Testimony of Fred J. Joseph

Colorado Securities Commissioner and

President of the

North American Securities Administrators Association, Inc.

Before the

United States Senate Special Committee on Aging

"Betting on Death in the Life Settlement Market – What's at Stake for Seniors?"

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Introduction

Chairman Kohl, Ranking Member Martinez, and members of the Committee:

I'm Fred Joseph, Colorado Securities Commissioner and President of the North American Securities Administrators Association, Inc. (NASAA).[1] I am honored to be here today to discuss the impact that life settlements have on our citizens and the need for strong regulation of these financial products by the appropriate regulatory authorities. As a representative of our nation's state securities regulators, I will focus my testimony primarily on the regulation of life settlements as securities. At the outset, I would like to offer three general principles that I believe should guide legislators and regulators as they address the challenges arising from these products.

First, life settlements are complex financial arrangements, involving both securities and insurance transactions. Consequently, regulating them effectively requires a joint effort by securities and insurance regulators, each applying their laws and expertise to different aspects of the product.

Second, although life settlements may serve a useful purpose by enhancing the value and liquidity of life insurance policies, they also pose significant risks to policyholders and to investors. For example, thousands of investors, many of them senior citizens, have been victimized through fraud and abuse in the sale of viaticals and life settlements. Notwithstanding substantial successes by securities regulators in their

[1] The oldest international organization devoted to investor protection, the North American Securities Administrators Association, Inc., was organized in 1919. Its membership consists of the securities administrators in the 50 states, the District of Columbia, the U.S. Virgin Islands, Canada, Mexico and Puerto Rico. NASAA is the voice of securities agencies responsible for grass-roots investor protection and efficient capital formation.

enforcement actions, and higher standards among some industry participants, abuses continue and diligent oversight of these products remains necessary.

Finally, life settlements are constantly evolving in terms of their product design, the policyholders involved, and the types of investors to whom they are marketed. Accordingly, lawmakers and regulators must carefully monitor these developments and respond to new challenges by creatively applying their existing laws, and where necessary, adopting new laws and regulations. That is one reason why I applaud the Committee for convening this hearing today and focusing attention on this important issue.

Overview of State Securities Regulation

The securities administrators in your states are responsible for enforcing state securities laws. They license broker-dealers and investment advisers, register certain securities offerings, examine financial firms, and investigate cases of suspected investment fraud. When our members find violations, they file enforcement actions to enjoin illegal activity, recover restitution for victims, and deter future violations through fines and licensing sanctions. Our members also provide a variety of investor education programs to your constituents.

We are often called the "local cops on the securities beat," and I believe that is an accurate characterization. When new investment offerings appear, such as viaticals, our members are often the first to receive complaints from investors and the first to respond with investigations and enforcement actions.

Over the years, NASAA and its members have been extremely active in dealing with the problems associated with viatical and life settlement investments.[2] Our members have taken countless enforcement actions against viatical settlement providers selling unregistered investments and committing fraud and abuse against Main Street investors. Our members have also fought successfully for statutory amendments and regulations that expressly define viaticals as securities under state law, to remove any uncertainly about their legal status. NASAA itself has issued model viatical guidelines to promote strong and uniform regulation of these products. NASAA has filed numerous amicus briefs in state and SEC enforcement actions arguing that viaticals are securities and must be regulated as such for the benefit of investors. Every year, NASAA issues a review of the most prevalent investment frauds confronting our citizens, and we have included viaticals in many of those annual compilations.

More recently, in recognition of the need to protect policyholders as well as investors, NASAA has supported the efforts of state insurance commissioners to regulate the insurance aspects of viatical and life settlement transactions. We have expressed our views in an amicus brief defending the validity of Virginia's viatical settlement act, and in comments that the National Conference of Insurance Legislators (NCOIL) invited us to submit on their model viatical settlement act in the Fall of 2007.

The Nature of Viatical Settlements

Viatical settlements first emerged in the early 1990s in response to the AIDS crisis. They created opportunities for terminally ill patients to obtain needed funds by

[2] Under many state securities laws, "viaticals" have now been broadly defined to include all types of settlement, regardless of whether the policyholder is suffering from a terminal illness. Accordingly, the terms "viatical settlement" and "life settlement," although they have different historical origins, are largely used interchangeably, as in my testimony.

selling their life insurance death benefits for much more than the cash surrender value available from their insurance companies. As the market has expanded, viatical settlement providers have turned to new classes of viators, including the elderly and the chronically ill.

