Supreme Court Holds Annuities Are Not "Securities" Subject to Illinois Securities Department Regulation

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INTRODUCTION

On March 21, 2019, the Illinois Supreme Court issued its long-anticipated decision in ***Van Dyke v. White*, 2019 IL 121452**.

The 30-page opinion affirms the 2016 Appellate Court decision, which had overturned a Final Administrative Order from the Illinois Department of Securities ("Department"). The Supreme Court holding: (1) confirms that equity indexed annuities ("EIAs") and Variable Annuities ("VAs") are not securities under the Illinois Securities Law ("ISL"); (2) holds that the Department has no authority to regulate the "issuance or sale of variable annuities" to individual buyers; and (3) finds that *Van Dyke* was "acting as an investment adviser" under Section 12(J) of the ISL when he was giving advice about the sale of EIAs, even though those EIAs were non-securities products.

BACKGROUND AND PRIOR DECISION

Richard Van Dyke, an Illinois Registered Investment Adviser ("RIA") and a licensed Illinois insurance producer, had recommended the purchase of EIAs to some of his clients. Based on a complaint from the children of some of Van Dyke's clients, the Department audited his files and in particular, focused on the sale of EIAs to his clients.

For years, the Department has taken the position that EIAs are "investment contracts" and, therefore, securities under Section 2.1 of the ISL. As such, the Department maintained, their sale is subject to regulation and oversight by the Department. *E.g., In the Matter of Senior Financial Strategies, Inc. d/b/a Pinnacle Investment Advisers, et al., ISD Administrative Order File No. 0800064*. Consistent with that position, the Department pursued an administrative proceeding against Van Dyke pursuant to Department Regulation 130.853, and, in 2014, issued a final administrative order finding that he had defrauded 21 clients through the sale of EIAs. As a result, the Department revoked Van Dyke's license and imposed a fine and assessed other costs.

Van Dyke filed a complaint for administrative review, arguing that indexed annuities were not securities under ISL, and, therefore, outside of the Department's jurisdiction. Further, he argued, Department could not regulate or sanction him for selling an insurance product. In vacating the Department's administrative decision, the Fourth District Appellate Court agreed with Van Dyke's argument that indexed annuities were, by definition, excluded as securities under Section 2.14 of the ISL. *Van Dyke v. White*, 2016 IL App. (4th) 141109, ¶24. Because EIAs were not securities, the Court concluded, that Van

Dyke could not have engaged in the fraudulent conduct relating to the offer of sale of securities under Sections 12(A), (F), (G) or (I) of the ISL. *Id.* at ¶24.

Yet, the fact that EIAs were not securities did not foreclose the Department's supervisory role. While the court declined to consider whether Van Dyke's conduct violated Sections 12(A), (F), (G) or (I) of the ISL relating to the sale of securities, the court also reviewed Van Dyke's actions as a registered investment adviser under the ISL. The Court concluded that the ISL's anti-fraud provision under Section 12(J) governed Van Dyke's recommendation and sale of the EIAs. *Id*. at ¶26. Nevertheless, the Court found that the evidence failed to establish that Van Dyke had violated the ISL in the sale of the annuities or that he had perpetrated a fraud on his clients. Accordingly, the Appellate Court reversed the Secretary's final order. *Id.* at ¶42.

SUPREME COURT DECISION

The unanimous Supreme Court decision substantially tracks the ruling of the Appellate Court.

1. <u>Annuities Are Not "Securities" Under the ISL.</u>

The Court held that, in determining whether an indexed annuity is a security, analysis begins with the definition of "security" found in Section 2.1 of the ISL:

> "'Security' means any note, stock, treasury stock, *** investment contract, *** face-amount certificate, *** or, in general, any interest or instrument commonly known as a 'security' ***." 815 ILCS 5/2.1 (West 2012).

