STATE REGULATION OF SECURITIES COMMITTEE NEWSLETTER

AMERICAN BAR ASSOCIATION Business Law Section

March 2018

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Business Law Section Spring Meeting
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Orlando, FL

NASAA Spring Meeting
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Washington, D.C.

EQUITY INDEXED AND VARIABLE ANNUITIES: WHAT ARE THE LIMITATIONS OF A STATE SECURITIES REGULATOR'S AUTHORITY (IF ANY) OVER THEIR SALES PRACTICES?

By John S. Monical

I. Introduction

Two Illinois cases, *Van Dyke v. Jesse White*, 2016 IL App (4th) 141109 (currently pending before the Illinois Supreme Court as Docket No. 121452) and *Thrivent Investment Management v. Illinois Securities Department*, Circuit Court of Cook County Case No. 2016-CH-16406 (currently pending before the First District Appellate Court as Docket No. 1-17-1913), could have broad-reaching implications for the multi-billion dollar annuity marketplace and for financial advisers across the country. In *Van Dyke*, the Illinois Supreme Court will evaluate the scope of the Illinois Securities Department's authority over the sale of equity indexed annuities ("EIAs"). In *Thrivent*, the Appellate Court will evaluate the Illinois Securities Department's authority to regulate sales of Variable Annuities ("VAs").

These cases continue a broader debate about which (if any) annuities should be included within the definition of "security" under the various state blue sky laws. The answer may determine: (i) which annuities are regulated by state securities regulators and which are under the exclusive domain of state insurance regulator; and (ii) the applicability and civil remedies under the antifraud provisions of state blue sky laws. These cases also raise questions about a state securities regulators' authority when a financial adviser wears two hats - the hat of an investment adviser representative and the hat of an insurance salesperson, mortgage broker, registered representative, or other professional.

II. The Debate About Which Variable Annuities Should be "Securities" under State Blue Sky Laws:

There has been a long-standing debate among the insurance and securities regulators regarding which annuities should be included within the definition of "security" under state blue sky laws. While there has been relative consensus that fixed annuities were not securities, variable annuities have been subject to discussion. The Model Uniform Securities Act (2005) ("Securities Model Act") neither excludes nor specifically includes VAs in the definition of securities. The drafters of the Securities Model Act found a divide in how states treated variable

annuities. A majority of states excluded both fixed and variable annuities from the definition of securities, but a minority of states included variable annuities under the state's blue sky law definition of securities and exempted them only from registration requirements of the state law. Recognizing this split of approaches, the Securities Model Act provides bracketed optional language for variable annuities so that "the decision whether to exclude variable annuities from the definition of security will be made on a state-by-state basis." Securities Model Act p. 32, Official Comments 28; *See also* Prefatory Note p. 4.

State securities regulators have pressed to include VAs in the definition of securities. When commenting on the Securities Model Act, the North American Securities Administrators Association ("NASAA") argued that including VAs within the definition would align state law with federal law and that, because of "the similarities between variable contracts and other securities products," it would be "incongruous for agents and sales practices involved in variable annuities not to be covered by state securities laws." Uniform Securities Act at 33, Official Comment 28 to §102(28).

The insurance industry, however, pressed for exclusive regulation of VAs by the insurance commissioners. Section 4 of the Variable Contract Model Law (1999) ("VA Model Act") promulgated by the National Association of Insurance Commissioners, states that "[n]otwithstanding any other provision of law, the [state insurance commissioner] shall have sole authority to regulate the issuance and sale of variable contracts." *See* VA Model Law (1999), www.naic.org/store/free/MDL-260.pdf. When commenting on the Securities Model Act, the American Council of Life Insurers argued that "thirty-seven jurisdictions currently exclude all insurance, endowment and annuity contracts from the definition of security" and that excluding variable annuities from the definition of securities would prevent statutory conflicts with the "48 jurisdictions that grant the insurance commissioner exclusive jurisdiction to regulate the issuance and sale of variable contracts." *Id.* at 33, Official Comment 28, §102 (28).