Traditionally, viatical settlements have involved two distinct transactions, each with their own legal character. In one, a viatical settlement provider pays the insured some portion of his or her life insurance death benefit, in exchange for an assignment or sale of the insurance policy to the provider. This is an insurance transaction, properly regulated under state insurance law. In the other transaction, the provider arranges for interests in the settled policies to be sold to investors, with the promise of returns to be paid upon the death of the insured. Those returns hinge on a combination of factors, including the difference between the discounted price paid for the policy and the death benefit ultimately received, the costs of maintaining the policy in force until the insured passes away, and the accuracy of the life expectancy determination made for the insured. This sale of interests in settled insurance policies for investment purposes is a securities transaction, properly regulated under state and federal securities law.

Abuse of Investors and the Remedies Available Under the Securities Laws

The offer and sale of investments in viatical settlements has been marked by a wide range of fraudulent practices aimed at investors. These abuses have been documented in scores of enforcement actions by securities regulators over the years, as well as scholarly articles profiling the viaticals industry. At one time, the industry was

characterized as "infected with scam artists, 'ponzi' schemes, and other fraudulent activities."[3]

Fraudulent practices targeting investors have been wide-ranging. In addition to Ponzi schemes, where no settled insurance policies are obtained, they include fraudulent life expectancy evaluations prepared by captive physicians; inadequate premium reserves that increase investor costs; and false promises of large profits with minimal risk.[4]

Viatical settlement providers have also perpetrated fraud by concealing material information about the risks and costs of the investments. For example, rates of return can vary significantly, depending upon the accuracy of life expectancy calculations. If viators do survive beyond their life expectancies, investors may be forced to pay premiums to avoid lapse of policies and loss of any recovery. Investors receive no payments whatsoever until viators pass away and claims for death benefits are properly filed and paid. An investor needing access to his or her funds has little recourse, since a secondary market for viatical investments contracts is virtually non-existent.[5]

There are other risk factors and fees associated with viaticals that may not be disclosed to investors. For example, policies may still be in their contestable periods, and term or group policies may be subject to subsequent contract changes.[6] The bankruptcy

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[3] Lisa M. Ray, *The Viatical Settlement Industry: Betting on People's Lives Is Certainly No Exacta*, 17 J. CONTEMP. HEALTH L. & POL'Y 321, 322 (2000).

[4] *See, e.g.,* Report and Recommendation of Magistrate Barry L. Garber, issued on November 10, 2004 ("Magistrate's Report"), in *SEC v. Mutual Benefits Corp.; see generally* Brief of NASAA as *Amicus Curiae* in Support of SEC, filed in *SEC v. Mutual Benefits Corp.,* No. 04-14850-C (11th Cir. filed Dec. 8, 2004), and cases and authorities cited therein.

[5] *See* Michael Cavendish, *Policing Terminal Illness: How Florida Regulates Viatical Settlement Contracts*, 74 FLA. B.J. 10, 14 (Feb. 2000).

[6] *See Eterna Benefits L.L.C. v. Hartford Life & Accident Insurance Co.*, 1998 WL 874296 *1 (N.D. Tex. Nov. 25, 1998).

of a viatical company can result in a total loss for investors.[7] The administrative fees charged in connection with these investments can be substantial. Finally, viatical companies and their principals have often concealed disciplinary histories replete with investor complaints, enforcement actions, and even criminal prosecutions.

In short, while viatical transactions have helped some people obtain funds needed for medical expenses and other purposes, those benefits have come at a high price for investors, many of whom have been senior citizens.[8]

To address these problems, state regulators and the SEC have fought strenuously to regulate viatical investments under the securities laws. By the mid-1990's, both state and federal securities regulators were asserting jurisdiction over viatical investments and taking enforcement actions against viatical promoters, principally on the ground that viaticals were investment contracts under the *Howey* test.[9] In *Howey*, the United States Supreme Court held that an investment offering is a security if it involves: (1) the investment of money, (2) in a common enterprise, (3) with the expectation of profits, (4) derived principally from the efforts of others. Viatical settlements clearly meet this test.

