

**SECURITIES AND
EXCHANGE COMMISSION**
Washington, D. C. 20549

**VARIABLE LIFE INSURANCE
AND THE PETITION FOR THE
ISSUANCE AND AMENDMENT
OF EXEMPTIVE RULES**

January 1973

SUMMARY

Report of

THE DIVISION OF INVESTMENT MANAGEMENT REGULATION



SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

Division of Investment
Management Regulation

January 30, 1973

To: The Chairman and Members of the
Securities and Exchange Commission

I am pleased to transmit the Division's report with respect to the Petition filed by the American Life Convention and the Life Insurance Association of America for the adoption of rules to exempt variable life insurance from the federal securities laws.

Pursuant to the Commission's notice of and order for hearing of February 15, 1972, the staff has considered the questions of whether variable life insurance contracts and the issuers thereof, and their related persons, are subject to the federal securities laws, and whether the exemptive rules proposed for such contracts, issuers and related interests and persons should be adopted.

The report summarizes and analyzes the positions taken on these questions by the participants in the proceeding. It is in two parts: a comprehensive analysis of the product, the issues, the arguments on both sides and the Division's recommendations, and a summary intended to serve as a ready reference. Based on the record, the report recommends that the Commission find variable life insurance contracts, the issuers thereof and their related persons to be subject to the federal securities laws and further recommends that the Commission not adopt the blanket exemptions proposed. The report also discusses the ramifications of the imposition of the federal securities laws on variable life insurance--it is clear that specific exemptions from the Investment Company Act of 1940 will be necessary so that variable life contracts may be sold.

The report was prepared by John N. Ake, Jr., Special Counsel, Burton M. Leibert, Acting Special Counsel and Richard Q. Wendt, Actuary, under the general supervision of Alan Rosenblat, Chief Counsel of the Division of Investment Management Regulation. Valuable assistance was also provided by Peter Ambrosini, formerly of the Division of Enforcement, Solomon Freedman, formerly Director of the Division of Corporate Regulation, directed the staff in formulating the procedure for the variable life insurance rulemaking proceeding and provided important guidance in the preliminary analysis of the issues.

Respectfully submitted,


Allan S. Mostoff
Director

VARIABLE LIFE INSURANCE

SUMMARY OF THE REPORT TO THE COMMISSION FROM THE DIVISION OF INVESTMENT MANAGEMENT REGULATION

1. Part I. Introduction and Background

The American Life Convention and the Life Insurance Association of America ("Petitioners") have filed with the Commission a "Petition for Issuance and Amendment of Rules and Rulemaking Proceeding Therefor," requesting that the Commission, through use of its rulemaking powers exempt from the federal securities laws certain variable life insurance contracts, their issuers and related persons.

The Commission issued on February 15, 1972, its notice of a rule-making proceeding with respect to the proposed rules. The hearing phase of the proceeding commenced on April 10, 1972 and concluded on June 7, 1972 after 23 days and 2336 pages of testimony. The testimony was supplemented by the submission of 85 exhibits. In addition, the Commission received the views of a number of interested persons who submitted their comments for inclusion in the proceeding.

Appearing at the hearing in addition to the Division were: the Petitioners in support of their proposed rules; the National Association of Insurance Commissioners ("NAIC") in opposition to any Commission jurisdiction over variable life insurance; the Investment Company Institute ("ICI") in opposition to the proposed exemptive rules; and the Mutual Fund Group, an ad hoc organization of mutual fund managers and underwriters, also in opposition to the proposed exemptive rules. The hearing officer permitted these participants to present testimony, cross-examine witnesses, and to submit memoranda of views for the record at the completion of the hearing.

