

APPLICATION OF THE FEDERAL SECURITIES LAWS TO THE ISSUANCE OF SECURITIES BY INSURANCE COMPANIES

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This article summarizes the application of the Securities Act of 1933¹ (the “Act”) to the issuance of securities by insurance companies.²

Attorneys who concentrate their practices in the regulation of insurance companies often overlook the fact that insurance companies that issue securities are regulated by the Securities and Exchange Commission (the “SEC”) and state securities commissioners in addition to state insurance commissioners.³

The kind of securities most often issued by stock insurance companies include common stocks, preferred stocks, surplus notes⁴, variable annuities⁵, index annuities⁶, variable life insurance products⁷, and guaranteed investment contracts⁸. While mutual insurance companies do not issue common or preferred stocks, they may issue surplus notes, variable annuities, index annuities, variable life insurance products, and guaranteed investment contracts. Variable annuities and variable life insurance products are hybrid insurance and securities products, and are subject to dual regulation as insurance and securities.

Section 5 of the Act prohibits persons⁹ from selling or delivering a security¹⁰ by any means of transportation or communication in interstate commerce or by use of the mails unless the security is (i) registered with the SEC, or (ii) is an exempt security under Section 3 of the Act, or (iii) is sold or delivered in an exempt transaction under Section 4 of the Act,¹¹ or (iii) is exempted from registration by Rule 701 under the Act.¹²

If an issuer sells or delivers a non-exempt security in a non-exempt transaction in interstate commerce or by the use of the mails without first registering the security with the SEC, Section 12(a) (1) of the Act gives the purchaser the right to sue the seller “... either at law or in equity in any court of competent jurisdiction to recover the consideration paid for such security plus interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security”. Section 13 of the Act provides that a suit to enforce a liability created under Section 12(a) (1) of the Act must be brought within one year after the violation occurs. Section 14 of the Act provides that, “Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this title or of the rules and regulations of the Commission shall be void.” Consequently, an issuer that violates Section 5 of the Act by issuing unregistered, non-exempt securities in non-exempt transactions in interstate commerce or by use of the mails should post a contingent liability on its balance sheet until the statute of limitations expires.

The Act does not provide a blanket exemption from registration for securities issued by insurance companies other than securities that represent ownership interests in risk retention groups.¹³ Therefore, securities issued by insurance companies must be registered under the Act unless an exemption from registration is available.

Exempted Securities

Section 3 exempts the following securities that might be issued by insurance companies from the other provisions of the Act, except for Section 17 of the Act which prohibits fraudulent interstate transactions.¹⁴

- Subsection (a)(3) exempts any note which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof.¹⁵
- Subsection (a)(8) exempts any insurance or endowment policy or annuity contract or optional annuity contract¹⁶ issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia.¹⁷

- Subsection (a) (9) exempts any security exchanged by an issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting the exchange.¹⁸
- Subsection (a) (10) exempts any security issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in exchange and partly for cash, where the terms and conditions of the issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all parties to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or any government official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.¹⁹
- Subsection (a)(11) exempts any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or if a corporation, incorporated by and doing business within such State or Territory.²⁰

Section 3(b) of the Act gives the SEC the authority to adopt rules and regulations that exempt offerings of securities from registration where the aggregate amount offered does not exceed \$5,000,000.²¹

Exempted Transactions

Section 4 of the Act exempts the following transactions in securities from the registration requirements of Section 5 of the Securities Act.

- Subsection (2) exempts transactions by an issuer not involving any public offering.²²
- Subsection (6) exempts transactions involving offers or sales by an issuer solely to one or more accredited investors, if the aggregate offering price of the securities does not exceed \$5,000,000, if there is no advertising or public solicitation in connection with the transaction by the issuer or anyone acting on the issuer's behalf, and if the issuer files such notice with the SEC as the SEC shall prescribe.

In *SEC v. Ralston Purina Co.*,^{346 U.S. 119 (1963)}, the Supreme Court said for a private offering to occur it must be made to offerees who are able to fend for themselves and have access to the same kind of information that registration would disclose. The court also said there is no requirement that the private offering be limited to a small number of the public, but the larger the number of purchasers, the greater likelihood that an offer may be made to an unqualified person.

Regulation D

To provide more certainty to the availability of an exemption under Section 4(2) of the Act, the SEC adopted Regulation D consisting of Rules 201 through 208 [17 C.F.R. 230-501 -230-508].

