March 14, 1959

Dear Bill:

I enclose a recirculation in the Variable Annuity case. These changes merely pick up loose ends and make minor corrections. This circulation does not reflect any of the ideas that you have put in your memorandum in these cases.

I have puzzled long and hard over your suggestion that I incorporate the gist of your memorandum in this opinion. I have tried to work it out by putting a lot of it in footnotes but that just does not jell. The only feasible alternative is to put in a second part.

I have gone through your memorandum and have boiled it down and digested it into relatively few pages. I attach a typewritten copy which I am not showing to any of the other Brethren. I wanted first to get your reaction. I could possibly put it in this form in my opinion as Part II. I still think it would be preferable for you to file your opinion as a separate concurring one. It develops the idea in greater detail. But if you still think that I should put in a Part II, then look this proposed Rider of mine over and give me your suggestions.

I suppose my basic difficulty is that I do not know which for a practical matter is better form of regulation. I have seen the S.E.C. deteriorate so far and so fast since my days there that I often wonder whether some State Insurance Commissions might not in fact be better watchdogs than the Federal Agency. Moreover, there is in the back of my mind the thought that if these bunnies have found a hole in the fence they should be allowed to use it even though it may seem to be against public policy to let them through.

I personally think that they have not found a hole in the fence; they are not writing insurance; these are investment contracts. So I am wholly content to rest on what I have written, leaving to you the fuller explanation of what you deem to be the practical consequences of the problem.

I will be away for a day or two, but I will be back on Wednesday, the 18th. Perhaps we can have a talk then.

William O. Douglas

Mr. Justice Brennan

<u>Rider 7</u>

Part II

We reach the same result if we analyze the Variable Annuity Contract in terms of the relevancy to it of state and federal regulation. The avowed philosophy of the 1933 Securities Act (sometimes known as the Truth-In-Securities Act) is full disclosure. Its requirements for detailed description in a prospectus of a security offered to the public is premised on the belief that a prospective investor ought to know where his money is going before he commits it to the use of other people.

The Investment Company Act of 1940 goes beyond the “full disclosure” philosophy. Its provisions call for registration of investment companies and recital of investment policies and operating practices, for regulating the managers of the companies, trading practices, capital structure, and investment policy, as well as detailed reports to investors. True, these provisions apply to “face-amount certificate companies” which issue fixed-dollar obligations, and certain bonds of a stated value. Nonetheless, the regulatory scheme is designed for the type of transaction where the investor commits his money to others on an equity basis for investment on his behalf.

Traditional state insurance regulation, on the other hand, proceeds on a different philosophy. The States control the provisions in policies; reserve requirements are imposed to insure solvency; and the scope of permissible investments is limited to prevent dissipation of the policyholders’ security. The whole direction of state regulation is to guarantee the perpetuation of the insurance company so that it will honor its obligations to its investors. Thus the company is shrouded with safeguards designed to minimize the risk of errant investments, which would otherwise undercut the investor’s security.

While the variable annuity contains some insurance features,[16] the closest analogy is to the certificate of an investment trust calling for periodic payments by the holder. The interest of a holder of a variable annuity contract is represented by "accumulation units," fluctuating reporting devices representing shares of the entire invested fund. The value of the unit is recomputed monthly, taking into account dividends and interest received, realized and unrealized capital gains and losses, and certain taxes. When each periodic payment is made by an investor he receives as many new units as his payment will buy, based on the newly computed value. Investors who borrow against their accumulated units do so at their value at the time of the loan, and on repayment the investor regains the number of units that the repayment would then purchase. A charge of 1.8 per cent of the asset value of the fund per annum is made by the company throughout the pay-in and pay-out periods, which is to cover company expenses, the risk of super-annuation, and provides for contingency reserves and additions to surplus. A portion of each premium is also deducted for these "loading charges."

As the investor's reason for investing in the company is the hope that prudent management will enlarge his invested return, the precise situation for which the full disclosure philosophy of the Securities Act, and the strict regulatory provisions of the Investment Company Act were designed, is presented.

Analysis of the benefit payment method also supports this conclusion.[17] Once the pay-outs begin the investor cannot withdraw his capital investment -- he is "locked in" and will realize on his investment only to the extent that his managers have undertaken wise placement of his money. Accordingly, while these contracts contain insurance features, they contain to a very substantial degree elements of investment contracts as administered by investment trusts. We do not mean to say, of course, that because federal regulation would be more desirable than state control, it is therefore accomplished. But this analysis of the purpose of the exemptions from the federal acts gives a guide to their scope. Congress intended a broad coverage in both the 1933 and the 1940 Acts, and since these contracts present regulatory problems of the very sort that Congress was attempting to solve, we are fortified in our conclusion that respondents, and their variable annuity which differs in kind from the usual annuity, are not within the “insurance” exemptions of those Acts.

FOOTNOTES

/16. E.g., a grace period, a suicide clause, an incontestability clause. In the event of death before maturity, a beneficiary will receive the cash value of the contract, determined by the value of the accumulations units held by the annuitant. And see note 15 supra.

/17. See note 14, supra.