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A Tangled Web? Some Peripheral Problems Under the Investment Company Act

H. James Sheedy

In recent years, several unique types of "investment companies" have come into existence. These companies have presented serious problems to the Securities and Exchange Commission and to the courts. Mr. Sheedy examines the application of the Investment Company Act of 1940 to these investment companies and critically analyzes the logic and pattern of the 1940 Act, concluding that with respect to the peripheral types of investment companies discussed, the 1940 Act has been unduly extended into areas where the need for such regulation has not been shown to exist.

In the course of investigating the part played by public utility holding companies in the financial collapse of 1929 and subsequent years, Congress discovered that investment companies were usually found at the top of the complex public utility company pyramids. Accordingly, section 30 of the Public Utility Holding Company Act of 1935, which virtually outlawed such pyramids, ordered the Securities and Exchange Commission (SEC) to study the investment company industry and to submit recommendations as to needed regulation. The Commission made an extensive study which revealed shocking abuses, during the 1920's, by investment company managements, their investment advisors, and underwriters. As a result of this study, Congress subsequently enacted the Investment Company Act of 1940 (the 1940 Act), a monumentally comprehensive and detailed regulation of the formation and day-to-day operation of investment companies.

The 1940 Act has, without question, accomplished much of its
original purpose with respect to the conventional type of open-end "mutual funds" and closed-end investment companies which were in existence at the time the 1940 Act was adopted. The vast increase in the assets of such investment companies since 1940 is undeniable evidence of the restoration of public confidence in the industry. Indeed, the abuses at which the 1940 Act was directed have been largely, if not entirely, eliminated.

However, in recent years several unique types of "investment companies" have come into existence which have presented problems of some magnitude to the SEC, to the courts, and, certainly, to the companies involved. The purpose of this article is to review briefly the application of the 1940 Act to these "investment companies."

I. THE PERIPHERAL PROBLEMS

The new peripheral types of investment companies include small business investment companies formed under the Small Business Investment Act of 1958, insurance companies issuing variable annuity policies, and bank-administered common trust funds offered to the public. While the problems presented in each of these areas differ, these "investment companies" have at least one element in common. They each represent a concept or form of institution which was not in being at the time the 1940 Act was adopted. In view of the comprehensive and detailed regulation imposed by the 1940 Act, a regulatory pattern specifically directed at a pre-existing industry, it is not surprising that these new situations have raised some basic questions regarding the logic of the regulatory scheme and the scope and purpose of the 1940 Act.

A. Definition of Investment Company and the Exemption Pattern

The problems that have developed under the 1940 Act stem from the necessarily broad and general definition of "investment company" contained therein. The investment companies of the time took many forms. Accordingly, the 1940 Act defined "investment

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4 The estimated aggregate market value of assets of registered investment companies increased from two and one-half billion dollars in 1941 to over forty-four billion dollars as of June 30, 1965. 31 SEC ANN. REP. 110 (1965).


"investment company" to include any natural person, corporation, partnership, association, joint stock company, trust, fund, or "any organized group of persons whether incorporated or not" which issues or has outstanding any security, and which (a) is engaged primarily in the business of investing in securities, or (b) is engaged in the business of investing in securities and owns "investment securities" having a value exceeding forty per cent of the value of such issuer's total assets (exclusive of government securities and cash items)." 7

"Investment securities" include all securities except government securities, securities issued by "employees' securities companies," and securities issued by majority-owned subsidiaries which are not investment companies. 8

An issuer owning investment securities having a value exceeding forty per cent of the value of its total assets is nevertheless not an investment company if it is primarily engaged, either directly or through wholly owned subsidiaries, in a business or businesses other than investing in securities. 9 In addition, the Commission may find, upon application and by order, that an issuer having more than forty per cent of its assets in investment securities is primarily engaged in a business other than investing in securities, either directly or through majority-owned subsidiaries, or through controlled companies conducting similar types of businesses. 10