In 1996, however, the SEC suffered a major setback in the United States Court of Appeals for the D.C. Circuit.[10] In *Life Partners*, the court applied the *Howey* test in a highly technical fashion, and held that the viaticals at issue were not investment contracts because the promoter's key managerial efforts – the determination of life expectancy – happened to occur before money was accepted from investors. The D.C. Circuit also held that *after* investors parted with their money, the viatical promoter's tasks were only

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[7] Alexander D. Eremia, *Viatical Settlement and Accelerated Death Benefit Law: Helping Terminal, But Not Chronically Ill Patients*, 1 DEPAUL J. HEALTH CARE L. 773, 777 (1997).
[8] *See, e.g.,* Lawrence A. Frolik, *Insurance Fraud on the Elderly*, 37 TRIAL 48, 51-52 (June 2001).
[9] *SEC v. W. J. Howey Co.,* 328 U.S. 293 (1946).
[10] *SEC v. Life Partners, Inc.*, 87 F.3d 536 (D.C. Cir.), *rehearing denied*, 102 F.3d 587 (D.C. Cir. 1996).

“ministerial” in nature, and the profitability of the investment really hinged upon the mortality of the insureds.

Although the decision in *Life Partners* was quickly and widely criticized, it nevertheless had a chilling effect on the SEC’s enforcement of the federal securities laws against those offering viatical investments.[11] State securities regulators continued to assert jurisdiction over viaticals, and were largely successful. State appellate courts and administrative tribunals emphatically rejected the *Life Partners* decision as bad law and bad policy.[12] But states were often confronted with defenses based on the *Life Partners* decision, and while state courts generally declined to follow the federal court’s ruling, they occasionally ruled in favor of the defendants.[13] Even when enforcements actions were successful, state regulators found themselves having to devote significant litigation resources just to establish their jurisdiction.

In recent years, the *Life Partners* decision has been largely neutralized. At the federal level, the SEC eventually won a favorable decision from the United States Court of Appeals for the Eleventh Circuit in a major viatical case.[14] In *Mutual Benefits,* the SEC filed an action against a viatical promoter that had sold over $1 billion in viatical investments to 29,000 investors through a fraudulent marketing campaign. The defendant invoked the decision in *Life Partners* to challenge the SEC’s jurisdiction, but the Eleventh Circuit squarely rejected that challenge. Citing to the lack of a persuasive rationale underlying *Life Partners,* and to Supreme Court precedent requiring a flexible –

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[11] *See* JOSEPH C. LONG, 12 BLUE SKY LAW §§ 3:15, 3:16.1 (June 2004) (explaining that the decision was irrational and that it was quickly the subject of judicial and scholarly criticism).

[12] *See In re Beneficial Assistance,* File No. S-01297, 2003 WL 297791, at *3 (Wisc. Comm’r of Sec. Feb. 5, 2003) (Order of Prohibition and Revocation) (citing over 200 opinions, administrative decisions, and court cases from states across the country finding that viatical settlements are securities).

[13] *See Griffitts v. Life Partners, Inc.,* No. 10-01-00271-CV, 2004 WL 1178418 (following *Life Partners* and holding that viatical investments were not securities).

[14] *SEC v. Mutual Benefits Corp.,* 408 F.3d 737 (11th Cir. 2005).

not technical – application of the securities laws, the court held that Mutual Benefits' viatical investments "amount[ed] to a classic investment contract."

At the state level, many legislatures added viaticals to their statutory definition of a security to remove any doubt that these investments are subject to securities regulation.[15] Today, over half the states regulate viaticals and life settlements under explicit statutory provisions in their securities laws, and nearly all the remaining states apply the investment contract test.

Regulation of viatical investments as securities is regarded as an effective way to help "alleviate many of the problems inherent in the viatical settlement industry."[16] Promoters must register their securities so that material information about an offering reaches prospective investors before they part with their money. Those who sell securities must submit to testing, licensing, and background checks to help ensure they have the knowledge and fitness to accept investor funds and render investment advice. The securities laws impose stiff civil and criminal penalties as a deterrent against violations of the licensing, registration, and anti-fraud provisions. Finally, the securities laws give regulators the authority to seek important remedial measures, including injunctions, disgorgement, and restitution. All of these provisions play an important role in limiting the harm that viatical settlement investments can inflict upon the investing public.[17]

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[15] *See* Brief of NASAA as *Amicus Curiae,* filed in *California v. Innovative Financial Services, Inc.,* No. D045555 (Cal. Ct. App. filed Sept. 6, 2005), at 28-29.

