



Point/Counterpoint: Are life settlements essentially securities?

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On July 22, the Securities and Exchange Commission released a report from its Life Settlements Task Force which recommended that the SEC urge Congress to amend federal securities laws to include life settlements as securities.

The report also recommended that the SEC monitor brokers and providers to assure that legal standards of conduct are being met.

The report raises a key policy question about life settlements, in which a policyholder sells the policy to someone else, who then assumes responsibility for paying the premiums. In exchange, the insured person receives a lump-sum payment that exceeds the policy's cash surrender value but is less than the expected payout in the event of death.

The policy question is: Should the SEC go forward with the recommendations made by its task force?

Larry J. Rybka and James W. Maxson -- who see the issue differently -- speak out below.

The SEC proposal to define life settlements as securities is both wise public policy and the only solution that would give all participants the confidence to create a sustainable secondary market for life policies.

Market participants blame disruption to credit markets and adverse legislation for the decline of the market of late. Instead, they should look no further than the lack of consistent regulation and abusive industry practices.

For this market to recover, investors, policyholders and other stakeholders need to be convinced that they aren't playing at a table with loaded dice. Classifying life settlements as securities would do just that.

We applaud the SEC staff report, which represented 18 months of comprehensive review of the entire life settlement market.

This 43-page report and its 40 pages of exhibits are the product of a joint task force that conducted an extensive review of existing law, litigation and enforcement actions. The task force also interviewed all major market participants, making the study the most comprehensive look at this complex issue to date.

The SEC study concluded with five recommendations. Because two of the five recommendations involve monitoring the market, and a third recommends informing investors that life settlements are neither transparent nor liquid, I will focus on just one recommendation — that life settlements be defined as securities.

The courts and regulators have found investments in life settlements to be securities. The SEC report, in fact, points to 25 SEC enforcement actions and 13 enforcement actions brought by the Financial Industry Regulatory Authority Inc. that rest on this conclusion, as well as numerous other cases.

But a definition of life settlements as securities, established by case law, would fail in several significant respects.

First, it would leave the door open for the unscrupulous to attempt to evade regulation by trying to disguise facts based on case law or by attempting to split elements of their activities to avoid compliance with securities regulation. A clear, uniform and comprehensive statutory definition of life settlements as securities would create clarity about the roles and obligations of every party to a transaction, ultimately leading to a fairer and more stable life settlement market.

Registering equities hasn't prevented the stock markets from becoming efficient. In fact, the presence of securities laws has been a major force in making equity markets more efficient and reliable over time.

This is the case in most markets for regulated securities. Because the purchasers of investment vehicles later deemed to be securities haven't suffered any substantially greater burden than purchasers of non-securities, the argument that a change in definition would dissuade investors from engaging in life settlements is spurious.

In October 2002, the North American Securities Administrators Association Inc. released guidelines regarding viatical settlements, which are similar to life settlements but usually involve policyholders with shorter life expectancies. The NASAA guidelines included a uniform definition of viatical settlements as investments.

If the definition of a security under the securities laws were amended specifically to include life settlements under the NASAA model — or something closely approximating it — the definition would preserve a place for state regulation of legitimate life settlements. At the same time, it would close the door to many abusive transactions, including almost all forms of stranger-originated life insurance.

If life settlements were defined as securities, many of the abusive practices that have spawned more than 300 lawsuits and loss of much personal wealth would have been avoided. Importantly,

few of these litigated cases involved variable policies, which come under the purview of securities regulation and demonstrate the relative effectiveness of Finra regulation and enforcement.

The incomplete and “still under construction” state settlement regulations have created a hodgepodge of rules. It is a situation that benefits no one other than a small number of market participants whose business models are built to take advantage of this byzantine regulatory landscape — inhibiting true market competition.

The regulatory climate, in fact, de-creates both market access and transparency, resulting in a loss of benefits for policyholders who want to sell their policies, as well as a disincentive for institutional investors to fund a predictably regulated and transparent business model.

In short, the SEC proposal to define life settlements as securities may be just what is needed to boost investors' confidence and encourage them to deploy capital, which would make the market more liquid.

Securities regulation would create full, fair and adequate disclosure of all material facts, and the discipline of Finra oversight would afford policyholders consistent protection in all U.S. jurisdictions. This would likely make it harder for abusers to sidestep the law.

Federal securities regulation, therefore, is the next logical progression for a market that is complex, opaque and riddled with too many intermediaries.

[Larry J. Rybka is president and chief executive of Valmark Securities Inc. Many of the broker-dealer's independent representatives work at insurance advisory firms.]