Having defined "investment company" in such inclusive terms, the 1940 Act goes on to exempt a long list of types of companies which Congress presumably felt would otherwise be within this definition, but with respect to which the safeguards of the 1940 Act were not required. 11 Companies thus exempted include securities dealers, banks (if "supervised and examined by State or Federal authority"), insurance companies (if "subject to supervision by the insurance commissioner or similar official or agency of a State"), savings and loan associations, certain bank holding company affiliates supervised by the Federal Reserve Board, small loan or indu-

7 1940 Act § 3(a), 54 Stat. 797, as amended, 15 U.S.C. § 80a-3(a) (1964). See also 1940 Act § 3(a) (2), 54 Stat. 797, as amended, 15 U.S.C. § 80a-3(a) (2) (1964), which provides that an issuer which is engaged in the business of issuing "face-amount certificates of the installment type" or has any such certificates outstanding is an investment company.


10 1940 Act § 3(b) (2), 54 Stat. 797, as amended, 15 U.S.C. § 80a-3(b) (2) (1964).

trial banking companies, discount companies, companies regulated under the Interstate Commerce Act\textsuperscript{12} or registered under the Public Utility Holding Company Act of 1935,\textsuperscript{13} and employee stock bonus, pension, or profit-sharing trusts meeting the applicable requirements of the Internal Revenue Code.\textsuperscript{14} Also exempted are common trust funds maintained by a bank for the collective investment of funds contributed by the bank in its capacity as trustee or other fiduciary.

Both the Senate and House reports on the 1940 Act\textsuperscript{15} are silent as to the reasons for these exemptions. However, one common denominator appears to be that each exempted type of company is either subject to some form of state or federal regulation or is engaged in essentially a financing business.

Finally, section 6(c) of the 1940 Act\textsuperscript{16} gives to the SEC the right, conditionally or unconditionally, to grant exemptions from the 1940 Act or from any provisions thereof if "such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title."\textsuperscript{17} This exemption power has, however, been used sparingly.\textsuperscript{18}

With this background of the statutory pattern, the application of the act to these new types of investment companies will now be examined.

B. Small Business Investment Companies

With the adoption of the Small Business Investment Act of 1958,\textsuperscript{19} Congress established a program to facilitate the formation of a new type of company, licensed and regulated by the Small Business Administration (SBA) and designed to furnish equity capital and long-term loan funds to small business concerns. It was the expressed congressional intent that this program would stimulate vast amounts of private capital to become available for the first time to small business concerns.\textsuperscript{20}

\textsuperscript{14} Int. Rev. Code of 1954, §§ 401-07.
\textsuperscript{17} 1940 Act § 6(c), 54 Stat. 800, 15 U.S.C. § 80a-6 (1964).
\textsuperscript{18} The SEC has "held that this broad power must not be so freely applied that the basic objectives of the Act are thwarted." Transit Inv. Corp., 28 S.E.C. 10, 15 (1948).
\textsuperscript{20} This congressional intent is spelled out in the first section of the act.
In order to obtain a license as a small business investment company (SBIC), an applicant must submit to the SBA a "proposal" setting forth in extensive detail information regarding all aspects of its proposed operations: its capitalization and plans for securing additional capital; its investment policies; the terms of the securities in which it proposes to invest; the fees, interest rates, and discounts it proposes to charge; the procedure for approval of investments; personnel to be employed, their duties and rates of compensation; and the internal controls to be adopted, including fidelity bonds to be secured and custodianship arrangements. The proposal form must also name each person who will be an officer, director, or ten per cent stockholder of the SBIC, the proposed annual compensation of each such person, and the amount of stock of the SBIC which each such person will own. Biographical information must be submitted with respect to each officer and director, including his education and business experience, and disclosure must be made of all other companies with which he is affiliated as an officer, director, or ten per cent stockholder. All material contracts relating to the management and operation of the SBIC must be submitted and approved by the SBA.