The debate over whether to include variable annuities in the definition of securities is not academic because it determines the applicability of the anti-fraud provisions of the law. The Uniform Act has two anti-fraud provisions. Section 501 generally prohibits fraudulent conduct "in connection with the offer, sale, or purchase of a security." Section 502 generally prohibits fraudulent conduct in providing investment advice - "advising others for compensation … as to the value of securities or the advisability of [buying or selling] securities … or promulgating analyses or reports relating to securities." Even if exempt from registration, a state's determination to include an annuity in the definition of security would determine whether the state securities regulator could bring enforcement actions for alleged fraud "in connection with the offer, sale, or purchase of" the annuity under Section 501 or could regulate "fraud in providing investment advice"

about it under Section 502.

The Comments to the Securities Model Act explain that whether VAs is included within the definition of security determines whether these anti-fraud sections apply. "When variable products are included in the definition of security and exempted from registration, state securities administrators can bring enforcement actions concerning variable insurance sales practices." *Id.* at 32. Thus, a State's decision to include or exclude VAs as securities determines "whether variable insurance products are or are not subject to fraud enforcement. Not surprisingly, NASAA promotes including VAs in the definition of securities for this very reason - because "when variable products are included in the definition of security and exempted from registration, state securities administrators can bring enforcement actions concerning variable insurance sales practices." *Id.* at 33.

Illinois has adopted language identical to Section 4 of VA Model Act. *See* 215 ILCS 245.24 ("Notwithstanding any other provision of law, the [Director of Insurance] shall have sole authority to regulate the issuance and sale of variable contracts.")

Illinois has not adopted the Securities Model Act, but has defined security in a way very similar to it. The Securities Model Act defines security to include a list of categories, then excludes from the definition "an insurance or endowment policy or annuity contract under which an insurance company promises to pay a [fixed or variable] sum of money either in a lump sum or periodically for life or other specified period." Securities Model Act §102(28). Illinois defines security with a virtually identical list, except that Illinois includes "face amount certificates," 815 ILCS 5/2.1, defined as "any form of annuity contract (other than an annuity contract issued by a life insurance company authorized to transact business in this State)" 815 ILCS 5/2.14. Illinois also adopted anti-fraud provisions similar to Section 501 of the Securities Model Act (the "Transaction Provisions"), which prohibit fraud connected to "the offer or sale of a security", 815 ILCS 5/12(A), (B), (F), (G), (I), (K) and a provision similar to Section 502 (the "Investment Advice Provision"), which prohibits fraud while "acting as an investment adviser, investment adviser representative, or federal covered investment adviser." 815 ILCS 5/12(J). Illinois generally defines "investment adviser" to mean a person who engages in the business of advising others about the value of securities or the advisability of buying or selling securities, or who issues analyses or reports concerning securities. 815 ILCS 5/2.11.

III. The Van Dyke Case

On July 29, 2016, the Illinois Fourth District Appellate Court rendered a decision in *Van Dyke v. Jesse White.* Van Dyke was an Illinois registered investment adviser and an Illinois insurance producer who recommended EIAs to clients. After an administrative hearing, the Illinois Securities Department ("Department") revoked Van Dyke's

license and imposed a $330,000 fine, holding that EIAs were securities under the Illinois blue sky law and that Van Dyke had violated the anti-fraud provisions of the law by recommending EIAs to 21 separate clients. The Circuit Court upheld the Department order and *Van Dyke* appealed to the Fourth District Court of Appeals.

Van Dyke argued that the Department had no jurisdiction over the marketing and sales of EIAs because EIAs are not securities under the Illinois law. The Department argued that EIAs were securities, but that even if they were not securities, Van Dyke was acting as an investment adviser when he recommended the EIAs and, accordingly, still was subject to the Department's jurisdiction under the Investment Advice Provision.

The Appellate Court reversed the Department's order. It held that EIAs were not securities. The Court upheld the Department's conclusion that Van Dyke was "acting as an investment adviser," but held that the Department had failed to prove that Van Dyke had committed fraud in violation of the Investment Advice Provision.

IV. The Thrivent Case

On June 20, 2017, the Circuit Court of Cook County, Illinois entered an order dismissing a case brought by Thrivent against the Department. *Thrivent* Order (June 20, 2017). In the case, *Thrivent* sought, among other things, a declaratory judgment that the Department did not have authority to regulate Thrivent's sales of variable annuities and an injunction prohibiting the Department from exercising such authority through an administrative action related to Thrivent's variable annuity sales.

