REMARKS OF

HAMER H. BUDGE

Commissioner, Securities and Exchange Commission

Before The

AMERICAN LIFE CONVENTION

Chicago, Illinois
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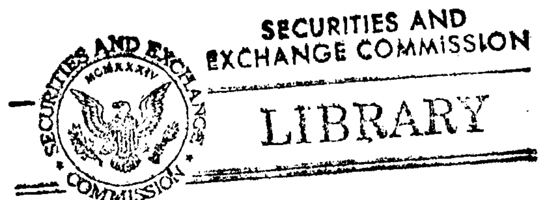

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At the very outset I would like to pay my respects to the industry which you represent. It is and has been an industry conducted with vision and with a spirit of responsibility and integrity which I heartily applaud.

I am also aware that the business in which you are engaged is pretty thoroughly regulated now and that at least some of you are thinking -- oh, no, not the SEC too. However, whatever our wishes in the matter, it is apparent that we are going to become better acquainted.

For about the first 25 years of the SEC's existence, its relationships with the life insurance industry were generally serene and quite remote. Stock life insurance companies were required to register public offerings of stock under the Securities Act and fraud in connection with transactions in such stock was a federal as well as a state offense, and that was about it. The Commission engaged in regulation of stocks listed on the stock exchanges, and life

insurance stocks were not exempt from this regulation, but this was not of much practical importance, since almost no life insurance stocks were so listed. Mutual companies had never heard of the SEC.

This remote, and I am sure from your standpoint eminently satisfactory relationship, resulted from the fact that insurance policies and annuities were expressly exempt under the Securities Act; were not treated as securities under the Securities Exchange Act, and insurance companies were expressly exempt from the Investment Company Act. This is basically still the law. Of course, in 1964, Congress made the regulatory requirements of the Securities Exchange Act applicable to the larger unlisted companies, but as to insurance companies, it exempted those which were subject to comparable regulation by their state insurance commissioners, and all 50 states provided such regulation. What has changed has been the facts.

As all of you know, the Commission's relationships with the life insurance industry are now neither remote nor maybe quite so satisfactory. We have been involved together in working out a number of

rather difficult and complex questions. Some of these have been resolved in a manner which I think and hope is mutually acceptable; others are still in the process of solution.

The initiative which brought about this change in our relationships came, I believe, not from us but from you. Commencing in the fifties, your industry decided to broaden its product line and to offer to the public various forms of equity investment as distinct from its traditional fixed-dollar policies and annuities. More recently, the life insurance industry, at an increasing pace, has directly entered the mutual fund field. These developments were, no doubt, a reaction to continued inflation and also, I suspect, they reflect what appears to be an increasing desire on the part of many investors for equity investment with its possibilities for growth as well as yield.

The first of these developments came when some life insurance companies were organized to issue and sell variable annuities. The

Commission took the position that under its statutes a variable annuity was a security, not an insurance product. This, basically because the variable annuity transferred the investment risk as well as the investment reward from the insurance company to the annuitant, and because the variable annuity thus represented an interest in a pool of equity securities just as a mutual fund share does. In 1959, the Supreme Court agreed in the so-called Valic case. Since Valic sold only variable annuities, the Supreme Court also concluded that for purposes of the Federal securities laws, Valic was an investment company not entitled to the exemption for insurance companies.

The next step was taken in 1963 and 1964 when the Commission, and a court of appeals on review, held that a separate account of an undoubted insurance company which was used to fund variable annuities, was an investment company distinct from its insurance company and subject to the Investment Company Act. This was the Prudential case.

Although I was not there at the time, I understand that success in these cases was viewed around the Commission as a great victory, but I suspect that some around our establishment may now wish that you had won and we had lost. It is not easy to adapt the variable annuity to the Investment Company Act or the Investment Company Act to the variable annuity, which of course had never been heard of when the Act was passed in 1940. In the area of individual variable annuities, this accomodation has, however, been largely completed.

We have encountered more significant problems with respect to group variable annuities and they are still in the process of final solution. I understand from representatives of your industry that group variable annuities now are, and promise to be, substantially more important than individual variable annuities primarily because they afford an attractive means of funding employee pension and welfare plans of corporations and other organizations such as schools and hospitals. In this area of employee plans, with a pool of equity

securities, sometimes the employer is the one who takes the risks and receives the benefits. If the securities in the account go up, his costs are reduced, but he also takes the risk of loss, while the employee still receives a fixed annuity. In other plans the employees receive variable annuities. Both types of arrangements appear subject to the Investment Company Act, although in the first type we have no concern after a fixed annuity is issued to a participating employee.