After the SBIC receives its license, any change in its policies, plans of operation, or in its officers, directors, and ten per cent stockholders, or any other departure from the proposal, must first be approved by the SBA and the proposal amended accordingly. The SBA requires comprehensive and voluminous semi-annual financial and operations reports, and field examinations are made periodically. Existing regulations of the SBA require at least forty per cent of the board of directors of an SBIC to be independent of any affiliation with its officers, directors, or ten per cent stockholders. Conflicts of interest and self-dealing between an SBIC, its officers, directors, or ten per cent stockholders, or any of their affiliates, are subject to detailed prohibitions. Any corporate reorganization or sale of additional securities by the SBIC must first be approved by the SBA. The public offering of its stock by an SBIC also, of course,

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requires a prior registration with the SEC under the Securities Act of 1933.\textsuperscript{23}

At the time the Small Business Investment Act\textsuperscript{24} was adopted, and on several subsequent occasions, the SEC has opposed a blanket legislative exemption for SBIC's from the 1940 Act.\textsuperscript{25} It has, however, made additions to its rules under the 1940 Act to meet a number of the problems presented by the different nature of SBIC's from the usual investment company.\textsuperscript{26}

C. Variable Annuities

Since about 1950, the idea of a variable annuity insurance contract designed to afford protection of retirement income against inflation began to grow in the insurance industry.\textsuperscript{27} The continuing post-war inflation furnished dramatic evidence of the need for such protection.

While details vary among the contracts offered, the essential features of the variable annuity contracts are similar. The purchaser makes periodic payments of a fixed amount over a period of years referred to as the "pay-in-period." The proceeds, after payment of expenses, are invested in a portfolio of securities, largely common stocks. Upon each payment, the purchaser is credited with "units" representing the proportionate interest in the fund to which each payment entitles him. The cost attributed to these units will fluctuate with the size of the fund and the investment results achieved. Upon reaching retirement, the purchaser is entitled to receive during the "pay-out period" periodic annuity payments in varying dollar amounts, determined by the total number of units accumulated by him during the pay-in period and by the value of that number of units from time to time during the pay-out period. Such value will vary, depending upon the continuing investment results of the fund. While the issuing insurance com-


\textsuperscript{26} See Rules and Regulations, 1940 Act, 3c-1, -2, 17a-6, 17d-1 (d) (3), 17d-2, 18c-1, 17 C.F.R. § 270 (1965).

\textsuperscript{27} Current interest in variable annuities apparently dates from the publication of a monograph in 1950 by Dr. William C. Greenough, Vice President of Teachers' Insurance and Annuity Association of America, entitled A New Approach to Retirement Income.
pany thus does not assume the investment risk that is involved with fixed dollar insurance, it continues to assume the actuarial risk of longevity. The obligation to continue to pay the annuity for the lifetime of the annuitant, or for the period of such other pay-out option as he may elect, is absolute.

The first of the variable annuity insurance contracts appear to have been issued by Participating Annuity Life Insurance Company in 1954. Variable Annuity Life Insurance Company (VALIC) commenced issuing such contracts in 1955. Shortly thereafter, the SEC instituted a proceeding against VALIC and another similar company to enjoin the sale of such contracts, asserting that they constituted "securities," the offering of which must be registered under the Securities Act of 1933 and that the issuers were "investment companies" under the 1940 Act.

Both the District Court and the Court of Appeals for the District of Columbia denied the injunction requested by the SEC. The Supreme Court, however, granted certiorari and, in a five to four decision, upheld the SEC's position. The majority opinion concluded that for the issuer to bear only the risk of longevity was not sufficient to constitute insurance since "in common understanding 'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts."

While the VALIC decision answered the question as to the necessity of registration of variable annuities under the Securities Act of 1933, there remained at least one major question as to the status of the issuers of variable annuities under the 1940 Act. VALIC was admittedly primarily engaged in issuing variable annuities. The exemption for insurance companies under the 1940 Act is confined to companies "whose primary and predominant business activity" is the writing of insurance. Accordingly, Pru-
Prudential Insurance Company of America filed an application before the SEC in 1961 seeking a determination that variable annuity policies issued by it would not require a registration under the 1940 Act since, for the foreseeable future, Prudential's "primary and predominant business activity" would consist of issuing fixed obligation insurance.

