Variable Life Insurance
Tamar Frankel*

The Birth of Variable Insurance

Since the beginning of the century, financial and money management services in this country have been provided by three institutions: banks, insurance companies, and investment companies. In the first half of this century, each of these institutions offered a very distinct product, and each was regulated in its services and its internal operations by a separate set of laws and separate agencies. The ability of banks and insurance companies to diversify their services was—and still is—to some extent—limited. Banks were prohibited from engaging in the investment banking business, and insurance companies were strictly restricted to conservative investments. And everyone was prevented from engaging in insurance or banking without committing substantial funds and obtaining prior approval by the appropriate agency.

In the last twenty years, this clear division of functions and regulation began to blur as financial institutions, especially insurance companies and banks, started to diversify. Inflation induced pension fund and the investing public to seek investments in equity securities, and the bearish market of the sixties produced large profits from brokerage and investment advisory services. These incentives were so great that insurance companies, even the large conservative ones, became convinced that, in order to increase or even to maintain their position, they must offer equity products.1 Life insurance and annuities are a combination of insurance coverage and savings arrangements. In annuities, the contract holder usually makes periodic payments, and the accumulation is used on retirement to purchase an annuity giving him fixed pay-

---

* Tamar Frankel is a Professor of Law at Boston University Law School.


---

2 Frankel, note 1 supra, at 182.

The lower the investment performance, the lower the death benefit, but not below the guaranteed amount. The guarantee covers only death benefits, and not the cash surrender value. And if the policyholder surrenders his policy to obtain his savings, he receives an amount affected by the investment performance of the mutual fund, without any guarantee minimum. Two more points should be kept in mind. Some of the differences between various variable life insurance policies are designed to eliminate fluctuations as a result of market performance of the underlying investments by using various formulas which are too complicated for me to understand. But the result is that death benefits will not go up as quickly and will also not decline as quickly. Second, it is expected that in the sale of these policies emphasis would be put on the investment-profit feature, and the use of these policies as a hedge against inflation. The insurance industry at one time hoped that more than a third of the policies in the future would be variable policies.

The Application of the Investment Company Act

The problem of applying Securities Acts to variable insurance products involves the question of applying the Securities Acts to insurance companies. The Investment Company Act of 1940 exempts “insurance companies” from its provisions. Insurance companies are defined as companies that issue insurance products and are regulated by insurance agencies of states of the United States. Since insurance companies usually bear the risk of investments of the reserves and promise their policyholders a fixed rate of return, regardless of investment results, the relevant regulation is the type of regulation that ensures their financial integrity, their ability to pay their obligations when they mature. This type of regulation was effectively enforced by the states from the beginning of the 1900s and was traditionally within the states’ domain. Congress affirmed the status quo in 1945 by declaring in the McCarran-Ferguson Act that the regulation of insurance is to be with the states and that an act of Congress should not impair, supersede, or alter state laws in the field of insurance.
or invalidate any state law regulating the business of insurance except when the federal statutes expressly apply to insurance.\textsuperscript{18}

If a company that issued variable annuities is not primarily in the business of issuing insurance contracts, then a finding that variable annuities are securities excluded such a company from the definition of an insurance company in the Investment Company Act, even if it is subject to regulation of insurance agencies in the states. But if that company is primarily in the business of issuing insurance products and only marginally engaged in the issuance of variable annuities, such a company is exempt from the 1940 Act, even if it issues some variable annuities that are securities.

The question of applicability of the Investment Company Act to old-line insurance companies is important because of the competitive position that insurance companies would have vis-à-vis mutual funds when issuing variable insurance products. Not only does the 1940 Act mean additional burden of regulation, but some of its provisions affect the freedom of issuers to pay sales commissions. Insurance policies and mutual fund shares are sold, rather than bought. If one industry could pay its sales force more for the sale of a very similar product, the other might lose at least part of its sales force. On the other hand, there are real difficulties with applying the 1940 Act to insurance companies. Congress did not have such companies in mind when it enacted the Act. The Act requires that

(1) "Securityholders" have a vote and elect the board;
(2) Investment advisory contracts be in writing and subject to approval of an independent board of directors;
(3) There be at least 40 percent of the board that would be independent;
(4) The investment policy of the investment company be determined in advance and not changed without majority securityholders' approval; and
(5) The investment company have not more than one class of stock, with some exceptions.

Since an insurance company also has stockholders or members (in a mutual company) and other policyholders and is strictly regulated\textsuperscript{18} under \textsection 1012(b) (1970).

1976] VARIABLE LIFE INSURANCE

as to the type of investments in which it could invest its reserves, the requirements of the 1940 Act were, in 1959 at least, to direct conflict with many of the basic provisions of state laws applicable to insurance companies.

Separate Accounts Funding Variable Annuities as Issuers

In Prudential Insurance Company,\textsuperscript{11} the SEC decided that the issuer of variable annuities is not the insurance company, but the "separate account" into which all the net premiums of the contractholders are being paid and which is invested and reinvested in securities at the contractholders' risk. Under the 1940 Act, a "fund" and an "organized group of persons" can be a "company" \textsuperscript{12} and an "issuer" \textsuperscript{13} and, therefore, an investment company.\textsuperscript{14}

The Third Circuit affirmed, and the question never reached the Supreme Court.\textsuperscript{15} In the meantime, Congress amended the Investment Company Act extensively and, among other provisions, exempted certain "separate accounts" from the application of the Act.\textsuperscript{16} By implication, separate accounts, at least of the type covered by the exemption, could be investment companies, but for the exemption. Thus, even though this novel approach recognizes a fund and its investors as an entity, when this fund is, by state law, part of an insurance company's business, separate accounts are, for the purposes of the Investment Company Act, investment companies, "issuers," and "companies."\textsuperscript{17}