C. Summary of the Report

1. Part II. The Petition

The Petition requested that rules be adopted to exempt variable life insurance contracts, the issuers of such variable life insurance contracts and their related persons from the Securities Act, the Investment Company Act, the Securities Exchange Act and the Investment Advisers Act.
^{1/}

The exemptive rules would apply to variable life contracts with the following specified characteristics: (1) provision for life insurance coverage for the whole of life and assumption by the insurance company of the mortality and expense risks thereunder; (2) provision for an initial stated amount of death benefit and guaranteed payment of a death benefit at least equal to such amount; (3) provision that the amount payable upon the death of the insured under the contract in any year will be no less than a specified minimum multiple of the gross premium payable in that year by a person who meets standard underwriting requirements; and (4) the contract, in its entirety, would be a life insurance contract subject to regulation under the insurance laws of any state in which the contract is offered. The Petitioners assert that these characteristics are designed to assure that the basic and predominant purpose and function of variable life insurance would be to provide protection against death.

2. Part III. Conclusions and Recommendations

The Report concludes that variable life insurance contracts, the issuers of such contracts and their related persons would be subject to the federal securities laws. Further, the Report concludes that total exemption of variable life insurance from the securities laws would not be appropriate or in the public interest.

^{1/} The proposed exemptions would leave the contract subject to the anti-fraud provisions of the federal securities laws.

3. Part IV. Variable Life Insurance - An Analysis of the Product
and its Economic Impact

Consideration of the Petition requires an analysis of the status of a variable life contract and its issuer under the federal securities laws. In order to make such an analysis, a sound understanding of the features of a variable life contract and how it would operate is essential.

The Features of a Variable Life Contract

The Petition was supported by several specimen contracts which would be non-participating (no dividends to be paid to the contractholder) and would provide for fixed premiums payable for the whole of life; other contracts would be participating, would provide for variable premiums or would provide for premiums payable only until age 65. Under all contracts, the death benefit and cash value would vary with investment performance but the actuarial formulae used for these purposes would vary from contract to contract. Some contracts would contain loan provisions while others would have partial withdrawal provisions. The feature common to all contracts would be the minimum guaranteed death benefit.

Under the proposed exemptive rules, each purchaser of a variable life contract would be assured that as long as he continued to pay premiums, his beneficiary would receive at least the face amount upon his death, regardless of investment performance. On the other hand, the cash value of the contract would vary directly with investment performance of the separate account maintained to fund obligations under the contract. No guarantee would be applicable if the insured surrendered the contract for its cash value or for one of the other non-forfeiture options. Thus,

the contractholder would bear all the investment risk with respect to the cash surrender value.

The cost of a variable life insurance contract would be higher than a corresponding fixed life insurance policy, either because of higher premium rates or lower dividends. Equitable proposes to set its premium rates at age 35 for variable life contracts about 8-1/2 percent higher than a fixed benefit policy. New York Life would charge the same premiums as a fixed benefit policy but would pay lower dividends.

The death benefits of the variable life insurance contracts would also be based on the investment performance of the underlying separate account. Although the determination of the exact amount of death benefit would be exceedingly complex and would vary from contract to contract, in general, investment performance above a predetermined assumed rate of investment return would result in an increase in death benefits, and investment performance below the same assumed rate would result in a decrease in death benefits. The Petitioners supplied hypothetical examples of death benefits, assuming that the investment performance of the separate account had been equal to the investment performance of the Standard and Poor's 500 Stock Price Index. If a \$10,000 contract had been issued to a male age 35 in 1930, the death benefits would have been from \$43,000 to \$53,000 in 1970, depending on the actuarial formula used. As long as premiums are paid when due, the minimum death benefit guarantee would be in effect but, current insurance company experience indicates that this guarantee would

benefit less than one per cent of the purchasers of variable life insurance contracts. This is due to the fact that over 60 per cent of the purchasers would be expected to lapse or surrender their contracts without any guarantee within the first 20 contract years; only 3 per cent to 4 per cent of the purchasers would be expected to die in that period and the minimum death benefit guarantee would be of value to only a portion of those dying. The cost of the minimum death benefit guarantee to the insurance company would depend to a great extent on the actuarial formula used to determine death benefits but, compared to the annual premium that would be charged for the contract, one witness testified that the cost would be trivial.