The SEC confirmed Prudential's contention that it was entitled to the exemption for insurance companies under the 1940 Act. However, it found that Prudential's variable annuity investment account would, itself, constitute an investment company which, as an issuer of securities, must be registered under the 1940 Act, and that Prudential would be the "investment adviser" and "principal underwriter" for that investment company. The SEC opinion appears to recognize that the security "issued" by the investment account is actually a contract of Prudential but asserts that the fact that "Prudential may in the same contract also make, in its own name and backed by its own assets, certain insurance or annuity promises is . . . irrelevant." The Court of Appeals for the Third Circuit affirmed the decision and a petition for certiorari was denied.

By the adoption of Rule 3c-3 under the 1940 Act, the SEC has made it clear that the decisions in the VALIC and Prudential cases do not apply to certain group variable annuity contracts for employees under pension or similar plans meeting the requirements of section 401 of the Internal Revenue Code, even where the employees as well as the employer make contributions under the plan. As amended in 1964, this rule exempts, with respect to such group contracts, both the insurance company involved and the investment account from the provisions of the 1940 Act.


Ibid.

Ibid.

Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964). In a recent decision, the Court of Appeals for the District of Columbia held that a variable annuity under which the purchaser was guaranteed annuity payments at least equal to the premiums paid, plus a share in any investment profits, constituted insurance rather than a security, and that the issuer of the annuity was, therefore, not subject to the 1940 Act. SEC v. United Benefit Life Ins. Co., CCH Fed. Sec. L. Rep. ¶ 91640 (D.C. Cir. 1966).

17 C.F.R. § 270.3c-3 (Supp. 1965).


D. Bank-Administered Common Trust Funds

At the time of adoption of the 1940 Act, the Federal Reserve Board Regulations limited the creation of common trust funds by banks to situations where the fund was "used for bona fide fiduciary purposes rather than as a medium for general public investment."\(^{43}\) Section 3(c)(3) of the 1940 Act contains a similar exemption for common trust funds maintained by a bank for the investment "of moneys contributed thereto by the bank in its capacity as a trustee, executor, administrator, or guardian."\(^{44}\)

Such limitations on the creation of common trust funds by banks remained substantially unchanged until 1963, when under the amended Regulation 9\(^{45}\) the Comptroller of the Currency authorized national banks to create 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."\(^{46}\)

The revised Regulation 9 required that each common trust fund must be established and maintained in accordance with a written plan filed with the Comptroller of the Currency. The plan must set forth how the fund is to be operated, the investment powers given to the bank with respect to the fund, the terms and conditions of admission or withdrawal of participants in the fund, and the auditing of accounts of the bank with respect to the fund. Provision is made for annual reports to be given to each person entitled to an accounting of the fund.

In a letter accompanying the revision of Regulation 9, the Comptroller of the Currency warned that there can be no mass merchandising under the regulation and that a bank which published "an advertisement which made other than incidental mention of its common trust fund in the course of advertising the range of the bank's fiduciary services, would violate this Regulation."\(^{47}\)

Despite this limitation on "mass merchandising," the SEC promptly took the position that interests in such bank-administered


\(^{46}\) Ibid.

common trust funds were securities which must be registered under the Securities Act of 1933 and that the fund itself was an investment company under the 1940 Act. As a result, the proposed Bank Collective Investment Fund Act of 1963 was introduced in Congress. This act sought to exempt interests in bank-administered common trust funds from the application of the federal securities laws but would have imposed certain disclosure requirements on such funds. The SEC opposed the adoption of the act and it was not passed. A similar bill introduced in the present Congress appears to have died in committee.

