroller of the Currency[69]—the effect on the industries and investment vehicles involved is likely to be unsatisfactory to both sides. If the claims of the SEC are upheld,[70] compliance with the Securities Act will pose no real problem. It will bring about merely the added cost of registration,[71] and it is unlikely that large insurance and banking corporations would balk at such an expense.[72] But the Investment

67 Chairman Cary of the SEC has outlined the disclosure shortcomings of Regulation 9 as follows:

> "In lieu of requiring that each prospective participant in a bank-sponsored mutual fund be given a prospectus, the regulation provides that the bank shall keep a copy of the written plan in accordance with which it is established at its principal office (it need not be available at branch offices) and that, upon request, a prospective participant shall be furnished a copy of the plan.
>
> "The regulation requires the plan to set out the rights of the participant in the fund. However, it does not appear to require that a specifically defined investment policy be set forth; or that fees and other charges payable by the fund be stated; or that a balance sheet and income statement for a recent period be included; or that the investments of the funds be listed (with a statement of the fund's assets in major fields and a showing of the unrealized appreciation or depreciation in the portfolio); or that transactions with affiliated persons be disclosed." *Hearings* 10.

68 One of the main problems which the Investment Company Act was designed to solve was that of self-dealing by the directors of the company. Section 9.12 of Regulation 9 sets out rules which are designed to prevent self-dealing and which roughly parallel some of the provisions against self-dealing found in § 17 of the Investment Company Act. But Chairman Cary of the SEC has pointed out the inadequacy of the § 9.12 provisions:

> "[A]ll or part of the rules set out in section 9.12 can apparently be negated by exculpatory provisions in the agreement between the bank and the investor. Moreover, to the extent that local law permits any of the activities forbidden by section 9.12, the prohibitions of section 9.12 are overridden. The rules set forth in section 9.12 themselves do not appear to prevent or place any restrictions around investments by the bank-sponsored mutual fund in companies to which the bank has loans outstanding—the mutual fund could be used to provide the cushion for bank loans." *Hearings* 11.

For an analysis of numerous other respects in which Regulation 9 does not provide the Investment Company Act safeguards (such as failure to require an unaffiliated director), see *id.* at 11-13.

69 Statement of James J. Saxon, Comptroller of the Currency, CCH FED. SEC. L. REP. ¶ 76901 (1963).

70 Of course, if all of the SEC's claims are held invalid, the controversy disappears.

71 The SEC has prepared a short form registration statement for H.R. 10 pension fund offerings. *Hearings* app. B19, at 168. This should reduce somewhat the expenses of registration.

72 In the Prudential case, Prudential had already agreed to register its variable annuity contracts under the Securities Act. Prudential Ins. Co. of America v. SEC, 326 F.2d 383,

Company Act apparently deals a fatal blow, for one of the key provisions of that act requires, as noted above, that the directors of the fund be elected solely by the participants in the fund.[73] The SEC has made it clear that it considers this provision "in a large part the very essence of that Act" and that in no situation would it grant an exemption from the requirement.[74] This means that a separate corporation with separate directors must be set up by every insurance company wishing to sell variable annuity contracts and by every bank wishing to pool managing agency accounts. Such a requirement would in many instances be unworkable,[75] and, as a practical matter, many banks and insurance companies will forget the whole matter, thereby leaving utilization of these investment vehicles entirely to the standard investment companies. Another problem arising from a judicial solution upholding the SEC's jurisdiction would be the overlap of regulation of banks by two federal agencies, the SEC and the Comptroller. Such an overlap, unplanned and unorganized by Congress, would result in an inevitable waste of government resources by duplication[76] and the possibility of an unseemly pitting of agency against agency. While these problems suggest the inadequacy of a judicial solution, there is a still more compelling reason to avoid the judicial route. These investment vehicles were neither in existence nor even contemplated when Congress passed the Securities Act and the Investment Company Act. Although both arrangements closely resemble investment devices which are clearly covered by those acts, the new vehicles have created new questions of regulatory and intra-governmental policy which, despite the temptation to wait and see what judicial resolution may be forthcoming, should be speedily subjected to congressional scrutiny and action.[77]

B. *Legislative*

If a legislative solution is sought, the first question of policy to be considered is whether these investment vehicles are really needed. The variable annuity seems a beneficial method of providing for old age. It is doubtful that Congress would want to regulate it out of existence. But it may be asked whether the variable annuity device should be made available to large insurance companies or left to standard investment companies

385 (3d Cir. 1964). And at least one bank has registered its pooled H.R. 10 pension fund offerings under the Securities Act. Wall Street J., Dec. 26, 1963, p. 2, col. 3. With short form registration available, *supra* note 71, even the smaller banks and insurance companies should be able to afford the cost of registration. *But see Hearings* 46.

73 Investment Company Act § 16.

74 Prudential Ins. Co. of America, SEC Investment Company Act Release No. 3620, Jan. 22, 1963.

75 *But see* Note, 1963 DUKE L.J. 807, 814-15, suggesting some possible methods of operation for an insurance company under the separate corporation requirement.

76 The hearings of May 20, 1963, referred to throughout the footnotes of the present comment, were held for the specific purpose of seeking a solution to this threatened duplication of federal regulatory effort. *Hearings* 3.