The Commission recognizes the rapid growth and great importance of employee plans. According to our statistics, the book value of private non-insured pension funds at the end of 1967 amounted to some $72 billion. The total as recently as 1963 was only $42 billion. The stockholdings of private non-insured pension funds, in terms of market value, have increased from $7.5 billion in 1957 to more than $51 billion in 1967. These figures indicate the magnitude both of the potential market and the opportunity for useful services with which your industry is concerned, and the potential magnitude of the public interest which the Commission has to bear in mind.

The principal problem which has troubled your industry and the Commission in this area is that employee trusts which satisfy the conditions of Section 401 of the Internal Revenue Code are expressly exempt from the Investment Company Act. Your industry is generally not authorized by state law to administer a trust, while banks are. Thus, your representatives tell us, you are placed at a disadvantage in competing for this business with banks, which can operate free of the Investment Company Act. The mutual fund bill in the form in which it passed the Senate would have given the life insurance industry exemptions comparable to those provided to the banks, but, since the House did not act on the bill, the Commission is going to try to resolve the problem administratively. In doing so, it is very conscious of the competitive disadvantage and is anxious to relieve it in some manner consistent with our responsibilities.

However, the competitive inequality is not the only difficult problem in the area. Many of these employee plans are quite complex both from the viewpoint of the employers and employees and from the viewpoint of the funding. Incidentally, as I understand it, the only

really significant funding agencies in this area are life insurance companies and banks. In the case of larger corporations, the plans will ordinarily be individually negotiated between the employer and the proposed funding agency. On occasion, a large employer will use several funding agencies in order to compare performances. Plans may be designed to provide pensions or they may be designed to provide various supplemental benefits or to encourage thrift. Employees may be called upon to make contributions or they may not be. Their participation in the plan may be purely voluntary or it may be a condition of employment. They may have numerous and perhaps fairly complicated options with respect to the type of benefit they take and when they take it. They may have the option to take a straight annuity or a variable annuity, or partly one and partly the other. These elections may be made when they join the plan or when they retire. They may have a right to withdraw their own contributions or they may not. They obtain a vested right to employer contributions at varying

times according to varying formulas and they may or may not be allowed to withdraw some or all of vested employer contributions.

Given this variety, it is not easy to determine when employers or employees or both need the protection of the Federal securities laws and which of these protections are important and also, just as importantly, which are not. The problem is not susceptible of easy solution or of simple across-the-board applicability to all plans. Furthermore, neither the Securities Act nor the Investment Company Act was written with employee plans particularly in mind. Such plans were much smaller in 1940 and, generally speaking, they usually provided for fixed benefits and were funded by fixed-dollar investment. The Federal securities laws were not particularly relevant in this context, but that is not the case today.

We have been working with an able committee from your industry for some time in an effort to work out an acceptable formula. As a result of these deliberations, certain solutions are emerging which I would like to briefly discuss.

Under the Investment Company Act of 1940, the Commission has broad power to grant exemptions by rule or by order. It also has power to exempt an investment company from registration altogether upon condition that certain provisions of the Act will nevertheless apply to it. It is proposed that we exercise the latter power with respect to any separate account, established by an insurance company pursuant to authorizing state law, where the only participations in such separate account are issued in connection with employee plans which meet the requirements for qualification of Section 401 of the Internal Revenue Code, if the plan meets certain conditions. Such an exempted account would therefore not be required to register under the Investment Company Act which would, we believe, mitigate the competitive problem with which your industry is concerned. At the same time, however, certain provisions of the Investment Company Act would be applicable to the account as if it were registered. I do not propose to catalog which of the 51 sections of the Act will and will not apply,

particularly as a good many of them deal with specialized types of investment companies and would have no application to a separate account in any event. In general, the line which we are seeking to draw would distinguish between certain regulatory or procedural requirements of the Act which either cannot practicably be applied to separate accounts used to fund pension plans or which would create competitive or other difficulties outweighing their usefulness in the context of such accounts and, on the other hand, provisions which create no serious, or at least no insurmountable, problems for your industry and yet have desirable features. Examples are the salutary protections against conflicts of interest and self-dealing, in general, what have been characterized as the "anti-sin" provisions of the Act. The exempted accounts would be required to provide initially, and at intervals, information and reports to the Commission.