Based on lapse and surrender experience and projections, it appears that the cash value element of the policy would be very important to the purchaser. As indicated, however, unlike a traditional fixed benefit life insurance policy, the cash value of a variable life insurance contract would not be guaranteed and would fluctuate with the investment performance of the separate account. Examples of historical investment performance show that if investment experience is favorable, variable life insurance contracts could provide an opportunity for greatly enhanced cash values over the long term. Thus, a \$10,000 variable life insurance contract issued in 1930 could have had a cash value of up to \$43,000 in 1970, more than 6 times the cash value of a corresponding fixed benefit policy and more than 5 times the amount of premiums paid.

Economic Impact of Variable Life Insurance

Professor Roger Murray, pursuant to a request by Petitioners, prepared a study on the impact of the development of variable life insurance upon the capital markets. He projected that life insurance companies may increase their fraction of ownership of common stocks from the current level of less than two per cent of all outstanding common stock to a level of approximately five per cent in another 15 years. Of that three per cent increase, 1.8% would be accounted for by sales of variable life insurance. He concluded that there would be no serious concentration of equity ownership in life insurance companies as a consequence of the successful marketing of variable life insurance on a broad scale. In general, it is Dr. Murray's view that variable life insurance would have a "positive influence on the capital markets, but would not have a significant impact."

Currently there are more than 45 insurance companies which have established and registered one or more variable annuity separate accounts. However, the dollar volume of sales of variable annuities has been relatively minor when compared to ordinary life insurance or annuities or mutual funds.

Despite the experience with variable annuities, the expectations for variable life insurance are at a high level. The companies estimate that within 10 years after introduction, variable life insurance would account for 20-40% of all insurance sales. It is also estimated that the total amount of insurance sold each year would increase by 8-10% with the introduction of variable life insurance.

There was conflicting testimony on the impact of variable life insurance upon the mutual fund industry. Dr. Murray's view was that variable life insurance would not be harmful to savings banks, government securities or mutual funds. He believed that the introduction of a new product to compete for the savings dollar would result in an increase in the total level of savings and that competition would be very stimulating to innovation and change.

John Bogle testified that mutual funds and variable life insurance would be in direct competition for investors who were trying to build an estate or retirement fund. He stated that if variable life insurance were exempt from the sales load requirements of the Investment Company Act, the mutual fund industry would be adversely affected.

4. Part V. The Federal Securities Laws - An Overview

Section 3(a)(8) of the Securities Act exempts from registration "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner . . . of any State" Similarly, Section 3(c)(3) of the Investment

Company Act excepts from the definition of investment company any insurance company. As the Supreme Court held in the VALIC case, the meaning of "insurance" or "annuity" under these federal acts is a federal question.^{1/} The threshold question to resolve concerning the Petition is whether the Securities Act exemption and Investment Company Act exception are applicable to variable life insurance.

The legislative history of the exemption of traditional insurance policies from the Securities Act indicates that they were not viewed as investment vehicles.

Insurance policies are not to be regarded as securities subject to the provisions of the Act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. (Emphasis added) (H. Comm. Rep. No. 85, 73d Cong., 1st Sess., at 15).

The legislative history of the Investment Company Act also indicates that the exception provided for insurance companies was based upon the fixed dollar nature of the benefits under the contracts and that a purchaser would not buy a contract in order to invest in the stock market.

The VALIC case was the first instance in which the Courts were called upon to construe the meaning of these provisions. There, the Supreme Court held that an annuity contract which provided benefits that varied based upon the investment experience of a portfolio invested primarily in equities was a security subject to the Securities Act. Such a variable annuity is

1/ S.E.C. v. Variable Annuity Life Insurance Company of America, 359 U.S. 65 (1959).

a security even though it contains elements of insurance, that is, pooling of longevity or mortality. The Court based its decision on the fact that the contractholder gets variable benefits based upon investment performance of the issuer, and also that the contractholder bears all of the investment risk and the insurance company bears none. In addition, the Court held that a company which issued a variable annuity was an investment company even though the company was also regulated by a state insurance commissioner.

