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Supreme Court Finds Variable Annuities are Securities

Reverses Lower Courts; Upholds NASD, SEC and Calls For Federal Controls

Variable annuities are securities and must be sold to the public under the same Federal controls that govern the distribution of other types of securities.

This is the ruling of the United States Supreme Court in perhaps the most important and far-reaching legal action affecting the securities business in recent years.

The Court upheld the contention of the NASD and the Securities and Exchange Commission that the variable annuity is not a form of insurance and in effect that it may not be sold by insurance companies and their agents in competition with other forms of investment without registration with SEC under the Securities Act of 1933 and the Investment Company Act of 1940.

The Association intervened in the litigation at its inception as an action seeking court injunction against the offering and sale of variable annuity contracts unless registered under the Federal Securities Acts. NASD Counsel, upon authorization of the Board of Governors, participated in all phases of the proceedings as the official representative of the Association.

In a 5-4 decision that reversed the Federal District Court and the U.S. Court of Appeals, the Nation's highest tribunal declared that Variable Annuity Life Insurance Company of America and The Equity Annuity Life Insurance Company are not entitled to an exemption from Federal securities regulation because, in the words of the Court majority opinion:

". . . The variable annuity places all the investment risks on the annuitant, none on the company. The holder gets only a pro rata share of what the portfolio of equity interests reflects — which may be a lot, a little, or nothing. . . We conclude that the concept of 'insurance' involves some risk-taking on the part of the insurance company. . . 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. . . There is no true underwriting of risks, the one earmark of insurance as it has commonly been conceived of in popular understanding and usage."

Justice William O. Douglas, a former SEC Chairman, wrote the majority opinion. He was joined by Chief Justice Warren and Justices Black, Brennan and Stewart. Justice Brennan also wrote a 21-page concurring opinion in which Justice Stewart joined.

The dissenting opinion, written by Justice Harlan, argued that Congress, not the Court, should decide whether any element of the insurance business should be Federally regulated. Justices Frankfurter, Clark and Whittaker joined in the opinion.

Noting that the lower Courts, the SEC and the Supreme Court majority had conceded that variable annuity contracts contained both "insurance" and "securities" features, the dissenters said they could not understand how the majority held the insurance features to be "not substantial," since some of them involved "classic insurance concepts." The dissenters admitted that the investment policies underlying the annuities, "and the stake of the annuitants in their success or failure, place the insurance company in a position closely resembling that of a company issuing certificates in a periodic payment investment plan."

Even so, it was argued, the majority had reached "unsound legal conclusions" through the "hazardous business" of "analysis by fragmentization" and a "color matching approach" . . . which fails to take adequate account of the historic congressional policy of leaving regulation of the business of insurance entirely to the states." Justice Harlan cited 90 years of "traditional federal 'hands off' policy," confirmed by the McCarran Act in 1944 in answer to a Supreme Court decision that had held insurance business subject to Federal regulation.

He said it was plain "in this framework of history" that "we should decline to admit the SEC into this traditionally state regulatory domain" even though a particular insurance development may have securities aspects.

Justice Brennan, in his detailed concurring opinion, struck this argument aside, stating it is not "rational to assume that Congress thought that *any* business whatsoever regulated by a specific class of officials, (such as) the State Insurance Commissioners, would be for that reason so perfectly conducted and regulated that all the protections of the Federal (Securities) Acts would be unnecessary.

"This approach of personally selective deference to

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the state administrators," he went on, "is hardly to be attributed to Congress . . . the point is not that if the insurance industry seeks to retain its exemption, it must limit itself to the forms of policies and contracts in effect in 1933 and 1940.

"But if a brand-new form of investment arrangement emerges which is labeled 'insurance' or 'annuity' by its promoters, the functional distinction that Congress set up . . . must be examined to test whether the contract falls within the sort of investment form that Congress was then willing to leave exclusively to the State Insurance Commissioners."

Traditional life insurance, he declared, fits into the scheme of state regulation, where adequacy of reserves, and solvency are paramount. But where the public is asked to entrust its money to a company for investment in a variable value contract, Congress provided the Securities Act. "The philosophy of the Act is that full disclosure of the details of the enterprise . . . should be made so that the investor can intelligently appraise the risks involved."

In contrast, the regulation of life insurance and annuities by the states "seems as paternalistic as the Securities Act of 1933 was keyed to free, informed choice.

". . . Where the investor is asked to put his money in a scheme for managing it on an equity basis, it is evident that the Federal Act's controls become vital . . . There is no reason to suppose that Congress intended to make an exemption of forms of investment to which its regulatory scheme was very relevant in favor of a form of state regulation which would not be relevant to them at all."

". . . Since these contracts are in fact covered by the (Securities) Acts, there can be no reason why their issuers should be able to carry on the investment business in a way which Congress has forbidden . . . Congress need not go through the initial travail of re-enacting its general regulatory scheme every time a new form of enterprise is introduced, if that new form falls within the scheme's coverage."

Special NASD Committee On Variable Annuities

The Association's three-year effort in behalf of the securities business to obtain equal competitive footing for investment securities and variable annuities was sparked by the Board of Governors' Special Committee on Variable Annuities.

Chairman of the Committee during most of this period was Lee H. Ostrander of William Blair & Company, Chicago. He was succeeded this January by John D. McCutcheon of John D. McCutcheon and Co., Inc., St. Louis, but remains a member of the Committee.

Other members of the Committee are Arthur H. Haussermann of Vance, Sanders & Company, Boston; Allen J. Nix of Riter & Co., New York City; and Erwin A. Stuebner of Kidder, Peabody & Co., Chicago.

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Continuing Commissions

Valid Contracts Given Clearance

Payment of compensation to registered representatives after they leave the employ of a member of the Association—or to their widows or other direct beneficiaries—will not be deemed in violation of NASD Rules, provided bona fide contracts call for such payment.

The Board of Governors of the Association made this clear in reaffirming the position taken last year that under normal circumstances compensation for the sale of securities may not be paid by a member of the Association to any person who is not a registered representative of a member.

Effect of the clarification is simply to recognize the validity of contracts entered into in good faith between employers and employees at the time the employees are registered representatives of the employing members. Such a contract may vest in an employee the right to receive continuing compensation on business done while with the firm in the event the employee retires and the right to bequeath such payments to his widow or other direct beneficiary.

The Board action in no way is intended to impose or imply any obligation on any member to enter into contracts with registered representatives for continuing compensation. Nor is there any intention to specify or rule on the terms of such contracts; employers may limit or restrict the right to receive continuing commissions or payments in any way they see fit.