In 1965, the First National City Bank of New York filed with the SEC an application for exemption from certain provisions of the 1940 Act on behalf of its "Commingled Investment Account." The application stated that the Commingled Account would be created pursuant to Regulation 9 of the Comptroller of the Currency and would accept investments of 10,000 dollars or more pursuant to managing agency agreements authorizing the Bank to place such funds in the Commingled Account. The application further stated that the Bank would register the Commingled Account under the 1940 Act and would offer interests therein pursuant to a registration statement and prospectus in compliance with the Securities Act of 1933. Permanent exemptions were requested from five provisions of the 1940 Act, the principal ones relating to requirements regarding the functions and affiliations of the "board of directors" of the Commingled Account. The Bank proposed that a committee elected by participants in the Commingled Account act as its "board of directors," and that the committee at all times have at least one member unaffiliated with the Bank. It was also proposed that the Bank serve as the investment adviser to the Commingled Account and determine what securities are to be purchased and sold. Both the Investment Company Institute and the National Association of Securities Dealers filed briefs in opposition to the granting of the requested exemptions, alleging, among other things, that the Bank rather than the Committee actually controlled the Commingled Account. In March of this year, the SEC granted four of the five requested exemptions,

50 First Nat'l City Bank (Commingled Investment Account) SEC File No. 812-1823.
insisting only that forty per cent of the Committee be unaffiliated with the Bank.\footnote{First Nat'l City Bank, SEC Investment Co. Act Release No. 4538 (March 9, 1966), CCH Fed. SEC. L. REP. ¶ 77332 (1966). Commissioner Budge dissented on the ground that the arrangement violated provisions of the Banking Act of 1933.}

II. CONSEQUENCES OF THE APPLICATION OF THE 1940 ACT

It is difficult, if not impossible, to measure the effect of regulation under the 1940 Act on the SBIC program. It is, however, perfectly clear that a number of problems arising from this regulation have plagued the SEC and SBIC's since 1958.\footnote{See Conwill, \textit{supra} note 25.} Because of the different nature of the business of SBIC's from that of the usual investment company, it is not surprising that such problems arose. For example, in many situations an SBIC could not amend an existing loan agreement to provide for ordinary and often essential changes, such as an extension of repayment schedules, without filing an application for approval with the SEC. Exercise of warrants\footnote{SBIC's have typically financed small business concerns by purchasing debentures which are either convertible into common stock of the small business concern or which are accompanied by warrants to subscribe for common stock. If, as is often the case, the small business concern comes within the 1940 Act definition of an "affiliated person" of the SBIC, the sale of additional stock to the SBIC is prohibited by section 17 of the 1940 Act.} often required a similar application and approving order from the SEC. Efforts to resolve these and other problems have involved long and frustrating delays to the SBIC industry and have consumed a disproportionate amount of SEC staff time.\footnote{The rules adopted under the 1940 Act which deal specifically with SBIC's are set forth in note 26 \textit{supra}.} The dual and detailed regulation by SBA and the SEC has inevitably contributed to the discouragements of SBIC managements to the extent that there appears to be a valid basis for the contention that the SBIC industry is the most regulated segment of the economy.\footnote{In the interests of full disclosure, the author has acted as counsel for an SBIC since 1960 and readily admits to a lack of objectivity in this area.}

Despite the extensive investor protection afforded by the 1940 Act, the public has not been favorably inclined to SBIC securities.\footnote{The SBIC Market Report for January 1965, published by S. M. Rubel and Company, Chicago, Illinois, reported that the market price of the SBIC shares included in its SBIC Price Index averaged 73% of the underlying asset values of such shares as of December 31, 1965. Even greater discounts from asset values of SBIC shares have been common since 1962.} For whatever reason, it is apparent that the SBIC program has not
realized congressional aspirations, and the program currently appears to be shrinking.\(^5\)

It is considerably easier to measure the impact of the 1940 Act on the issuance of variable annuities by insurance companies. As a result of the VALIC and Prudential decisions, the availability of such policies to individuals is limited. VALIC has registered as an investment company and with the benefit of a series of exemptions from provisions of the 1940 Act granted by the SEC,\(^5\) it is offering variable annuities on an individual and group basis. Prudential, on the other hand, is offering variable annuities only on a group basis under the rule adopted by the SEC referred to previously. In both cases the offerings are made pursuant to a registration statement and prospectus filed under the Securities Act of 1933.\(^6\)