Justice Brennan's concurring opinion in VALIC elaborated on the Court's decision. He explained that the Securities Act exemption and the Investment Company Act exception reflect a Congressional determination that there was no practical need for their application. Insurance and annuity policies were not regarded as securities offered to the public primarily for investment purposes. Particularly since such policies did not permit direct participation by the contractholder in the investment experience of the insurance company, they did not present situations with which the federal securities acts were intended to deal. But, Justice Brennan pointed out, to the extent the investor becomes a direct participant in the investment experience of a fund of securities, the federal protections become very relevant. He noted that a variable annuity cannot be divided into distinct insurance and investment elements; it contains elements of both. In that case, because the contractholder participated in the investment experience of the insurer and the insurer did not bear the investment risk, the federal securities laws with their emphasis on disclosure and shareholder protection were meaningful.

The Prudential case represented the second effort of the insurance industry to interpret the statutory provisions as inapplicable to an insurance company promoted equity-linked product.^{1/}

^{1/} Prudential Ins. Co. of Am. v. SEC, 326 F. 2d 383 (3rd Cir.), cert. denied 377 U.S. 953 (1964).

In that case, the Third Circuit upheld a Commission determination that a separate account established by an insurance company to fund variable annuities was an issuer subject to the Investment Company Act. The Court noted the legislative history of the Investment Company Act which described investment companies as essentially "large pools of the public's savings entrusted to managements to be invested" and discussed the "agency relationship" type of investment company where "the group of individual investors is not a legal entity but rather constitutes in essence a combination of distinct individual interests."

In light of this legislative history, the Appeals Court concluded that when Congress wrote the broad definition of "company" in Section 2(a)(8) of the Investment Company Act, to include "a trust, a fund, or any organized group of persons whether incorporated or not," it did not intend to limit the coverage of the Act to recognizable business entities. The Court accordingly held that for purposes of the Act, the investment fund - Prudential's separate account and not Prudential itself - was the "issuer" of securities.

The third, and until this Petition the last, chapter in the development of the law with respect to the equity-linked activities of insurance companies involved the United Benefit Life Insurance Company.¹⁷ After the Prudential case, United Benefit created a variable annuity funded by a separate account which provided some minimum insurance protection and contained a pay-out period for each contractholder limited to a fixed annuity. In the United Benefit case, the Supreme Court held that the product was still subject to the Securities Act. The Court set forth a number of considerations in determining that United Benefit's variable annuity was not "insurance" within the meaning of the

¹⁷ SEC v. United Benefit Life Ins. Co., 357 U.S. 202 (1977).

exemption: The contractholder of a variable annuity contract obtained the benefit of professional investment management; such a variable annuity appealed to the purchaser on the basis of "growth" through investment rather than on the basis of stability; and the competition with mutual funds was indicative of the character given to variable annuities in commerce, that is, growth through professionally managed investments. The assumption of a mortality risk by the insurance company was not enough to make the policy "insurance". Further, while the minimum insurance protection placed some of the investment risk on the insurer, the assumption of that investment risk alone did not render the variable annuity an insurance contract entitled to the Securities Act exemption. The Court held, in the light of these considerations, that the Securities Act with its emphasis on disclosure and shareholder protection was very relevant to the variable annuity contract there in question.

Essentially, the import of these decisions is that the applicability of the federal securities laws to variable life insurance should be a function of the extent to which the contractholder would share in the investment experience of the insurer's investment portfolio; the extent to which the contractholder and the insurance company would bear the investment risk; the nature of the appeal of the contract, and the relevance of traditional state insurance regulation to the contract. These factors not only determine the applicability of the statutes, they also provide important insight into the appropriateness of the exemptions requested.

5. Part VI. State Insurance Regulation - An Overview

The McCarran-Ferguson Act provides 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. This does not preclude the Commission, however, from administering the federal securities laws with respect to a security simply because it is promoted or issued by an insurance company.