Rejecting Thrivent's position, the Circuit Court held that the Department "has the authority to investigate and discipline any fraudulent business practice, whether or not such practices involve the sale of a security." *Id.* at p. 7.Relying upon *Van Dyke*, the Court ruled that, the Department has grounds to investigate its registrants' purportedly fraudulent or manipulative conduct" under the Investment Advice Provision "whether or not it has authority to regulate variable annuities." *Id.* p. 9. *Thrivent* has appealed the decision to the First District Appellate Court.

V. Questions for the Illinois Supreme Court in Van Dyke and the First District in Thrivent

The Illinois Supreme Court in *Van Dyke* and the First District Appellate Court in *Thrivent* have several questions to answer, including the following:

a. *Are annuities "securities" under the Illinois blue sky law?*

In *Van Dyke,* the Illinois Supreme Court will determine whether "annuities contracts issued by a life insurance company" are excluded

from the Illinois blue sky law definition of security, 815 ILCS 5/2.1, 2.14, or are only excluded from registration requirements. 815 ILCS 5/3(M). Although Van Dyke involves EIAs, the statutory sections being interpreted do not distinguish EIAs from fixed annuities or VAs. If the Court concludes that annuities are securities, the ruling would overturn prior Illinois appellate court precedent . *See Rasgaitis v. Waterstone Financial Group, Inc.*, 2013 IL App (2d) 111112 (holding that fixed and equity indexed annuities were not securities); *Babiarz v. Stearns*, 2016 IL App (1st) 150988 (holding that fixed annuities were insurance products, not securities). It also may have broad reaching consequences on the Department's enforcement authority and on claims for civil liability under the Illinois blue sky law.

b. *If annuities are Not securities, when a registered investment adviser wears an insurance producer hat, what does it mean to be "acting as an investment adviser"?*

The Court in *Van Dyke* concluded - with very little analysis - that Van Dyke "acted…as a registered investment adviser" under the Investment Advice Provision. *Van Dyke, supra* at ¶ 30-31. The Court noted that *Van Dyke* was registered as an investment adviser under the Illinois blue sky law, that he marketed and otherwise held himself out to clients as a registered investment adviser, and that "one client paid him a $1,975 retainer for future investment advice and received over $360,000 in commissions". *Id.* at ¶ 31. The Investment Advice Provision, however, requires that the person be "acting as" (not simply "registered as") an investment adviser when committing the alleged fraud. The definition of investment adviser under the Illinois Blue Sky Law indicates that a person acts as an investment adviser when that person engages in the business of providing advice relating to securities. 815 ILCS 5/2.11. The *Van Dyke* Court found that the EIAs were not securities. It did not analyze whether each of the 21 clients separately engaged Van Dyke to provide advice or whether Van Dyke did provide any advice regarding something that was a security. It did not analyze whether Van Dyke recommendation of EIAs were part of a broader investment adviser relationship with each of the 21 separate clients at issue. It is entirely possible that some of them had no investment adviser relationship with Van Dyke whatsoever. If a client did not engage Van Dyke to be an investment adviser and the only advice received related to a non-security, can Van Dyke have been "acting" as an investment adviser? If Van Dyke had more than one relationship with a single client - as an investment adviser and as an insurance producer - what does it mean to be "acting" in an investment adviser capacity as opposed to the insurance producer capacity?

c. *When a product is a "security" under federal law, but not state law, what does it mean to be "acting as a federal covered investment adviser"?*

The analysis of Investment Advice Provision for *Thrivent* is even more complicated. The Investment Advice Provision applies to a person

"acting as an investment adviser, investment adviser representative, or federal covered investment adviser". 815 ILCS 5/12. While Van Dyke is a state registered investment adviser, Thrivent is registered under the Federal 1940 Investment Advisers Act ("1940 Act") and is a "federally covered investment adviser." So, while the question under the Investment Advice Provision in *Van Dyke* is whether Van Dyke was "acting as an investment adviser" under the state's definition, the question for *Thrivent* is whether it was "acting as a federal covered adviser".