With respect to the Securities Act of 1933, the situation is somewhat different. That is not a regulatory statute in the sense that the Investment Company Act is. Its objective is to provide disclosure

and to prohibit fraud. Disclosure is accomplished essentially through the requirement that when an issuer makes a public offering of securities, it must file a registration statement with the Commission containing a description of its business and operations and including financial information. The major portion of this registration statement is the prospectus, which must be furnished to all persons to whom the securities are offered or sold. As I mentioned earlier, the Supreme Court has held that a separate account, funding variable annuities, is an issuer of securities to which the Securities Act applies. The Commission does not have the same statutory authority to grant exemptions from the Securities Act as it has with respect to the Investment Company Act. On the other hand, it has been possible, over the years, to interpret this Act in such a way as to treat it as inapplicable in situations where its application would serve no useful purpose and presumably was not contemplated by the Congress. Thus in connection with a noncontributory pension plan, we can say that interests in this plan are not "sold" to the employee,

particularly where he has no choice with respect to participation in the plan. Similarly, the Act applies only where there is a public offering. We can easily say that where General Motors sits down with an insurance company or a bank to negotiate the terms of a pension plan, this negotiation does not constitute an offering of securities to the public. Such a conclusion would clearly make sense, since General Motors, having its staff of actuaries and pension consultants, has little need to be handed a prospectus. On the other hand, where an insurance company, or for that matter any other financial institution, devises a packaged program for the funding of a standardized Keogh plan and puts this in the hands of its sales force, for the purpose of offering it to self-employed persons and their employees -- ranging from doctors to beauticians to xylophone players -- there may be a real need for the disclosure which registration affords. Certainly it would be difficult to conclude that there was no public offering or no sale. Our existing Rule 156 under the Securities Act attempts to draw distinctions along this general line in connection with participations in employee plans meeting the requirements of

Section 401 of the Internal Revenue Code, including Keogh plans, and in our discussions with representatives of your industry, we have attempted and will continue to attempt to revise and refine this rule in a manner which will conform to the statute, avoid unnecessary burdens on your industry, and draw lines in a manner which makes sense.

I hope we can do the same in other areas, such as that of broker-dealer and salesman registration. It may come as a surprise to some of you to know that there are 79 insurance and affiliated companies offering variable annuities which have registered with the Commission, together with about 11,500 salesmen. These numbers are certain to grow rapidly and quickly.

Since it seems that you and we are going to be seeing a lot more of each other, I think it appropriate to sort of introduce us to you.

The SEC is the federal agency which has the responsibility for regulating the securities industry and many major corporate activities. It makes the rules, which is a legislative function. It enforces those rules, which is an executive function. It penalizes infractions of those rules, which gives it, also, the judicial function. Approximately 1,400 persons are on its payroll and about 350, including the five commissioners, are lawyers. That is enough lawyers to cause a lot of trouble for a lot of people. The statutes and rules administered by the Commission encompass such things as public corporations, stock exchanges and over-the-counter markets, securities brokers and dealers, investment advisers, investment bankers, public utility holding companies and investment companies, including the $53.5 billion mutual fund industry.

Today, the Commission's activities are receiving unusual attention, but the headlines are due not so much to increased activities of the Commission but rather to the almost fantastic activity in

the areas of its concern. The following are illustrative. There are 24 million individual American investors, compared with 6 million in 1952. The trading on the NYSE now averages over 12 million shares each day it is open and on one day 21,350,000 shares changed hands. I recall my conversations with the Exchange in the fall of 1964 when I was told that there might be as many as 10-million-share days on the Exchange by the year 1975. Trading there is averaging 20% more than last year and nearly 2.5 times what it was when I became a Commissioner in 1964. The interim volume discount which has been proposed will result in savings to the public on commissions paid of some $750,000 every trading day. An even more sensational increase in business is occurring on the Amex. Trading there has been averaging over 6 million shares a day; up more than one-third from the already hectic pace set during 1967 and four times the 1964 rate. Trading in the over-the-counter market is even more of the same where volume is at least 50 percent above 1967 and far more than

in 1964. It is small wonder that the back office can't keep up with the front office.

In the mutual fund segment of the industry, total assets have jumped from $31 billion in 1964 to $53.5 billion by mid-1968. In the twelve months alone ended June 30, total assets grew almost $9 billion. These totals may become astronomical if all the financial institutions now indicating an interest actually get into the fund business.