Although the SEC's Life Settlements Task Force has recommended that Congress amend the definition of “security” to include life settlements explicitly, a careful review of case law and the operations of the mainstream life settlements industry leads to the conclusion that such an amendment is unnecessary and inadvisable.

It is unnecessary because the SEC already possesses the authority to characterize life settlements as securities in appropriate situations.

It is inadvisable since the most probable consequence of such an amendment would be to increase significantly transaction costs and diminish investor interest in the asset class. The resulting harm to consumers would outweigh any benefits that might accrue to them.

In its analysis, the SEC report addresses whether life settlements are securities in two contexts.

First, it looks at whether fractionalized interests in life settlements — sales of interests in one policy to more than one investor — are securities. It also examines whether the sale of one policy to one investor is a security.

The report's premise that the status of fractionalized interests in life settlements as securities is unclear under federal law isn't borne out by existing case law. Indeed, in its 1996 decision in the case *SEC v. Life Partners Inc.*, the U.S. District Court in the District of Columbia concluded that under the specific facts and circumstances in front of it, fractionalized interests in life settlements were not securities.

In the 14 years since that case was decided, however, the decision has been the subject of almost universal criticism, and every court since, whether state or federal, has concluded that fractionalized interests in life settlements are securities.

The complete rejection of the *Life Partners* case (including its explicit rejection by the 11th U.S. Circuit Court in the 2005 *SEC v. Mutual Benefits* case) suggests that the issue of whether interests in fractionalized life settlements are securities under federal law is one that has been resolved definitively. It has, and fractionalized life settlements are considered securities.

The second issue — whether one policy sold to one investor is a security — is more critical to today's life settlements industry.

The SEC report notes: “Since the cases brought by the SEC to date involved the sales of fractional interests in life insurance policies or groups of policies, it is unclear whether a federal court would hold that the sale of a single insurance policy wholly to one investor would constitute an offer or sale of a security” under the Securities Exchange Act of 1934.

The outcome of an enforcement action is unclear, as none has ever been brought. But one thing is clear: If the SEC believes that the sale of a policy to an investor is a transaction involving a security, it has the power to bring enforcement actions without having to urge the sweeping step of amending the federal securities laws.

Federal securities laws list a limited number of investments that are, by definition, securities. Most other investments found to be securities under federal law fall within the catch-all definition of an “investment contract.”

Federal case law going back over six decades sets out the parameters for when an investment is an investment contract and, thus, a security.

The key factor in determining investment contract status is whether the investor expects to receive profits solely from the efforts of others, typically the promoter of the investment. This prong of the test isn't satisfied when a single policy is sold to a single institutional investor.

In a typical life settlement transaction, an institutional investor, in this case known as a financing entity, enters into a master purchase agreement with a life settlement provider.

The agreement contains the investor's eligibility criteria for policies it will purchase. Specifically, the financing entity determines the types of policies, the carriers that are acceptable, the insured's age, the insured's life expectancy, the categories of acceptable impairments, the range of acceptable face values and many other factors.

In typical life settlement transactions, therefore, it is the financing entity — not the provider or broker — that sets all relevant parameters for the investment. Additionally, most financing entities have their own sophisticated software to determine the net present value and potential return on their investments in the settlements they purchase.

Practically speaking, life settlement brokers and providers are service providers executing purchase orders; they have little or no ability to influence investment decisions. The entities that purchase these settlements have no expectation that the profits they derive are the sole result of the efforts of brokers or providers.

Of course, this analysis changes if the investors are individuals, not sophisticated institutions. If the promoter of an investment locates and then conducts due-diligence and valuation analyses on life insurance policies — and then solicits investors — this investment will almost certainly be an investment contract and, therefore, a security under federal law.

In fact, relying on the well-established investment contract analysis, most life settlement investment programs aimed at retail or individual investors, whether involving the sale of one policy to one investor or the sale of fractionalized interests in one policy to multiple investors, will meet the definition of an investment contract and fall within the SEC's jurisdiction.

Although reasonable minds can disagree as to whether the current regulatory scheme governing life settlements is perfect, it is certainly comprehensive, covering more than 90% of the U.S. population. Compliance with the varying settlement regimes of more than 45 states already entails significant cost and compliance burdens for industry participants.

If life settlement brokers and providers are required to obtain securities licenses and become Finra members in order to transact the sale of one policy to one investor, the additional expense and regulatory burden will likely drive many, if not most, of them out of the business. Unfortunately, it is the individual policy owner who is likely to be harmed by the proposed amendment to the securities laws, as consumers will have few, if any, choices if they decide to explore the option of accessing the true value in their life insurance policies.

In sum, nothing about life settlements makes the legislative blunderbuss of a revision to the definition of securities under federal law necessary or advisable.

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