Van Dyke, 2019 IL 121452 ¶48. ISL section 2.14 further defines the "face amount certificate" to include any form of annuity "other than an annuity contract issued by a life insurance company authorized to transact business in this State." 2019 IL 121452, ¶49, citing 815 ILCS 5/2.14. "According to the clear and unambiguous language of this provision, the type of financial instrument designated as a 'face amount certificate' specifically excludes all annuity contracts issued by an authorized life insurance company." *Id.*

Notwithstanding the clear language of Section 2.14, the Department argued that indexed annuity might still be considered a "security" under the catch-all term "investment contract." *Id.* at ¶50. The Court, however, disagreed. While annuities might arguably be deemed "investment contracts," and, therefore, "securities," under federal securities law, the Court found that the Illinois statute's more particularized term "face amount certificate" precluded the broad, alternate definition offered by the Department. *Id.* at ¶55. "Given that our statutory definition of 'security' includes a reference to a particular type of financial instrument that encompasses annuities issued by insurance companies…the specific statutory provision excluding insurance annuities from the definition of 'face amount certificate' in Section 2.14 takes precedence over the generally descriptive term 'investment contract' in Section 2.1." *Id.* at ¶55 The Court concluded:

> Considered in its entirety, our statutory regime demonstrates the legislature's intent that annuity contracts issued by authorized insurers are insurance products and are not securities because they fall within the exclusion from face amount certificates and are not investment contracts under section 2.1. As a consequence, Van Dyke's recommendation that his clients purchase the indexed annuities at issue in this case cannot form the basis of a violation of sections 12(A), (F), (G), or (I) of the Act. *Id.* at ¶64.

2. <u>The Department Has No Authority to Regulate the Sale of VAs to Individual Buyers</u>

The *Van Dyke* opinion analyzed Section 245.24 of the Illinois Insurance Code, which provides:

> Notwithstanding any other provision of law, the Director [of Insurance] has sole authority to regulate the issuance and sale of variable contracts, and to promulgate such reasonable rules and regulations as may be appropriate to carry out the purposes and provisions of this Article." 215 ILCS 5/245.24

The Department argued that Section 245.24 granted the Director of Insurance exclusive authority to regulate the companies that issue variable contracts as well as the registration and form of such contracts and the maintenance of their separate accounts, but did not grant exclusive authority over the sale of variable annuities to individual buyers. 2019 IL 121452, ¶58.

The Supreme Court, however, disagreed. It refused to "read into" Section 245.24 an exception excluding sales to individual buyers.

3. <u>Van Dyke's Behavior Is Governed by Section 12(J)</u>

As did the Appellate Court in its decision, the Supreme Court found that Van Dyke acted as an "investment adviser" in connection with the sale of the EIAs. *Id*. at ¶73.

> Under the clear and unambiguous language of section 2.11, the definition of an "investment adviser" expressly includes any person who holds himself or herself out as providing investment advisory services regarding securities. Thus, even if a particular transaction does not involve a security, a person can fall within the purview of section 12(J) by holding himself or herself out as providing such investment advice.

Id. at ¶72, citing 815 ILCS 5/2.11 (West 2012).

The Supreme Court, however, diverged from the Appellate Court as to the appropriate standard governing Van Dyke's behavior. While the Appellate Court seemed to apply a "suitability" standard set forth in section 130.853 of the Illinois Administrative Code, 14 Ill. Adm. Code 130.853 (1997), *see* 2016 IL App (4th) 141109, ¶40, the Supreme Court held that investment advisers must be held to a higher, fiduciary standard. 2019 IL 121452, ¶¶74, 76. Indeed, the Court held that a fiduciary standard is "coextensive" with the anti-fraud provisions found in ISL section 12(J).

Even under an exacting fiduciary standard, however, the Supreme Court concluded that the Department's determinations of fraud were arbitrary and capricious and not substantiated by reliable or competent evidence. "[W]e find that the evidence presented failed to establish that Van Dyke violated the Act or perpetrated a fraud on his clients with regard to the replacement transactions at issue in this case." *Id.* at ¶86.

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