There is another speeding up which I view with considerable apprehension. That is the marked increase in the turnover of the common stocks. It used to be that stocks were bought for the long pull and a company's shareholder lists remained much the same year after year. Now it seems that anybody who is anybody should swap stocks at least with the seasons. In 1960 the average portfolio

turnover rate in the mutual funds was 14.7 percent. By 1965 it had increased to 18.7 percent. In 1966 it was 31.8 percent, in 1967 38.7 and by the second quarter of this year 47.3. A number of funds are swapping common stocks so fast that the portfolio will be turned over twice in one year. Even that pace does not have enough "go" for the latest "go-go's" and even in your own industry the rate for the second quarter this year was 21.1 compared with a rate of 12.8 in 1967. Your net value of purchases over sales was $340,000,000 during the quarter compared with a quarterly average of $85,000,000 in 1964.

The accelerated rate of switching by investors generally -- and sometimes I wonder when one becomes a speculator rather than an investor -- is evidenced by the gains in annual turnover rates on the two largest exchanges. Only 14.5 percent of all shares listed on the NYSE changed hands in 1965; this figure was 19.3 percent in 1966; 25 percent in 1967 and by the second quarter of this year 27 percent.

The turnover rate on the Amex is even a clearer picture of what is going on. The rate of turnover there had been about twice that of the NYSE for several years, but last year it jumped to 66 percent and it was running 86 percent during the quarter ended last June 30.

The intense activity is also reflected in the number of stock offerings processed by the Commission. During fiscal 1968 almost 3,000 registration statements covering approximately $54 billion in securities became effective -- the largest dollar amount on record. In contrast, in 1964 slightly in excess of 1,100 registration statements became effective, representing only $17 billion worth of securities.

It is in this atmosphere that the Commission is undertaking a study of the impact of the institutional investors on the securities markets. The authorization bill recently enacted and which was strongly supported by the industry will give the Commission a chance to determine the market effects of all this action. It will require looking at almost every single aspect of institutional investment and

determining first, how that particular activity fits in the over-all picture of institutional activity and second, whether it is compatible with the maintenance of fair and orderly markets.

Although the study will probably reach others, such as personal and common trust funds, foundations and college endowments, I am referring particularly to such financial intermediaries as insurance companies, banks, mutual funds, and pension and welfare funds. When we realize that the total value of stocks held by these institutions has increased during the last ten years from $29-1/2 billion to almost $200 billion and that the trades they effect account for 50% of all trading on the NYSE, the significance of their participation is quite apparent. My information is that life insurance companies hold common and preferred stocks with a market value of about $12 billion which is a very considerable growth from the $3.5 billion of ten years ago.

Since many of you undoubtedly are now in it, I should tell you that among the tools used by the SEC and well suited to the present pace of things is a large computer. Our computer has proven to be uniquely adapted to the job of market surveillance and we have ready access to information on some 25,000 securities issues. In the past it was a physical impossibility to check, for example, on the activities of the more than 8,000 over-the-counter stocks quoted daily in the pink sheets. Now, however, fed with raw data from those sheets, the computer prints out the names and pertinent data concerning those securities which may be suspect for reasons such as abnormal price movements or unusual dealer interest or concentration. The number not falling within the allowable tolerances average perhaps 200 issues for the weekly print-out. When this preliminary search has been completed by the computer, it is a relatively easy matter for the surveillance staff to determine whether there is a quick explanation for what took place or whether further investigation of possible manipulation or other law violation is indicated.

It is obvious that if we are to continue to maintain a high level of investor confidence -- upon which, after all, all security issuing and trading depends -- we must keep abreast of the activity and do our best to understand it. We must also attempt to determine, in addition to our day-to-day responsibilities, whether our equipment is suited for the task.

In preparing my remarks for today, I made an effort to look around the Commission to find unresolved matters of particular interest to you. Then I asked that the Commission take some definitive action in each area of interest. Unfortunately, the resolution was not always as you would like it or sometimes even as I would like it; as, for example, the recent decision of the Commission not to permit the use of hypothetical net investment rates in the literature used for the sale of variable annuities.

You fared better on the second matter considered when the Commission agreed with you that only forward pricing should be used in the computation of values for redeemable securities and that such pricing need be done only once daily instead of the twice-a-day computation which was suggested when Rule 22c-1 was proposed for comment.

Another item pending before the Commission and on which you have expressed an opinion with which I personally agree is that the Commission should not adopt the proposed Rule 10b-12 under the Exchange Act which would make it a fraud to issue certain stock dividends unless the issuer makes a transfer from earned surplus equal to the fair value of the securities. The comments received by the Commission on this proposal were extensive and it had not received consideration by the Commission prior to the time I left Washington.

