Testimony Concerning "Recent Innovations in Securitization"
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Good afternoon Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee. I am pleased to testify on behalf of the Commission today on the topic of life settlements and new developments in securitization. I appreciate the opportunity to discuss with you the Commission's work in this area.

Background

Securitization is a financing technique in which financial assets, in many cases themselves relatively illiquid, are pooled and converted into instruments that may be offered and sold in the capital markets. In a typical securitization, a sponsor initiates a securitization transaction by selling or pledging to a specially created issuing entity, such as a trust, a group of financial assets that the sponsor either has originated itself or has purchased. The trust or other issuing entity sells securities. The money from the sale of the securities is used to purchase the financial assets from the sponsor. The financial assets are pooled and the pool typically is designed to cover a wide range of obligors on the underlying assets. The securities pay a return based on the assets in the trust.

Although we recognize that securitization plays an important role in the financial markets, the recent experience with securitization in the mortgage markets argues for the careful review and analysis of all developing securities activities. In this regard, the Commission is taking steps to address issues with securitization. The staff currently is engaged in a broad review of the Commission's regulation of asset-backed securities including disclosure, offering process, and reporting of asset-backed issuers.

The securitization market continues to develop, and we recognize that securitization of life settlements appears to be a growing practice. A life settlement is the sale of an existing life insurance policy to a third party for more than its cash surrender value but less than its net death benefit. For a policy owner, a life settlement offers an alternative source of liquidity to those that historically have been available from the issuing life insurance company.[1] A life settlement becomes possible when the policy's market value exceeds its cash surrender value. We understand that the key factors determining market value are the amount of the death benefit, cost of expected premiums, and life expectancy of the insured.

Traditionally, an owner of a life insurance policy could access the value in the policy either through taking a loan against the cash value of the policy or by surrendering the policy for its cash value less any applicable surrender charges. The cash value or cash surrender value are frequently significantly less than the policy's death benefit. For a policy owner who may no longer need the policy, who may be unable to afford the policy's premiums, or who may have an immediate need for cash, a life settlement can

[1] The so-called "viatical settlement" industry emerged in the 1980s in response to the AIDS epidemic. During that time, the industry developed as a means for AIDS patients to obtain needed cash by selling their life insurance policies. Generally, a viatical settlement involves a policyholder with a life expectancy of less than two years, while a life settlement generally involves a policyholder with a life expectancy of more than two years. The life settlement market developed as an offshoot from the viatical settlement market as seniors began to access the life settlement market as an option to exit life insurance policies. The market has grown rapidly in recent years.

offer a means for obtaining greater value than is available from the insurance company itself.

We understand that this additional liquidity may make life settlements attractive to some policy owners. At the same time, a life settlement may have certain drawbacks for the policy owner. Some of these drawbacks may include sacrificing the right to a death benefit substantially greater than the amount of the life settlement, potential loss of insurability, adverse tax consequences, and the difficulty of determining whether a life settlement provides a fair price for the policy. In addition, the sale of a life settlement potentially could result in dissemination of sensitive health or other personal information about the insured.

A life settlement offers the third party purchaser of the policy the opportunity to profit by receiving a death benefit that exceeds (in some cases substantially) the amount paid to the policy owner for the policy. The third party purchaser pays the premiums due on the policy during the insured's life. Upon the insured's death, the third party purchaser receives the death benefit from the insurer. Profitability depends on the value of the death benefit relative to the amount paid to purchase the policy from the insured and to maintain the policy through premium payments.

An industry source states that the life insurance settlement industry has grown from a $2 billon industry in 2001 to $16 billion in 2008.[2] Life settlements generally are considered securities when a third party purchaser sells a fractional interest in a single

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[2] Life Insurance Settlement Association, "The Basics of Life Settlements," *available at* http://www.thevoiceoftheindustry.com/files/content/docs/Brochures/ConsumerEducationweb.pdf (last visited September 21, 2009).

policy[3] or pools the life settlements and sells interests in the pool. To date, we are not aware of any securitized life settlements pool being registered with the SEC and publicly sold to investors, but we will continue to monitor this developing practice involving life settlements.