In VALIC, the Supreme Court resolved the argument that the McCarran Act was dispositive of Commission jurisdiction by holding the availability of the McCarran Act as well as the exemptive provision of the Securities Act and the Investment Company Act exclusion depends upon "whether the [issuers] are issuing contracts of insurance." In other words the test is identical for purposes of both the securities laws and the McCarran Act. If the contracts have substantial equity features, they are not totally and simply insurance and a fortiori, the federal securities laws do not infringe upon the state laws.

Justice Brennan, in his concurring opinion in VALIC, reasoned that where the purchaser has no investment risk, as in traditional life insurance in which the obligation is measured in fixed dollar terms, state regulation is adequate and there is no need for disclosure. On the other hand, where the purchaser is investing in a product in which he has an equity participation in the investment experience of the issuer and bears investment risks, the

federal requirement of full disclosure is relevant, so that the purchaser can intelligently appraise the investment risks of the product. Adopting this rationale in United Benefit, the Supreme Court made clear that, as a matter of law, the Securities Act exemption for insurance policies was not available to the variable annuities there in question, regardless of the adequacy of state regulation, because they were securities and involved considerations of investment not present in conventional insurance.

More recently in the National Securities case, the Supreme Court again considered an asserted conflict between the McCarran-Ferguson and the federal securities laws.^{1/} The Court followed the precedents established in VALIC and United Benefit and agreed with the Commission, holding that state regulation of "insurance securities" does not pre-empt federal securities regulation because, with respect to "insurance securities," federal securities laws would not supersede state laws which regulate the business of insurance but not securities.

One of the four conditions to availability of the proposed exemptive rules, specified by Petitioners, is the applicability of state insurance regulation. The effect of this condition is to suggest that even if variable life insurance would be a security, the exempting rules should be adopted because state regulation would make federal regulation unnecessary or inappropriate. Review of state regulation indicates, however, that now at least this is not the case. Historically state insurance regulation has been directed at maintaining the solvency of insurance companies and not at providing the purchaser with full disclosure. The rationale underlying traditional state concepts of insurance regulation is that a purchaser receives an insurance contract in fixed dollar terms and disclosure is unnecessary.

^{1/} SEC v. National Securities Inc., 393 U.S. 953 (1969).

Where the contract is in variable terms, however, disclosure is necessary (as Petitioners concede) to assist the purchaser in making an informed judgment.

In recognition of the shortcomings of existing state regulation with respect to variable life insurance, the state insurance commissioners have developed a Model Variable Contract Law and Regulation and disclosure requirement. This effort is a significant break with traditional state insurance regulation, however, and in the area of disclosure it so far has been adopted by only seven states.

6. Part VII. Variable Life Insurance Under the Securities Act

Proposed Rule 157 requested by Petitioners would provide total exemption from the registration provisions of the Securities Act for variable life insurance contracts. In passing upon this proposal, the Commission must consider the status of variable life contracts under the Securities Act, in light of the Supreme Court's decisions in VALIC and United Benefit, and whether exemption from the disclosure requirements for variable life insurance is in the public interest and consistent with the protection of investors.

The status of variable life insurance under the Securities Act presents two separate questions which are closely interrelated: First, would variable life insurance involve the offer of a security? Second, would it be exempted from registration under the Act by Section 3(a)(8)?

First, variable life insurance would fall within the definition of a "security" in Section 2(1) of the Act and would meet the test of a security

1/ 2/ 3/
set forth by the Supreme Court in Howey, Joiner, and Tcherepnin cases.
Each of the components in the definition of an "investment contract" used
in Howey would be present in variable life insurance; that is, the contracts would
provide that the purchaser invest his money (labeled "premiums") in a
common enterprise (the separate account) with the expectation of profits
(from market appreciation and from dividends and interest) solely from the
efforts (professional investment management) of the promoter or a third
party (the insurance companies or investment managers selected by them).

