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Notice From National Association Of Securities Dealers: Life Settlements Of Variable Insurance Policies Are Securities Transactions

In August, 2006, the National Association of Securities Dealers (“NASD”) issued Notice to Members 06-38 (the “Notice”) addressing “Member Obligations with Respect to the Sale of Existing Variable Life Insurance Policies to Third Parties.” The stated purpose of the Notice is to remind NASD members and associated persons (registered representatives) that life settlements involving the sale of variable life insurance policies are sales of securities, and NASD members and associated persons involved in such sales are subject to applicable NASD rules. The Notice points out the rapid expansion in the life settlement market, noting a potential market which “exceeds \$100 billion.”

The Notice defines a life settlement as the sale of an existing life insurance policy to a third party for less than its net death benefit but more than its cash surrender value. The Notice begins with a discussion of the background of life settlement transactions and the value and risks they pose to sellers and purchasers of existing life insurance policies.

Obligations of Associated Persons

The Notice is primarily focused on the duties and obligations of the NASD members and associated persons to their customers when recommending the sale by such customer of an existing variable life insurance policy. While the Notice reminds NASD members and associated persons of their duties to their customers under NASD regulations related to sales to such customers of variable life insurance policies (i.e., suitability, due diligence, training, supervision, best execution and compensation), the Notice also provides that the NASD “is also concerned” about life settlement transactions involving non-variable life insurance policies. It is unclear exactly what this concern is and whether this statement indicates (as we elaborate on below) that the NASD or another regulator plans to express additional views with regard to non-variable life insurance policies in the future,

but it is clear that the NASD has applied certain sales regulations to all business activities of associated persons in the past. In light of the position that the NASD took in Notice to Members 05-50 (“NTM 05-50”) titled “Equity-Indexed Annuities - Member Responsibilities for Supervising Sales of Unregistered Equity-Indexed Annuities,” which addressed the responsibility of NASD member firms to supervise sales by their associated persons of equity-indexed annuities that are not registered under the federal securities laws, the foregoing concern expressed in the Notice is significant to life settlement brokers (including life insurance producers who engage in such brokerage activities) as well as life settlement providers that transact business with life settlement brokers.

Best Practices for Life Settlement Transactions

The Notice also implies what might be some best practices for NASD member firms to adopt in permitting and supervising life settlement brokerage transactions by associated persons who also act as life settlement brokers. For example, in reminding regulated persons of their duties regarding suitability, the Notice states, “[a] variable life settlement is not necessarily suitable for a customer simply because the settlement price offered exceeds the policy’s surrender value.” The Notice states that the seller may have a continued need for coverage and should fully understand the aspects of a replacement life insurance policy if the transaction contemplates a replacement for the policy sold. The NASD also notes the need to consider any tax implications of a recommended life settlement transaction. In light of these specific references in the Notice, regulated persons should document their analysis and discussions with their clients relating to the client’s continued need for life insurance coverage and any tax implications.

The Notice also states a specific concern regarding confidentiality of the identity of the insured and medical records regarding his or her

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life insurance policy in the life settlement transaction. The foregoing concern appears to be a thinly veiled reference to a best practice suggestion of only recommending a life settlement where the “life settlement provider” maintains confidentiality even where such confidentiality may not be mandated by law because of an exception to such requirement. The Notice also *recommends*, without using that word, that member firms develop lists of approved life settlement providers, based on review of such providers and their practices.

As to “best execution,” the Notice states its “belief” that NASD members recommending life settlements provide a range of choice in life settlement providers. The NASD states that due diligence of available markets for settlement and prices within those markets is a “core duty” in meeting the best execution obligation. The Notice also reminds NASD members of their obligation to provide appropriate training and supervision of their registered representatives. Further, the NASD reminds firms of their obligations regarding compensation. Specifically, the Notice refers to Rule 2820(g)’s prohibition upon an associated person accepting compensation from anyone other than the member firm with which the registered representative is associated.

Looking Forward... Is There More to Come?

Most interestingly, perhaps, the Notice ends with the statement that life settlement transactions involving non-variable life insurance policies are an area of concern for the NASD. Given the strong statements the NASD has issued with respect to indexed annuities in NTM 05-50, referenced above, one wonders if a “suggestion” by the NASD that member firms supervise the sale of ALL life settlements within the firm—rather than as an authorized outside business activity—might soon follow, or be born out in subsequent enforcement actions.

Aside from reminding firms and their associated persons of their duties and implying certain best practices with respect to life settlement recommendations, what really is NASD’s intended message for the Notice? After all, it has long been conceded by the life settlement industry that NASD members and associated persons involved in the purchase of a variable life insurance policy by one of their customers involves the sale of securities, so it is not “news” *per se* for the NASD to state that the

secondary sale of such policies for and on behalf of a customer, i.e., a life settlement transaction, also involves the sale of securities. What the Notice may, in fact foreshadow—as a warning perhaps—is that life settlement providers may have a similar duty to their investors or financing sources, regardless of whether the policy is a variable one or not. Indeed, the message might be targeted at a broader audience than just current NASD members and associated persons because of the statement in the Notice, “[e]ntities participating in the sale and marketing of interests in life insurance policies, variable or not, for investment purposes may trigger broker-dealer registration requirements under the Securities Exchange Act of 1934.”

Regardless of what finally transpires, life settlement providers as well as NASD-regulated persons should consider the impact of the Notice on their current practices relating to variable policy transactions and consider adopting some of the intimated “best practices,” i.e., representing only life settlement providers who are pledged to confidentiality, conducting due diligence on such providers, and securing multiple bids.

ABOUT THE AUTHORS

Brian T. Casey, Eric Marhoun, Michael Renetzky and Robin Choi focus their practices on the business needs of financial service firms and insurers, with a unique emphasis on the interplay between the insurance, broker-dealer, variable product, and life settlement businesses. They represent insurers, investment advisers, life settlement businesses and financing sources, broker-dealers and private investment funds.