SEC Life Settlements Task Force

In light of the potentially far-reaching consequences of the recent movement toward securitization of life settlements, Chairman Schapiro has established a Life Settlements Task Force to examine emerging issues in the life settlements market and to advise the Commission whether market practices and regulatory oversight can be improved. The Task Force will consider, among other things, the application of the federal securities laws to life settlements, the emerging role of securitization, the life settlements marketplace (including trading platforms), and market intermediaries. In particular, in light of reported recent efforts to collect and securitize life settlements by some large investment banks, the Task Force will focus on investors, sales practices and intermediaries. This assessment will require a multi-disciplinary approach; our Life Settlements Task Force is comprised of senior SEC officials from throughout the agency. Participants include representatives from the Divisions of Corporation Finance; Trading and Markets; Investment Management; Enforcement; and Risk, Strategy, and Financial Innovation, as well as the Offices of General Counsel; Chief Accountant; Compliance Inspections and Examinations; and Investor Education and Advocacy. The Task Force has started researching the issues and has initiated discussions with state regulators and other market participants. As discussed below, the Task Force is reaching out to fellow regulators to obtain a greater overview of the life settlements marketplace and assess any

[3] See Footnotes 9-18 and accompanying text.

regulatory gaps. In addition, we will be reaching out to other interested parties, such as investor representatives and counsel who practice in the area. In light of the recent market turmoil, some investors may be looking for additional investment opportunities, while some holders of life insurance policies may be looking for additional liquidity. However, these individuals may be more vulnerable due to the current environment. The Task Force will consider ways to better inform and protect these individuals.

Disclosure

Various groups of investors are affected by life settlement securitizations, including investors in the companies that sponsor securitizations, investors in insurance companies, and investors that purchase securities backed by life settlements. Not only will the staff be looking at issues raised with respect to these groups, but we also will be looking at the disclosure provided to these groups of investors.

With respect to investors in public companies that are sponsors of securitizations of life settlements and investors in insurance companies, we will assess whether the companies have clear disclosure about their businesses and the risks involved in their business model. With respect to the securities backed by life settlements (or life settlement securitizations), investors need clear disclosure. Many securitizations in general, and life settlement securitizations in particular, are complex financial instruments. Investors need the information necessary to understand these products, including the structure of the transaction and issues related to that such as provisions for payment of policy premiums. Investors need clear disclosure regarding risks, among other things, such as the risk of changes in expected returns if assumptions and estimates used to structure the transaction prove inaccurate and risks related to all parties in the chain of ownership of the life settlement, including the provider, seller and issuer of the securities. We realize there are some evolving issues. For instance, how do we resolve the tension between full disclosure to investors (a hallmark of SEC regulation) versus the legitimate privacy rights of the insured?

We also will be considering possible issues raised by the business model of creating securitized pools of life settlements, how that model relates to the interest of investors, and what kinds of fees are generated for securitizers. But foremost, we will work to assure that investors receive the information necessary to understand these products. The Task Force will consider the adequacy of disclosure investors receive, and whether securities offerings that purport to rely on exemptions from registration under the federal securities laws are doing so properly.

Sales Practices

In addition to issues related directly to investors, the Life Settlement Task Force will consider sales practices regarding both the sale of existing life insurance policies by contract holders and the sale of interests in life settlement pools to investors. Both transactions raise important investor protection concerns.

As to the sale of an existing life insurance policy, the Task Force will consider what information market participants are receiving regarding the terms of the sale. There have been reports of extremely high commission rates paid to life settlement brokers, and we will consider the effect such compensation has on the sales process. The Commission is especially concerned that life settlement brokers may be targeting policyholders who are particularly vulnerable to abusive sales practices, including seniors and the seriously ill.

We understand that some contract holders may consider selling their policy based on a need for cash. The Task Force will consider whether contract holders are being told of other alternatives to the sale of their insurance policy. For instance, are contract holders being informed that there may be alternatives to a settlement, such as borrowing against the policy or invoking other contract features, such as the right to an accelerated death benefit? To the extent regulation of these disclosure practices is beyond our jurisdiction, we will share our findings with the appropriate regulators.

Regarding the sale of interests in life settlement pools, the Task Force will assess whether intermediaries soliciting potential sellers of existing contracts or purchasers of life settlement pools are adequately licensed and trained given the nature of their activities.

Working with Fellow Regulators

In executing its responsibility for maintaining fair, orderly, and efficient markets, the Commission oversees self-regulatory organizations, including the Financial Industry Regulatory Authority (FINRA).[4] FINRA, the self-regulatory organization for most U.S. securities firms, has for a number of years been addressing the obligations of member firms in the life settlement area. Most recently, in July of this year FINRA issued a regulatory notice reminding firms that variable life insurance settlements are securities transactions subject to the federal securities laws and FINRA rules, and focusing on

[4] In July 2007, the member regulation functions of the National Association of Securities Dealers, Inc. (NASD) were merged with those of the New York Stock Exchange (NYSE), creating the Financial Industry Regulatory Authority (FINRA). Since that time, FINRA has been engaged in the consolidation of NASD and NYSE rules into a single rulebook. For ease of reference, this testimony will refer to FINRA throughout.

suitability, disclosure and commission rates.[5] In the past, FINRA has reminded firms that recommendations to sell an existing variable insurance policy must be suitable, and that firms must adequately train and supervise associated persons involved in such transactions. FINRA also has reminded firms of their best execution obligations regarding the sale of the policy, including the need to obtain a favorable price.[6]

The Task Force will work closely with FINRA in its efforts to reach out to its members regarding their obligations in the area of life settlements. In addition, because FINRA only has jurisdiction over its member firms and their associated persons, the Task Force will consider whether investors would benefit from similar protections being applicable to other participants in the life settlement industry.