[16] Dave Luxenberg, *Why Viatical Settlements Constitute Investment Contracts Within the Meaning of the 1933 & 1934 Securities Acts*, 34 WILLAMETTE L. REV. 357, 386 (Spring 1998); s*ee also* Timothy P. Davis, *Should Viatical Settlements Be Considered "Securities" Under the 1933 Securities Act?*, 6 KAN. J. L. & PUB. POL'Y 75 (Winter 1997).

[17] All of these licensing, registration, and antifraud standards are found in both the federal and state securities laws. *See generally* the Securities Exchange Act of 1934, the Securities Act of 1933, and the Uniform Securities Act of 1956, which is the predominant model for state securities laws.

Using these regulatory and enforcement tools, state securities regulators and the SEC have significantly reduced the incidence of fraud in the marketing of viaticals and life settlements. Nevertheless, state securities regulators continue to see significant evidence of the "scam artists" that once characterized the entire industry. Our members still file enforcement cases and continue to litigate the legal status of viaticals as securities. For example, in May of 2007, my office in Colorado filed an enforcement action against Life Partners and its affiliates and agents. We alleged that from 2004 to 2007, the defendants sold unregistered viatical settlement investments to at least 110 Colorado investors, netting over $11 million. We also alleged that the Life Partners sales agents were unregistered and that they marketed the investments using fraudulent misrepresentations and omissions about the risks, costs, and returns associated with viaticals. In December 2008, the court held that the offerings were unregistered securities marketed through unlicensed agents. Life Partners subsequently stipulated to a permanent injunction and agreed to make a rescission offer to all Colorado investors.[18]

Earlier this month, my colleague at the Texas State Securities Board issued an Emergency Cease and Desist Order against The Stamford Group and its affiliates and principals, who were selling interests in portfolios of senior life settlement policies. The Texas Board found that the investments were unregistered securities and that the respondents were not properly licensed to sell them. The Board also found that the respondents were making numerous misrepresentations and omissions in the sale of the

[18] *See Joseph v. Life Partners, Inc.*, No. 07CV5218 (Denver D. Ct. Dec. 2, 2008).

investments, including bold claims of guaranteed returns and omissions regarding the principals' complaint history.[19]

On March 20th of this year, the Securities Bureau of the Idaho Department of Finance filed a complaint against another group of entities and individuals who bilked 40 Idaho investors out of $6 million by selling them unregistered securities in the form of a "life settlement purchase" program. The Complaint alleges that the defendants promised returns of 10% per month, but never in fact purchased any insurance policies and instead diverted the investors' funds offshore. Idaho seeks injunctive relief, restitution, and substantial civil penalties.[20] Thus, unscrupulous elements in the viaticals industry continue to target our investors, and state securities regulators continue their fight against fraud and abuse.

Emerging Trends

The viatical settlement industry has changed significantly since its early days, and it continues to evolve in terms of the viators, investors, and industry participants involved. For example, the class of viators has been expanded with the advent of so-called "stranger originated life insurance," or "STOLI." This mechanism involves the purchase of life insurance coverage with the intention of settling it, thereby creating investment opportunities for third parties. STOLI raises fundamental issues of insurance law and policy, and it has generated controversy among insurance regulators and insurance companies. It is relevant to NASAA and its members insofar as STOLI

[19] *See In the Matter of the Stamford Group, Inc.,* No. ENF.-09-CDO-1671 (Tex. State Secs. Bd. Apr. 2, 2009).
[20] *See State of Idaho, Dept. of Fin., Secs. Bur. v. Potter*, CV OC 0905488 (D. Ct. 4th Jud. Dist. Mar. 20, 2009).

transactions will affect the universe of life insurance policies that are available for securitization—a process overseen by securities regulators.

Another significant trend is the increased role of institutional investors in the life settlement market. Along with this development is a desire among some industry participants to raise standards of conduct, promote sound regulation, and develop a legitimate industry sector untainted by past abuses. Lawmakers and regulators must follow all of these trends, and must be prepared not only to acknowledge improvements in the industry but also to address any new threats to viators and investors. I look forward to the findings of the Committee in this important area of financial services regulation, and I thank you again for the opportunity to share my views.