The definition of investment adviser under the 1940 Act is nearly identical to the definition of investment adviser under the Illinois Act and both appear to require advice relating to a "security". Compare 815 ILCS 5/2.11; 1940 Act §202(11). However, the definition of security is different. Assuming VAs were not securities under Illinois law, they still would be securities under federal law. 15 U.S.C. §77c(a)(8); Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §989J, 124 Stat. 1376, 1949-50 (2010). Could recommending the same VA constitute acting as a federal covered adviser (i.e., giving advice about a security as defined by federal law), but not acting as an investment adviser under the state definition (i.e., giving advice about a security as defined by state law)?

d. *When a registered investment adviser wears a broker-dealer hat, what does it mean to be "acting as an investment adviser"?*

By its terms, the language of the Investment Advice Provision does not apply to broker-dealers, only to investment advisers (state or federal covered). At both the state and federal level, a registered broker-dealer is not an investment adviser. 815 ILCS 5/2.11(3); 1940 Act §102(11)(C). Thrivent is not only an investment adviser, but also a registered broker-dealer. The *Thrivent* Court appears to have made no distinction between variable annuities recommendations by registered representatives of Thrivent's broker dealer on the one hand and recommended by investment adviser representatives of Thrivent's investment adviser on the other. If the recommendation to a specific client came solely through a broker-dealer account, can Thrivent have been acting as a federally covered investment adviser?

e. *Is the Securities Administrator's investigatory power limited to investigations of conduct while "acting as an investment adviser"?*

The *Thrivent* Court accepted the Department's position that it "has the authority to investigate and discipline any fraudulent business practice." *Thrivent* at p. 7. In support of this position, the Department cited 815 ILCS 5/11 and the Investment Advice Provision. Most of the subsections of 815 ILCS 5/11, however, appear to have language limiting the Department to investigations of violations of the Illinois blue sky law and as noted above, the Investment Advice Provision appears limited to business practices when a person is "acting as an investment adviser, investment adviser representative, or federal

covered investment adviser". 815 ILCS 5/12(J); *See 5/11(C)*(limited to times when it appears "this Act or any rule or regulation prescribed under authority thereof, has been or about to be violated"), *5/11(D)* (limited to investigations "necessary for enforcement of the Act"), *but of 5/11(B)* (granting the power to require financial statements and reports from investment advisers and investment adviser representatives). If the investigatory power of the Department is not limited to investigations of violation of the blue sky law, what are the limits (if any) of the investigatory power?

f. *What Does it mean to Regulate "the Sale of Variable Annuities" Under the Illinois Insurance Code and Section 4 of the VA Model Act?*

As noted above, the Illinois Insurance Code and Section 4 of the Model Act both provide that "[n]otwithstanding any other provision of law, the [state insurance commissioner] shall have sole authority to regulate the issuance and sale of variable contracts". The *Thrivent* Court misread *Van Dyke* decision as acknowledging that "even if a particular investment instrument falls within the sole jurisdiction of the Department of Insurance, the Department may address its registrants' purported fraudulent or manipulative conduct" pursuant to the Investment Advice Provision. The *Van Dyke* Court never, in fact, came to this conclusion. In fact, the *Van Dyke* decision did not analyze whether EIAs are 'variable contracts' under the Illinois Insurance Code, but assumed the provision applied solely to VAs, not EIAs. *Van Dyke* p. 10-11. As a result, neither the *Van Dyke* nor *Thrivent* Courts have analyzed the effect of this provision on VAs.

Is an investigation or a disciplinary action by the Securities Administrator an exercise of "authority to regulate"? If so, does the Insurance Code preempt any investigation or disciplinary action related to sales practices of VAs? If not, what limit (if any) does this provision place on the Department's authority over VA sale practices?

VI. Conclusion

When decisions come down in *Van Dyke* and *Thrivent*, they could significantly change the regulatory and civil liability landscape for annuities in the state of Illinois. They also could inform similar arguments in cases interpreting the VA Model Act and Securities Model Act and could set the stage for a renewed legislative debate over whether annuities should be regulated by the state insurance or securities regulator. Players in both the insurance and securities industries should watch *Van Dyke* and *Thrivent* very closely.

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