An individual who wishes the protection against inflation offered by a variable annuity policy must, it appears, acquire such a policy from a company which is primarily engaged in issuing that type of policy. The major life insurance companies which have substantially greater assets to underwrite the longevity risk and also have extensive insurance and investment experience are, at present, effectively precluded from issuing such policies to individuals. Whether this limitation on the source of individual variable annuity policies is in the best interest of the "investor" may not be entirely free from doubt.

The effect of the application of the 1940 Act to bank-sponsored common trust funds will have to be determined at a later date. At this writing, First National City Bank of New York is the only bank to have obtained the necessary exemptions from the SEC and its Commingled Account has only recently been put into operation.

III. THE LOGIC OF THE REGULATORY PATTERN

This review of the application of the 1940 Act to three types of "investment companies" not in being at the time of the 1940 Act's adoption raises several questions as to the logic of the regulatory pattern. With respect to SBIC's, there appears to be a legitimate

\(^{58}\) Marine Capital Corporation and Growth Capital, Inc., two publicly held SBIC's, have announced their intention to transfer their SBIC licenses to wholly-owned subsidiaries, subject to obtaining necessary approvals and exemptions from the SBA and the SEC. If these programs are carried out, their SBIC activities will be reduced substantially.


question as to the consistency of exemptions in that small loan and industrial banking companies, discount companies, and the like are allowed such exemptions, while no exemption is afforded SBIC's despite much more extensive regulation by the SBA. The SEC, on several occasions, has pointed out that regulation by the SBA is not a substitute for SEC regulation since the SBA is not concerned as such with the protection of stockholders, and although a number of SBA regulations appear to be motivated, at least in part, by the desire to protect stockholders, it is certainly true that this is not the primary function of SBA. On the other hand, it would appear to be equally true that protection of stockholders is not the primary function of state insurance commissioners or state or federal banking authorities, regulation by which is a prerequisite for the exemption of insurance companies or banks under the 1940 Act.

According to the SEC, the fundamental problem with Prudential's requests for exemptions with respect to its proposed variable annuities was that they contemplated "total exemption from all of the sections of the Act which together express and effectuate the policy that those at risk in investment funds should have ultimate voice in their management and policy." The SEC further states in its opinion in the Prudential case:

Specifically, the Act requires that those having funds at risk in the equity securities of an investment fund elect its directors. The directors or the holders must recurrently review the principal underwriting and investment advisory arrangements and have the power to change or terminate them. Holders must pass on changes in investment policy and ratify the selection by the directors of the independent auditors of the fund.

While this is certainly the policy of the 1940 Act, it is somewhat difficult to understand why these safeguards are required with respect to individual variable annuities and not with respect to group variable annuities qualified under section 401 of the Internal Revenue Code. Those with "funds at risk in the equity securities of an investment fund" which happens to be a group plan have no such

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61 See authorities cited in note 25 supra.


63 See text accompanying notes 34-39 supra.


65 Id. at 81293-94.
vote. Regulation with respect to investor protection is hardly the
criterion in this instance.  

Even more difficult to reconcile is the action of the SEC with re-
spect to VALIC's application for exemptions from the 1940 Act. Since VALIC itself registered as an investment company, the SEC
found that it was unnecessary for its variable annuity fund to regis-
ter and granted it a blanket exemption. While VALIC's variable
annuity holders are given the right to vote along with the holders
of its voting stock, there appears to be no assurance as to the propor-
tion of the total voting power of the company to be held by the
variable annuity holders. Accordingly, it may be questioned
whether the rights deemed essential by the SEC in the Prudential
case, as set forth above, are, in fact, possessed by VALIC's variable
annuity holders. Certainly, they appear not to have the right to
terminate the principal underwriting and investment advisory ar-
rangements — a fundamental policy of the 1940 Act. In view of
the fact that VALIC, and not its variable annuity fund, actually is-
sues the annuity contract, and that VALIC continues to carry the
risk of longevity, any termination of the connection with VALIC
would seem to present legal and mechanical problems of some mag-
nitude. Such problems appear to result inherently from the deter-
mination that a variable annuity fund is a separate and distinct in-
vestment company.