Second, as already indicated, in considering the applicability of
the Securities Act, the question should turn on the four tests evolved by
the Supreme Court in VALIC and United Benefit -

(1) The extent of the purchasers' interest in the investment
experience - Variable life insurance would provide significant
insurance protection in the form of the minimum death benefit
guarantee at the risk of the insurance company. At the same
time, however, the variable life insurance contractholder would
participate to a substantial degree in the investment experience
of the separate account with respect to the variable benefits
under the contract. Both the death benefit and the cash
surrender value would vary depending upon the investment perfor-
mance of the account. In this circumstance, the investment

1/ SEC v. W. J. Howey Co., 328 U.S. 293 (1946).

2/ SEC v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943).

3/ Tcherepnin v. Knight, 389 U.S. 332 (1967).

management capabilities of the issuing company, or its designated investment manager, would obviously be critical to the investment interests of the purchaser in the contract, and thus have a direct bearing on the decision which the purchaser must make as to which variable life contract to buy.

(2) The extent to which the purchaser bears the investment risk - The minimum guarantee, an important and critical provision of the variable life insurance contracts which would meet the terms of the proposed rules, would put a floor under only one of the variable features in the contract - the death benefit. The other variable features in the contract, the very important cash surrender value, the non-forfeiture options, and the policy loan or withdrawal options, would not be guaranteed against adverse investment performance, and the contractholder would bear the entire investment risk.

The insurance company would bear the investment risks with respect to the death benefit, but this appears insubstantial when examined over the entire group of policies which are offered. In addition, the multiples under the proposed rules would permit the insurance companies in most instances to increase their premium rates substantially and still come under the exemptive rules.

(3) The sales appeal - Even though variable life insurance is not publicly marketed in this country, it could reasonably be expected that the sales appeal of variable life insurance would lie in the

potential increase in the benefits of the policy through professional management of a portfolio of equity investments. It could also reasonably be expected that the emphasis on "living benefits" now found in the sale of fixed benefit life insurance, would continue with an added inducement that the cash surrender value could grow through a participation in a portfolio of equity securities.

(4) State insurance regulation - Analysis of traditional state insurance regulation indicates that it is directed at maintaining the solvency of insurance companies and not at providing the purchaser with full disclosure. Where the contract is in variable terms, disclosure would be necessary to assist the purchaser in making an informed judgment, but, traditional state insurance regulation does not meet this need. The state insurance commissioners have developed their own model disclosure code for variable insurance but it would not now provide adequate disclosure and would be of limited application since only seven states have adopted even this "mini-prospectus" requirement.

Under the four tests developed by the Supreme Court in VALIC and United Benefit to determine whether variable annuities were exempt from the Securities Act, variable life insurance contracts would not be exempt from the Securities Act as "insurance."

7. Part VIII. Variable Life Insurance Under the Investment Company Act

In analyzing variable life insurance under the Investment Company Act the following issues were considered: first, would the separate account which issues the variable life contract be an investment company, and if so, would it be exempt from coverage under the Act by the exemption in Section 3(a)(3) or by the McCarran-Ferguson Act; second, if the separate account would not be entitled to exclusion or exemption from the Act, how should it to be classified and how would the applicable restrictions on total sales loads and front-end loads affect variable life insurance.

The separate account to be organized to fund variable life insurance would invest, reinvest and trade primarily in equity securities. The value of the variable features of the contract would be determined by the results of such investments. As such, the separate account would fall within the definition of "investment company" contained in Sections 3(a)(1) and (3) of the Act.