As I mentioned before, representatives of your industry and our staff have been attempting to work out various exemptive rules to meet

the problems which arise in the sale of group variable annuity contracts. The Commission has just recently reached tentative conclusions which may serve as a basis for resolving some of the more difficult problems. We are considering a proposed Rule 6e-1 under the ICA and a proposed amendment to Rule 156 under the Securities Act. For those plans which qualify under the IRC and meet certain conditions, the proposed Rule 6e-1 would provide an exemption from the registration provisions of the ICA for the separate account, leaving only a requirement to comply with the so-called "anti-sin" and reporting provisions of the Act which I mentioned earlier. At one point in the discussions, it was suggested that there be a requirement in the rule that an employer be required to make a "substantial" contribution to each separate account in order to obtain an exemption from the ICA. In reviewing this position, the Commission tentatively concluded that a substantial contribution requirement is not necessary for this purpose. Such a requirement, however, in terms of the employer's overall pension or profit-sharing

plans was placed as a condition in the proposed exemption under the Securities Act.

Our thoughts on a possible proposed amendment to Rule 156 under the Securities Act can be summarized as follows: If a separate account meets the conditions specified in Rule 3c-3 of the ICA or the proposed 6e-1 under that Act and the substantial contribution requirement is satisfied together with certain others, an exemption from the Securities Act would be available. Our thinking as to the amount necessary to constitute a "substantial" contribution is that it should be at least one-third of the aggregate; or in other words, at least one-half the amount of the employees' contribution.

Some of you may not be familiar with the extent of self-regulation which exists in the securities industry. In addition to the self-regulation by the stock exchanges, the National Association of Securities Dealers is a self-regulatory association charged by statute with the initial responsibility for setting up standards of conduct and policing its own members. Its officers are elected by the people

in the securities industry and it has offices throughout the country. It is my understanding that to avoid a duplication of facilities and personnel, that the life insurance industry has discussed with the NASD the possibility of forming an association affiliated with the NASD, but specifically related to securities activities carried on by the life insurance companies. While the proposal has not yet reached us, I know of no opposition from our side.

In view of the interest taken by your Washington Office and by my good friend and former SEC staff member, Bob Routier, in each of these matters I thought an informal run down might be helpful. I must also say that the Commission -- its Chairman, Commissioners and its staff -- are genuinely interested in resolving any problems which now exist or which will arise in the future. We are available to each of you and would be delighted to have you call on us when you are in Washington.

Since it seems fairly clear that SEC regulation is going to be a part of doing business for more and more members of the life insurance industry, it may not be amiss to conclude by examining the how and why of SEC regulation.

Being a life time Republican, the very dates 1933 Act and 1934 Act associate them for me with other legislative products of that era for which it could be said I have a minimum of high regard. Those knowing me might assume that it would be difficult for me to give them an all-encircling embrace. However the fact is that this legislation had long been preceded by English statutes enacted under economic conditions somewhat similar to our early 30's and which had as their goal the restoration of public confidence in the securities markets of those days. The English pattern of regulation based on the concept of full disclosure is part and parcel of our present day securities statutes.

Speculation was popular in England in the early 1700's and among the favorites were the shares of a company called the South Sea Company. As you may recall, George I was the Governor of that company and it was organized to trade with the South American countries and the Islands in the Pacific. During the year 1720 the price of the

company's stock rose from 128 pounds in January to over 1,000 pounds in July and back to 125 pounds in December. Human nature must have improved since then, for the directors of the company unloaded 5 million pounds of the stock at the high. It was not long after the "Great South Sea Bubble" burst, bringing with it the ruin of thousands of investors, that Parliament passed the so-called "Bubble Act" of 1720.

The English law evolved over the next two centuries and our own Securities Act of 1933 and Securities Exchange Act of 1934 are strikingly similar to that of the English.

I think it must be conceded that they have done much to reassure the investor and produce the continued health and vitality in our own securities markets.

It is, of course, essential to all of us, that there be confidence in securities as a product and confidence in the places where those securities are marketed, if our people's savings are to continue to

support the corporate free enterprise system which we have in America. The maintenance of that confidence is the SEC's very reason for being and all its efforts and the efforts of everyone connected with the securities industry should always be toward that end.

I know the life insurance people, dedicated as they are to protecting the future of the nation as well as the future of its citizens, join in that effort.