SEC Determines Securities Regulations Applicable

In 1972, the insurance industry asked the SEC to adopt rules to exempt variable life insurance policies from the Securities Act of 1933 and the Securities Exchange Act of 1934, the Investment

\textsuperscript{11} 41 S.E.C. 335 (1963).
\textsuperscript{15} 336 F.2d 393 (3rd Cir.), cert. denied 377 U.S. 953 (1964). See Frankel, note 1 supra, at 231.
\textsuperscript{17} see 2 Lone. note 1 supra, at 496-497; 4 Lone, id. at 2378-2394; Frankel, "Regulation of Variable Life Insurance," 48 Notre Dame L. Rev. 1017 (1973).
Company Act of 1940, and the Investment Advisers Act of 1940. Since the antifraud provisions of these Acts were not mentioned, these provisions might, by implication, apply. After lengthy formal hearings, the SEC determined that variable life insurance policies are securities within the Securities Acts and that the registration requirements and the other requirements of the Securities Exchange Act of 1934 should apply to them. The SEC also found that separate accounts funding variable life insurance policies are investment companies but that the application of the Investment Company Act and the Investment Advisers Act to these separate accounts would raise many difficult problems. On the other hand, the SEC found that there is not adequate state regulation to protect such policyholders. Because of these problems, the SEC granted exemptions from the Acts but promised to monitor state laws closely to see if they improve investor protection.  

SEC Sets Up Department for Insurance Products

Throughout the following year, the staff and the National Association of Insurance Commissioners negotiated a draft of model regulations as a basis for state legislation. The final draft was subject to formal hearings and comments. The negotiations were not successful, and the SEC conceded that uniform adequate protection by state law was not in the offing, whereupon, in 1974, the SEC proposed to amend the excessive rules and, later in 1975, completely withdrew the exemptions. Instead, the SEC reorganized its division of investment management regulation and established a department for insurance products, and proposed to alleviate some of the difficulties arising from the conflict between state laws and the 1940 Act, first through ad hoc exemptions by orders.

SEC Grants Exemption to Equitable Life Insurance Company—Proposes Rule 6e-2

The Equitable Life Insurance Company is up to date, the only company that has filed a registration statement under the 1933 Act for a variable life insurance policy. That policy has some features that did not exist in the variable life insurance policies proposed in 1972. For example, cash surrender value is available from the first year of the policy, not from the third. The SEC granted Equitable an exemption by order. The terms of the exemption are fairly limited, especially with respect to the sales commissions. Apparently, at least some of the leading mutual funds feel that this order is acceptable and represents the outer limits of such exemptions. In 1975, the SEC proposed Rule 6e-2 to exempt separate accounts funding certain variable life insurance policies from some of the provisions of the Investment Company Act.  

Proposed Exemptions

These are some of the proposed exemptions: Under the Investment Company Act, control over investment policies and the choice of investment adviser is vested in the shareholders of the company; in the case of separate accounts, the choice is vested in the policyholders. But with respect to insurance companies, insurance regulators and the management of the insurance company, as representative of the shareholders of the insurance company and the other policyholders, ought to have a say. Therefore, under the exemption, insurance regulators and the insurance company may disapprove of changes in the investment policy of the separate account under certain circumstances. Another adjustment is made in connection with the requirement that each share of the investment company have a vote. The exemption translates this requirement in terms of life insurance policies so that each $100 of cash surrender value (not face amount) of the policy is accorded one vote. The nondiscrimination provisions of the Investment Company Act are adjusted to permit premiums based on age, sex, and medical underwriting standards. The Act limits the amounts of sales load that can be deducted in advance from the sales price of shares which are bought on an installment arrangement to prevent losses of this sales load by purchasers who lapse their contracts. A similar adjusted provision is made for policyholders who lapse their policies. In addition, the
Rule proposes substituted forms for registration and certain notifi-
cations which would be more appropriate to insurance companies
and life insurance policies. There is also an exception from the
requirement of an independent accountant to be elected by the
shareholders and for safeguarding of the assets of the separate
accounts.

Variable Life Insurance Quiescent

At present, the interest of insurance companies in variable life
insurance policies is not great. The tax status of these policies is
far from clear, both with respect to the insurance company and the
recipient beneficiary. This raises questions under the Securities Acts
of how the uncertainty can be effectively disclosed. The present
equities market, the strict regulation, and the tremendous expense
of establishing and introducing variable insurance products have
deterred most companies from actively pursuing the variable life
insurance route at present. For the time being, all is now quiet on
the variable life insurance front.

---

REAL ESTATE STOCKS ARE A HEDGE
AGAINST INFLATION YUHE

<table>
<thead>
<tr>
<th>Company</th>
<th>Number</th>
<th>Cost</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Avco Corporation</td>
<td>365</td>
<td>$1,880,968</td>
<td>$2,065,710</td>
</tr>
<tr>
<td>C Onion Properties</td>
<td>266</td>
<td>3,491,063</td>
<td>3,525,000</td>
</tr>
<tr>
<td>&quot;</td>
<td>225</td>
<td>3,032,141</td>
<td>3,177,000</td>
</tr>
<tr>
<td>&quot;</td>
<td>215</td>
<td>$6,956</td>
<td>33,750</td>
</tr>
<tr>
<td>&quot;</td>
<td>307</td>
<td>4,856,273</td>
<td>5,014,900</td>
</tr>
<tr>
<td>&quot;</td>
<td>18,162,170</td>
<td>$18,162,170</td>
<td>$18,162,170</td>
</tr>
</tbody>
</table>