In that regard, life settlement issues draw on the expertise of regulators throughout the Unites States. For instance, a number of states have adopted laws regarding life settlements.[7] Thus, Chairman Schapiro has asked the Task Force to reach out to regulators and other interested parties, including the National Association of Insurance Commissioners, the North American Securities Administrators Association and

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5 *See* FINRA Regulatory Notice 09-42, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p119546.pdf (last visited September 21, 2009). With variable insurance products, the policyholder's premium payments are allocated to a segregated or "separate" account investing in securities, typically mutual funds, not to the company's general account (which receives premiums for non-variable life insurance and annuity policies). Under variable contracts, certain benefits (such as cash surrender values, annuity payments, and death benefits) reflect the investment performance of the portfolio of the applicable separate account.

6 In August 2006, among other things, FINRA reminded firms and their associated persons that life settlements involving variable insurance policies are securities transactions subject to applicable FINRA rules. *See* Notice to Members 06-38, *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p017131.pdf (last visited September 21, 2009).

7 *See, e.g.*, OHIO REV. CODE ANN. § 3916 (2009).

FINRA, to coordinate regulatory efforts and analyze whether gaps in oversight exist that should be filled through legislation or other action.

<u>Enforcement</u>

The SEC has the ability to use its civil enforcement authority to combat fraud and other unlawful securities-related activity in the life settlements market and has brought a number of cases in this area since the 1990s.[8] Initially, life settlements involved the sale of interests in individual policies. As a threshold matter, the SEC has taken the position that life settlements are securities, and, therefore, are subject to the requirements of the federal securities laws, including the antifraud rules. The courts have not reached a uniform answer on this question, which has raised some obstacles to the SEC's ability to protect investors in this growing market. Selling interests in a pool of life settlements, which is a securitization, does not raise the same issue present in the prior enforcement cases.

The first major case, *SEC v. Life Partners, Inc.*,[9] focused on the issue of whether a participation in a viatical settlement investment is an investment contract and therefore a "security" under the Supreme Court's decision in *SEC v. W.J. Howey Co.*[10] The *Life Partners* opinion held that the defendants' offerings satisfied the first two elements under *Howey*, specifically, they involved (1) an investment of money (2) in a common enterprise but did not satisfy the "efforts of others" third element in *Howey*, because the

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8 *See, e.g., Sec. & Exch. Comm'n v. Mutual Benefits Corp.*, 408 F.3d 737 (11th Cir. 2005).

9 87 F.3d 536 (D.C. Cir. 1996).

10 328 U.S. 293, 298-99 (1946). *Life Partners* involved investors buying parts of a policy as opposed to a life settlement securitization where investors buy a piece of a pool of life settlements. As noted above, a life settlement securitization does not raise the security question addressed in *Life Partners*.

promoters' "post-purchase" efforts – holding the policy, designating the beneficiaries, monitoring the insured's health and paying the premiums – were mostly "ministerial" in nature.[11]

Life Partners has been widely criticized and most courts have not followed it, either factually distinguishing their cases or rejecting *Life Partners'* distinction between pre- and post-purchase efforts – a distinction that was not part of the Supreme Court's *Howey* test – and its conclusion that the success of the investment depends principally on the death of the viator.[12] In 2004, the SEC obtained emergency relief to stop an ongoing fraudulent securities offering by Mutual Benefits Corporation, then the largest viatical settlement investment company in the country, which had raised over $1 billion from 30,000 investors.[13] The district court declined to follow *Life Partners* and held that the Mutual Benefits' investments were securities.[14]

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11 *Life Partners*, 87 F.3d 536, 545-546. Although the D.C. Circuit subsequently clarified its decision by stating that they were not adopting an "artificial bright-line rule," the court went on to discount the pre-purchase efforts in that case, noting that the dispositive factor relative to the success of the investment was the death of the viator, which was not in the promoter's control. *Life Partners*, 102 F.3d 587-89 (D.C. Cir. 1996). By the time the D.C. Circuit considered *Life Partners*, the company had significantly re-vamped its procedures to eliminate nearly all of its post-closing work.