77 All three opinions in the *VALIC* case intimate that a congressional solution might be best.

and concerns such as VALIC, which issue only variable annuities[78]—a thorny question of policy the solution of which must depend on the airing of the views of all camps at a legislative hearing.

As for the pooling of managing agency accounts, the bankers' strongest argument in favor of this device is that it allows a bank to give more complete service to its established customers who already have a number of dealings with the bank.[79] The weight of this argument is questionable in the face of the fact that mutual funds presently provide exactly the same investment service and do so with all the investor safeguards of the federal securities laws, often with investment analysis more comprehensive than that provided by banks for agency account customers. Relaxation of the requirements of the securities acts might, however, be justifiable in connection with the pooling of managing agency accounts if the availability of that device were limited to certain select customers. This could be done by restricting the pooling to the managing agency accounts of customers who, for a preceding period of given duration, have maintained with the bank accounts of a specific type and of a minimum value. Advertising of the pooling arrangement would, of course, be tightly restricted in order to avoid "merchandising."[80] Further, the pooling of H.R. 10 pension funds seems almost inevitable. Congress has already expressed a desire that banks (among others) handle these funds.[81] If pooling is not allowed, many banks will not be able to handle them because of the expense involved.[82] Since, as mentioned above, these funds are essentially long-range trust arrangements and not primarily investment vehicles, it seems that Congress would be justified in allowing their pooling even though some of the safeguards of the securities laws cannot be provided. However, some periodic reporting requirements might be appropriate to enable the investor to check on the progress and management of the fund. The investor, if dissatisfied, could then withdraw from the fund simply by cancelling his consent to the pooling of his monies.

The biggest obstacle under the securities laws to the use of pooled managing agency accounts by banks and the sale of variable annuities by large insurance companies is the election-of-directors requirement of the Investment Company Act, for this provision necessitates the establishment of a separate corporation. If Congress decides that the banks and insurance companies should be allowed to utilize these investment vehicles without setting up separate corporations, such an elimination of the

78 A large segment of the insurance industry, led by the Metropolitan Life Insurance Company, is opposed to the issuance of variable annuities by insurance companies. They fear that low returns on variable annuities during market declines would destroy public confidence in the traditionally stable insurance industry. Note, 1959 WASH. U.L.Q. 206, 207.

79 *Hearings* 81.

80 "Open" advertising of managing agency account pools is currently forbidden by Regulation 9, § 9.18(b)(5)(iv), but it may be doubted whether this provision is sufficiently strict. See note 45 *supra*.

81 The statute specifically provides for the eventuality of a bank's serving as the trustee. INT. REV. CODE OF 1954, § 401(d)(1).

82 See note 14 *supra* and accompanying text.

election-of-directors requirement could conceivably be justified. If the investor is kept well-informed through required periodic reports, he can express his dissatisfaction with the management by withdrawing from the fund.[83] Dispensing with the requirement of a separate corporation would probably raise the temptation toward self-dealing as between the fund and the sponsoring institution, since the sponsor's directors would be the ultimate managers of the fund, but such temptations might be reduced by a tightening of the prohibitions against self-dealing presently included in the Investment Company Act. Other safeguards of the securities laws, such as the provision giving the investment fund participants the right to vote on proposed changes in investment policy, could be applied intact to these funds, even though such funds are not separately incorporated.

The fundamental legislative objective which must pervade Congress' deliberations on the present controversy is substantive uniformity of regulation. Variable annuities and pooled managing agency accounts are essentially mutual funds. To discard uniformity of regulation in this area would be to give some institutions certain administrative advantages which others engaged in substantially the same business do not enjoy. This is not to say that the details of the *methods* of regulation must necessarily be identical, but merely that the *impact* of the regulation must be uniform throughout the industry.[84] If any of the investor safeguards which surround mutual fund operations must be dispensed with to permit the participation of banks and general insurance companies in the collective investment business, as to them a compensating reinforcement of the remaining safeguards is necessary. It is clear that reconciliation of the diverse interests involved in the present controversy will require a delicacy of balance unobtainable in the courtroom. Resolution of the conflicting policies, which were not within the purview of Congress when it enacted the existing federal securities laws, should be left to that body. And this question should be acted upon by Congress before judicial pronouncements, not based on the kind of investigation of current conditions which Congress is able to undertake, force changes in the structure of the collective investment industry different from those which Congress might wish to make—changes possibly deleterious to a prompt realization of the structure which Congress may ultimately conclude is best for the industry.[85]

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83 Such a withdrawal from an annuity fund after the annuitant has begun to receive monthly payments might seem inconceivable. However, the annuitant need not be "locked in" as he is under the present contracts. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 89 (1959) (concurring opinion of Brennan, J.). The contracts could provide that, until the date of his actuarially predicted demise, he may recover a cash surrender value based on the value of the number of units remaining to be paid between the date of withdrawal and the predicted date of his death. After that predicted date he will have recovered his original investment and will no longer need the protection afforded by the withdrawal right.

84 As before, an exception should be noted with respect to the essentially different H.R. 10 pension trust pools.

85 Three almost identical bills have been introduced—two in the House, one in