- Rule 501 sets forth the definitions and terms used in Regulation D, including the term “accredited investor” which is defined as meaning, among other things, a bank, an insurance company, certain employee benefit plans, the directors and executive officers of the issuer, a business entity with total assets in excess of \$5,000,000, and an individual with net worth in excess of \$1,000,000 or income is excess of \$200,000 in each of the two most recent years or joint income with that person's spouse in excess of \$300,000 in each of those years and has a reasonable expectation of reaching the same income level in the current year.
- Rule 502 sets forth the general conditions which must be met by issuers effecting offerings under Regulation D. The general conditions include rules relating to the integration of offerings, the type of information that must be furnished to nonaccredited investors, the prohibition of the use of any

form of general solicitation or general advertising, and the requirement that the securities sold in an offering are deemed to be “restricted securities” that are prohibited from resale unless registered under the Act or an exemption from registration is available.²³

- Rule 503 provides that the issuer must file a Notice on Form D with the SEC within 15 days after the first sale of a security made in reliance on Regulation D.²⁴
- Rule 504 permits sales of securities by certain issuers not exceeding \$1,000,000.
- Rule 505 permits sales of securities to any number of accredited investors and up to 35 nonaccredited investors not exceeding \$5,000,000.^{25 26}
- Rule 506 permits sales of securities in any amount to any number of accredited investors and up to 35 sophisticated²⁷ nonaccredited investors.²⁸

Under Section 18 (b) (4) (D) of the Act, securities issued in compliance with Rule 506 are exempt under state law. Securities issued in compliance with Rules 504 and 505 are not exempt under state law. Therefore, issuers making offerings in compliance with Rules 504 and 505 must comply with the registration requirements of state law unless state law provides an exemption from registration. Because Rule 506 offerings are exempt from state law, most securities lawyers tailor private offerings to comply with Rule 506 even though the amount of the securities offered is less than the amounts permitted under Rules 504 and 505.

Integration

Rule 502(a) of Regulation D provides that all sales that are part of the same offering under Rule 504, 505 or 506, must meet all of the requirements of that rule. However, offers and sales made more than six months apart will not be considered to be part of the same offering. Offerings made under Regulation D that are less than six months apart may not be integrated if they (i) are not part of a single plan of financing, (ii) do not involve the same class of securities, (iii) have not been made at or about the same time, (iv) are not sold for the same type of consideration, and (v) are not made for the same general purpose. The integration doctrine is also applicable to other offerings exempted from registration under Sections 3 and 4, unless safe harbors are available or the above tests are satisfied.

Available Exemptions

- Depending on the nature of the transaction, an insurer would usually rely on Section 4(2) and Regulation D, or Sections 3(a) (9), (10), or (11) of the Act to exempt the issuance of common and preferred stocks from registration.
- An insurer would usually rely on Section 4(2) and Regulation D to exempt the issuance of guaranteed investment contracts and surplus notes from registration.
- Insurance policies and annuity contracts are exempt from registration under Section 3(a) (8) of the Act, but variable insurance products which are mass marketed would have to be registered under the Act.

Summary

Registration of securities under the Act is expensive and time consuming and will result in the issuer having to file periodic reports with the SEC after the registration statement becomes effective.²⁹ Therefore, issuers should try to structure transactions involving the issuance of securities to take advantage of the available exemptions.

Endnotes

¹ 15 U.S.C.S. 77a *et seq.*

² Section 2(a) (13) of the Act provides, “The term ‘insurance company’ means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner, or a similar official or agency or any liquidating agent for such company, in his capacity as such.”

³ Every state has securities laws that require securities issued in that state to be registered unless an exemption from registration is available under that state’s laws.

⁴ Surplus notes are sometimes called surplus debentures or contribution certificates. A surplus note is a promissory note that can only be paid out of surplus in excess of an amount stipulated in the note. They can only be issued with the consent of the domiciliary insurance commissioner and principal and interest can only be paid with the consent of the domiciliary insurance commissioner. Surplus notes are recorded as surplus because they are subordinate to the issuer’s other liabilities.

⁵ A variable annuity is an annuity the value of which is determined by the market value of the portfolio of stocks in which the insurer invests the premiums.

⁶ Index annuities are designed to mirror the performance of an index of securities, such as the S&P 500, and the Russell 5,000.

⁷ Variable life insurance is permanent life insurance in which the cash value component is invested in specified baskets of securities.

⁸ A guaranteed investment contract is an investment sold by insurance companies that guarantees repayment of principal and a fixed or floating interest rate for a predetermined period of time.

⁹ Section 2(a)(2) of the Act defines “person” to include corporations.

¹⁰ Section 2(a)(1) of the Act provides, “The term ‘security’ means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option or any privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation therein, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

¹¹ This article does not address the rules governing offers and sales of securities made outside the United States.