12 *See Wuliger v. Christie*, 310 F. Supp. 2d 897, 904 (N.D. Ohio 2004) (declining to follow *Life Partners* and observing that the decision has been "not been embraced by other circuits"); *see also Sec. & Exch. Comm'n v. Tyler*, 2002 U.S. Dist. LEXIS 2952 (N.D. Tex. Feb 22, 2002) (entering preliminary injunction in SEC action, distinguishing *Life Partners* based upon defendants' post-purchase efforts to create a secondary market for viatical settlements); *Sec. & Exch. Comm'n v. Viatical Capital, Inc.*, Case No. 8:03-CV-1895-T-23TGW (January 22, 2004, Merryday, J.) (adopting Report and Recommendation distinguishing case from Life Partners due to certain post-purchase activities).

13 We argued that the district court should decline to follow *Life Partners* because: (1) the D.C. Circuit's distinction between pre- and post-purchase efforts was novel and not supported by *Howey* and its progeny, and (2) information developed about the viatical settlement industry since *Life Partners* was decided established that the "profit" earned by investors is far more dependent upon the expertise of the promoter than "the death of the viator" as the D.C. Circuit observed.

14 *Sec. & Exch. Comm'n v. Mutual Benefits Corp.*, 323 F. Supp. 2d 1337, 1343 (S.D. Fla. 2004). The court stated that the "bright-line rule enunciated by the D.C. Circuit . . . is inconsistent with

In affirming the district court's decision, the Eleventh Circuit observed that under *Howey* and the more recent decision of the Supreme Court in *SEC v. Edwards*,[15] a court must construe what constitutes an "investment contract" broadly, to "'encompass virtually any instrument that might be sold as an investment.'"[16] The Eleventh Circuit disagreed with the pre- and post-purchase bright line approach adopted by the D.C. Circuit in *Life Partners*, stating that neither *Howey* nor *Edwards* requires such a distinction.[17] Importantly, the court noted that investors "relied heavily" on Mutual Benefits' pre- and post-purchase activities, concluding that Mutual Benefits "offered what amounts to a classic investment contract."[18]

The SEC also has brought a number of other cases related to life settlements. For instance, we have brought cases against viatical settlement providers that have made misrepresentations to investors about the underlying policies and quality or reliability of the medical assessments of life expectancies.[19] Similarly, the SEC has brought cases

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the policies underlying the federal securities laws and misconceives the nature of investments in viatical settlements."

15 540 U.S. 389 (2004).

16 *Sec. & Exch. Comm'n v. Mutual Benefits Corp.*, 408 F.3d 737, 742 (11th Cir. 2005).

17 The court stated: "While it may be true that the 'solely on the efforts of the promoter or a third party' prong of the *Howey* test is more easily satisfied by post-purchase activities, there is no basis for excluding pre-purchase managerial activities from the analysis." *Id.* at 743.

18 *Id.* at 744.

19 *See Sec. & Exch. Comm'n v. Viatical Capital, Inc., et al.*, SEC Litigation Release No. 19598 (March 8, 2006). *See also Sec. & Exch. Comm'n v. Mutual Benefits Corp.*, 323 F. Supp. 2d 1337, 1343 (S.D. Fla. 2004), *aff'd by* 408 F.3d 737 (11th Cir. 2005); and *Sec. & Exch. Comm'n v. Viatical Capital, Inc.*, Case No. 8:03-CV-1895-T-23TGW (M.D. Fla. 2003) (VCI's portfolio contained policies that were fraudulently obtained, thus subject to cancellation, and many terminated and canceled policies).

alleging that ponzi schemes promised safe and profitable investments in life insurance policies.[20]

The enforcement cases to date have focused on sales of life settlements as investment opportunities. In the event that possible securities law violations are present in sales of securities through life settlement securitizations, we stand ready to pursue those cases vigorously.

Conclusion

Life settlements, and the growing trend toward securitization, create issues relating to disclosure and sales practices that could significantly impact investors. Chairman Schapiro has established the Life Settlement Task Force to address the emerging issues raised by the life settlement market. By incorporating a multi-disciplinary approach and working with fellow regulators and other interested parties, we will make a fresh, in-depth analysis of the issues raised in the securitization and life settlements market, so that we can make sure investors are informed and protected.

Thank you again for inviting me to appear before you today and for the Subcommittee's support of the agency at this critical time for the nation's investors. I would be happy to answer any questions you may have.

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20 *See Sec. & Exch. Comm'n v. Secure Investment Services, Inc., American Financial Services, Inc., Lyndon Group, Inc., Donald F. Neuhaus, and Kimberly A. Snowden*, SEC Litigation Release No. 20362 (November 13, 2007).