The VALIC case established that a company which funds variable annuity contracts is an investment company. Prudential extended this rule to a separate account of an insurance company. Unless distinguished, a separate account established to fund variable life insurance contracts would also be an investment company. Petitioners presented four main arguments in support of their position that the variable life separate account should not be regulated under the Investment Company Act. First, they point out that when the Supreme Court remanded the United Benefit case for consideration of the 1940 Act question, the Court did not specifically refer to either the Third Circuit or Commission opinions in Prudential. On the remand, the

questions relevant to this issue which the Supreme Court specified for consideration by the lower court in United Benefit were the relationship between the variable and fixed business and the distinctions between the two, and the possible conflicts in federal and state regulation. There is no reason to believe any contrary conclusion would have been reached on the facts in United Benefit. The question of Investment Company Act applicability was remanded at the request of the Commission and the issues specified by the Court for remand had been considered by both the Commission and the Court of Appeals in Prudential. Nevertheless, consideration of these issues is an important part of the analysis of variable life insurance.

Second, Petitioners argue that variable life insurance, unlike variable annuities, would involve insurance and investment elements in such a closely woven fabric that would be impossible for the Commission to regulate just the investment aspects. This argument, which involves really three separate contentions (that the contract is indivisible, that the account is a mere activity of the insurance company, and that the company and its stock and policyholders are interested in the operation of the account) was made in Prudential and rejected there by both the Commission and the Third Circuit. The same analysis would seem to be applicable to the variable life separate account.

Petitioners' also argue that the variable life separate account would be a bona fide operational insurance mechanism and therefore excepted from the Act. The question at issue, however, is whether the separate account would be covered by the federal definition of "insurance company" and VALIC and Prudential indicate that the definition should not turn simply on whether or not the account would also involve insurance aspects.

Petitioners' final argument against regulation of the separate account under the 1940 Act is that the Act was simply not designed so as to apply to variable life contracts or the funding medium. The Division believes, based on testimony presented in the hearing, that participations held out to variable life contractholders would be similar in material respects to participations available to mutual fund shareholders and variable annuity contractholders and that, although perhaps a difficult fit, certain provisions of the Act could provide very important protections.

As is the case with respect to the Securities Act, state law in its present formative stages would not provide an acceptable substitute for the comprehensive protections of the Investment Company Act which include regulation in such diverse areas as valuation of assets, corporate democracy, investment advisory services and transactions with affiliates. At the same time, however, the very important minimum death benefit guarantee element of the contract, which will require comprehensive state regulation, suggests the appropriateness of the development of a comprehensive pattern of state regulation to also provide such protections with respect to the variable element of the contract.

The specimen contracts examined in the hearing would be periodic payment plan certificates within the meaning of the Investment Company Act. Variable life contracts would meet the two-part test for periodic payment plans in the sense that they contemplate: (1) a series of payments, and (2) would represent an "undivided" interest in a fund of securities purchased in part with the proceeds of the contractholder's premiums.

Section 27(c)(1) of the Act requires that periodic payment plan certificates be redeemable, i.e., that upon presentation the holder must receive his proportionate share of assets or cash equivalents. This requirement would be satisfied by provisions for cash value which would entitle the contractholder to receive, on surrender or termination, an amount equal to premiums paid, plus investment performance, less expenses and less the cost of insurance. In the context of a variable life contract, this amount would be the contractholder's "proportionate share" of the assets in the separate account. The fact that in early years of the contract the value would be non-existent only reflects the early and very heavy amortization of sales and administrative expenses now permitted insurance companies under state law.

Petitioners and the investment company industry have indicated that the Act's limitations on sales loads is a key factor in their opposing views on the applicability of the Act. The investment company industry views variable life insurance as a directly competitive product and asserts that those who sell such comparable products will emphasize that product which provides them with the highest remuneration. Petitioners, on the other hand, assert that any variation in the commission rate prevalent for insurance products would create a conflict of interest for the agent that could prevent a free choice by the insurance-buying public between the variable and fixed products.

While there has been testimony to the contrary, the variable life insurance contract contemplated by the insurance industry would involve a "sales load" within the meaning of the Act. In the typical

fixed-benefit insurance policy, the incidence of sales expenses does not necessarily correspond to the incidence of sales charges. In other words, even though policyholders pay a portion of first year expenses in each year of the premium paying period, Policyholders who terminate before full amortization of their first year's expenses are assessed a charge against their surrender value for the unamortized portion.