Many of the same problems are involved in the exemptions
granted for the Commingled Account of First National City Bank
of New York. While the Committee to be elected by the partici-
pants in the Commingled Account is deemed to be its board of di-
rectors, the Bank itself determines its purchases and sales of securi-
ties. Whether this arrangement gives the investor the "ultimate

66 Regulation specifically for the protection of investors does not appear to have
motivated the statutory exemption for pension and profit sharing plans meeting Inter-
state Commerce Act.

67 See text accompanying notes 59-60 supra.


69 VALIC proposed to allocate voting rights by determining the asset value per share
of its voting common stock and dividing that amount into the redemption value of each
variable annuity contract which is in the pay-in period and into the reserve for each
such contract which is in the pay-out period. The quotient obtained in each case would
be the number of votes entitled to be cast by the variable annuity contract holder, with
the holders of the common stock entitled to one vote per share. Variable Annuity Life

70 See text accompanying notes 50-52 supra.
voice" in the management of his investment funds is, at best, open to question.

Regardless of problems as to the logic behind the exemptions granted, a much more fundamental question is involved. For many years before and since the adoption of the 1940 Act, banks have been managing and investing billions of dollars in their fiduciary capacities, both through individual trust accounts and through common trust funds. The beneficiaries of such accounts have had none of the protections afforded by the 1940 Act, but the protections afforded by state and federal regulatory authorities appear to have been adequate. To conclude that "those with funds at risk in the equity securities of an investment fund"\(^7\) operated by a bank require the protection of the 1940 Act if an agency account but not if a fiduciary account is involved, would seem to overemphasize form without regard to substance.

The legislative history of the 1940 Act contains numerous references to banks and insurance companies, contrasting their existing regulation with the then totally unregulated investment companies. No instance of the types of scandalous activity found in investment companies during the 1920's are reported with respect to bank-operated common trust funds. In its study of investment companies, the SEC noted:

> The formation of investment companies ... [during 1921-1926] was materially facilitated by the virtual absence of statutory restraint or governmental regulation or supervision with respect to the organization of investment trusts and investment companies, the nature of their capital structure, the scope or character of their activities, or their relationship and transactions with their sponsors. Unlike banks, insurance companies, and trust funds, the new investment vehicle enjoyed almost complete freedom from any protective restrictions.\(^2\)

Throughout the legislative materials there are recurrent contrasts between investment companies and banks and insurance companies. For example, the Senate Committee, in the course of describing face-amount certificates, stated:

> Although savings banks and insurance companies are subject to strict regulation as to assets and reserves, the face-amount certificate companies have operated without such uniform type of regulation with the result that, in some cases, assets have been car-


ried at highly fictitious values and, in other cases, inadequate reserves have been maintained for the fixed obligations.\footnote{73 S. REP. NO. 1775, 76th Cong., 3d Sess. 10 (1940).} 