¹² Rule 701 under the Act exempts, subject to certain limitations, the issuance of securities as compensation to employees, directors, exclusive agents, consultants and advisors by issuers that are not required to file periodic reports with the SEC.

¹³ Section 3904 of the Liability Risk Retention Act of 1986 [15 USCS 3904].

¹⁴ Section 17 of the Act makes it unlawful for any person in the offer or sale of securities in interstate commerce or by use of the mail to employ any device, scheme, or artifice to defraud, or to obtain money or other property by means of any untrue statement of a material fact or any omission of a material fact, or to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon the purchaser. Subsection (c) of Section 17 provides, “The exemption provided in Section 3 shall not apply to the provisions of this section.”

¹⁵ In *Reeves v. Ernest & Young*, 494 U.S. 56, the court held that the phrase “any note” must not be interpreted literally, but must be understood in the context of what the Act was trying to accomplish. The court listed the following notes as not being deemed to be securities: notes delivered in consumer financing transactions, notes secured by a mortgage on a home, short-term notes secured by a lien on a small business or some of its assets, notes evidencing a “character” loan to a bank customer, short-term notes secured by an assignment of accounts receivable, notes that simply formalize an open-account debt incurred in the ordinary course of business, and notes evidencing loans by commercial banks for current operations.

¹⁶ Rule 151 [17 C.F.R. 230.151] under the Act sets forth the requirements for annuity contracts or optional annuity contracts to be exempted as securities under Section 3(a) (8) of the Act. Variable annuities are not exempt securities because their value is determined by the value of the underlying portfolio of stocks.

¹⁷ Issuers of guaranteed investment contracts sometimes incorporate optional annuity provisions in the contracts to take advantage of this exemption.

¹⁸ Rule 149 [17 C.F.R. 230.149] under the Act provides, "The term 'exchanged' in section 3(a)(9) of the Act shall be deemed to include the issuance of a security in consideration of the surrender, by the existing security holders of the issuer, of outstanding securities of the issuer, notwithstanding the fact the surrender of the outstanding securities may be required by the terms of the plan of exchange to be accompanied by such payment in cash by the security holder as may be necessary to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange."

¹⁹Section 3(a) (10) will exempt securities issued by an insurance company in a merger if the approving insurance commissioner is authorized by law to rule on the fairness of the exchange. However, the Model Insurance Holding Company Systems Act adopted by the National Association of Insurance Commissioners and by most if not all states, does not give insurance commissioners authority to approve the fairness of the exchange.

²⁰ Rule 147 [17 C.F.R. 230.147] under the Act provides a safe harbor for persons relying on Section 3(a) (11).

²¹ Regulation A [17 C.F.R. 230.251-230.263] exempts public offerings not exceeding \$5,000,000 in any 12 month period. To take advantage of this exemption, the issuer must file an offering statement with the SEC. Rules 504 and 505 of Regulation D [17 C.F.R. 230-501-508] are also based on the SEC's authority to promulgate rules and regulations under Section 3(b).

²² Rule 152 [17C.F.R. 230.152] provides, "The phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement."

²³ Rule 144 [17 C.F.R. 230.144] under the Act provides an exemption for the resale of restricted securities or control securities. Control securities are securities, however acquired, that are owned by an affiliate of the issuer of the securities. If certain conditions are met, after one year the holder of restricted or control securities can resell a limited amount of such securities during any three month period. Under Rule 144(k) after two years the holder can resell restricted securities, but not control securities, without complying with the other requirements of the Rule, but only if the holder is not then, and for the prior three months has not been, an affiliate of the issuer.

²⁴State Blue Sky Laws also require that a Form D be filed, and filing fee paid, in each state within 15 days after the first sale of a security in the state made pursuant to Rule 506.

²⁵Rules 504 and 505 were adopted by the SEC pursuant to its rule making authority under Section 3(b) of the Act.

²⁶Rule 507 [17 C.F.R. 230.07] provides that the exemptions under Rules 504, 505, and 506 are not available for an issuer if the issuer or any of its predecessors or affiliates have been subject to any order, judgment, or decree of any court of competent jurisdiction temporarily, preliminary or permanently enjoining such person for failure to comply with notice filing required by Rule 503.

²⁷A sophisticated nonaccredited investor is an investor that is not an accredited investor, but who, either alone or with a purchaser representative, has such knowledge in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment.

²⁸Rule 506 was adopted under Section 4(2) of the Act.

²⁹ Rules 15d-1, 15d-11 and 15d-13 under the Securities and Exchange Act of 1934 [15 U.S.C.78 a et seq.] require issuers that register securities with the SEC to file annual reports, quarterly reports and current reports with the SEC.