Section 27 restricts the total sales charge of periodic payment plans to 5% over the life of the plan. Insurance industry figures set forth in hearing exhibits indicate that compensation paid to insurance salesmen over the life of the contract is not radically different from the total sales charge permitted under Section 27. When such compensation is added to the cost of other sales related expenses, however, the total exceeds the 9% limit.

Section 27(a)(2) of the Act limits the maximum sales charges (sales loads) which can be deducted from the first 12 monthly payments under a periodic payment plan to no more than 50 per cent.

Sections 27(d)-(g), enacted in 1970, contain important new protections for investors who change their mind or fall significantly behind in their monthly payments. These statutory protections, on their face, clash with traditional insurance methods of salesmen compensation and amortization of other selling expenses in the early years of the insurance contract.

The Section 27 restriction on front-end loads serves two purposes: (1) it insures that a purchaser will immediately have at least some of the benefit of his bargain in the sense that at least 50 per cent of his

gross payments will be invested for him and (2) provides that a purchaser who terminates his contract at an early date will not be unduly penalized by disproportionate payments of sales charges in the early years. Both of these protections would be important to the purchaser of a periodic payment plan. Although variable life insurance would provide immediate life insurance protection in the form of the minimum death benefit guarantee, these protections could also be of importance to the purchaser of a variable life contract.

As for the argument by Petitioners that regulation under this Section would make it difficult to sell the product, the Act, reinforced by the 1970 Amendments, reflects a Congressional decision to limit and protect against harmful forfeitures by investors even though such preventive provisions make it less attractive to sell periodic payment plans. Total exemption from the protections of Section 27 of the Act, simply to facilitate equivalent compensation structures for the fixed benefit and variable benefit life insurance, does not appear warranted.

E. Part IX. Variable Life Insurance Under the Investment Advisers Act

If a variable life separate account would be an investment company, its adviser, including the insurance company-organizer or its subsidiary providing investment advisory services, would be required to register under the Investment Advisers Act. Petitioners have requested proposed Rule 202-1 which would specifically exempt from the Investment Advisers Act an insurance company or an affiliated company thereof to the extent it performs investment management or advisory services for a separate account funding variable life insurance contracts.

Insurance companies and their subsidiaries are now required to be registered under the Investment Advisers Act to the extent they act as investment advisers to accounts used to fund variable annuities which are registered investment companies. In the event that the adviser of a variable life separate account would be required to register under the Act, it is not anticipated that the regulation of the adviser would differ from the regulation of the insurance company-adviser of variable annuity separate accounts. It should be noted in this regard that though Petitioners presented witnesses who described the investment management and advisory facilities and operations of the companies, they did not argue that regulation under the Investment Advisers Act was inappropriate or troublesome.

9. Part X. Variable Life Insurance Under the Securities Exchange Act

The Petitioners request that the Commission adopt two rules under the Securities Exchange Act defining variable life insurance as an exempted security. The effect of their proposed rules would be to relieve sellers of variable life contracts from complying with the registration and reporting requirements of the Act.

A determination of the status of variable life sales organizations under the Securities Exchange Act is contingent upon the determination of the status of variable life insurance under the Securities Act. If variable life insurance is subjected to the Securities Act, then the variable life insurance distribution system should be also subject to the Securities Exchange Act.

Because regulation of variable life insurance under the Securities Exchange Act would parallel the present dual regulation of variable annuities, the variable annuity experience with respect to federal and state regulation and licensing requirements is relevant. Dual regulation of the variable annuity distribution system is very well defined and does not seem to impose substantial burdens upon insurance companies and their agents. Since the same distribution system would also be utilized for variable life insurance, registration under the Act would not seem unduly burdensome. Additionally, the majority of those companies offering and the agents selling variable annuities are also offering mutual funds as a part of the insurance industry's trend towards "total financial planning" for its customers. Moreover, many agents of companies who are not yet offering either product have already become registered representatives in order to sell these products in an effort to retain their customers' business.