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FUND FORMATION & INVESTMENT MANAGEMENT GROUP ALERT

SEC ISSUES STAFF REPORT RECOMMENDING LIFE SETTLEMENTS BE DEFINED AS SECURITIES

The Securities and Exchange Commission ("SEC") recently issued a staff report recommending that life settlements be clearly defined as securities so that the investors in these transactions are protected under the federal securities laws. The report by the SEC's Life Settlements Task Force noted that the market for life settlements has grown rapidly over the past decade raising questions about its regulation and oversight. The Staff also issued an investor bulletin to inform investors of critical risks involved with life settlements.

A life settlement is a transaction in which an individual with a life insurance policy sells that policy to another person, who then assumes responsibility for paying the premiums. Most individuals who sell their life insurance policies are seniors with a life expectancy of more than two years. Typically, the seller no longer wants the policy or can no longer afford to pay the premiums. In exchange, the insured party typically 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.

A life insurance policy owner may either discuss a life settlement with his insurance agent or financial adviser, who then contacts a life settlement broker, or a policy owner may be solicited directly by a life settlement broker. Life settlement brokers may also be life insurance agents or securities brokers. Brokers may be licensed depending on the requirements of the states in which they do business. The broker obtains the insured's authorization to release medical records and forwards the insured's application and medical information to life settlement providers. Many, but not all, states license life settlement providers, who also charge a commission. The provider obtains life expectancy estimates on the insured and bids on the application.

Life expectancy underwriters calculate the risk of mortality on the insured based on his personal characteristics. If the bid is accepted the policy is offered to investors, either to retail investors or institutional investors often in a pool of policies. The investor (or pool) makes a payment to the policy owner and pays the premiums to keep the policy in effect until the investor receives the death benefit. The dollar amount offered by the investor normally takes into account the insured's life expectancy, as well as the terms and conditions of the policy. The Staff Report noted there is inconsistent regulation of participants in the life settlements market, including those who arrange for the purchase and sale of policies and those who provide estimates of an insured's life expectancy.

The Staff Report noted that purchasers of life settlements would benefit from the application of baseline standards of conduct to market participants.

The federal courts have split as to whether fractional interests in viatical settlements (the insured has a life expectancy of less then two years) were securities. Since the SEC has brought numerous enforcement actions based on alleged fraud in connection with the sale of life settlements, the Staff Report recommended increased regulation. While 48 states treat life settlements as securities, some states exclude from the definition of a security, the original sale from the insured to the provider.

(Please see next page for more information.)

The National Association of Insurance Commissioners and the National Conference of Insurance Legislators have adopted model state statutes to address life settlements. However, there are many variations in the acts, because of the different ways the states have enacted them.

The Staff Report outlines the Task Force's findings about the life settlements market and recommends ways to improve market practices and regulatory oversight. It recommends that the Commission should:

- Consider recommending to Congress that it amend the definition of security under the federal securities laws to include life settlements as securities. If enacted, market intermediaries will be included in the SEC's and FINRA's regulatory framework. The offer and sale of life settlements would have to be registered under the Securities Act of 1933 unless an exemption such as Regulation D or Rule 144A was available.
- Instruct the Staff to continue to monitor that legal standards of conduct are being met by brokers and providers.
- Instruct the Staff to monitor for the development of a life settlement securitization market.
- Encourage Congress and state legislators to consider more significant and consistent regulation of life expectancy underwriters.

The SEC also issued an investor bulletin regarding investments in life settlements consistent with one of the recommendations of the Task Force. The bulletin explains how life settlements work and certain risks involved with them.

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