If logic is to be restored to the regulatory pattern under the 1940 Act, it is suggested that a key may lie in these quotations. It is apparent from the foregoing review that the mechanical application of an abstract definition drafted in 1940 to situations which have developed in the 1960’s has raised some legitimate questions. It is also apparent that the definition in question, and the 1940 Act itself, are predicated on an extensive study of the wrongdoings of investment companies which occurred during the 1920’s. Since that relatively lawless — and from a financial regulation standpoint, prehistoric — era, the atmosphere surrounding the issuance and sale of securities, the management of corporations, and the rights and remedies of shareholders has drastically changed. The Securities Act of 1933\footnote{74 48 Stat. 74, as amended, 15 U.S.C. §§ 77a-aa (1964).} required full disclosure in connection with the public sale of securities. The Securities Exchange Act of 1934\footnote{75 48 Stat. 881, as amended, 15 U.S.C. §§ 78a-jj (1964).} imposed numerous requirements on companies whose shares are listed on national securities exchanges, including the proxy rules, periodic reporting requirements, and the short-swing profit provisions of section 16 applicable to officers, directors, and ten per cent stockholders. While in 1940 most investment companies were not listed on a securities exchange, the Securities Acts Amendments of 1964\footnote{76 Pub. L. No. 467, 88th Cong., 2d Sess. (Aug. 20, 1964).} imposed many of the same requirements, including specifically the proxy rules and the short-swing profit and periodic reporting requirement provisions, on unlisted companies with more than 500 shareholders and assets of more than one million dollars.\footnote{77 78 Stat. 565, 15 U.S.C. 78f (1964).} Investment companies registered under the 1940 Act are exempted from these requirements since they are already subject to them under the 1940 Act.\footnote{78 Section 12(g) (2) (B) of the Securities Exchange Act of 1934 as added by the Securities Acts Amendments of 1964, 48 Stat. 892, as amended, 15 U.S.C. § 78l(g) (2) (B) (1964).} Banks and insurance companies are presently subject to the 1964 amendments, and a determination that publicly held SBIC’s are not investment companies would bring the provisions of the 1964 amendments into play in substantially every case.\footnote{79 Administration of provisions of the 1964 Amendments with respect to banks is vested in the Comptroller of the Currency, the Board of Governors of the Federal Re-
the prophylactic effect of the disclosure requirements of the proxy rules should not be disregarded, particularly as such requirements are expanded. 80

In addition to the extension of statutory regulation since the 1920's, an even more comprehensive regulatory force has developed, primarily since the end of World War II, and largely supported by the SEC. It consists of shareholder remedies against wrongdoing of all kinds by corporate managements and principal stockholders. 81 Coupled with the extensive disclosure requirements of the various SEC administered acts, the stockholder derivative suit has become a potent deterrent to wrongdoing by corporate managements, a deterrent which can be considerably more effective and more pervasive than governmental regulations.

In view of the foregoing developments which postdate the studies giving rise to the 1940 Act, and which in large part postdate the 1940 Act itself, it can hardly be asserted that the 1940 Act is all that stands between the investing public and a recurrence of the shocking behavior of investment companies and their managements in the 1920's.

IV. CONCLUSION

It can, perhaps, be argued that more regulation for the protection of investors is desirable in all types of companies, and that shareholders in industrial and other companies might benefit from the application of some of the "safeguards" contained in the 1940 Act. And it can be expected that in coming years additional legislation will be enacted for the protection of investors as studies by the SEC and others indicate the need. However, unless a departure is to be made from some fairly fundamental governmental philoso-

80 See, e.g., amended Item 7(f) of the Proxy Rules which expands the reporting requirements with respect to transactions in which officers, directors and principal shareholders have an interest — the so-called "Chrysler rule." SEC Securities Act Release No. 7804, Jan. 27, 1966, 31 Fed. Reg. 2592 (1966).

phy, additional regulation will be imposed only where a clear need for it is shown. It is suggested that such a need has not been shown in applying the 1940 Act to the peripheral types of investment companies discussed here. There is certainly no demonstration whatsoever of wrongdoing by the managements of such companies or of the inadequacy of the regulation to which each is already subject. Application of the 1940 Act under these circumstances is to base regulation solely on conjecture. It is also suggested that it is difficult to reconcile the existing statutory exemption pattern with the inclusion of these new investment companies.

While the SEC has the authority to exempt these companies, it has declined to do so. In view of the potential magnitude of the activities of these new types of companies, the granting of exemptions should properly be the responsibility of Congress. This responsibility arises from the all-inclusive definition of investment company which Congress enacted in 1940, a definition which has led to an extension of the 1940 Act into areas well beyond those in which the present need for such comprehensive regulation has been shown to exist.

82 See text accompanying notes 16-19 supra.