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Not Quite The Time Yet For Life Settlement Funds to Follow The Crowd

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In April 2012, Locke Lord published "CrowdFunding – Who in their Right Mind Would....."At that time, we were all impatiently awaiting proposed regulations from the Securities and Exchange Commission (the "SEC") that would flesh-out the requirements for CrowdFunding equity and debt offerings that would be exempt from the registration requirements of Section 5 of the Securities Act of 1933 (the "Securities Act"). However, we are still waiting. No proposed regulations have been published, but that may change soon now that a new chairman of the SEC has been sworn into office.

One prominent lawyer, formally with the SEC and now in private practice in Washington, DC, recently wrote, "But the devil is in the details, and those details have doomed equity crowdfunding in my view." He went on to say, pointedly, "The intermediary requirement to use a registered broker-dealer or 'funding portal' is a kiss of death."

A Quick Review

CrowdFunding is a new exemption from the registration requirements for securities in Section 5 of the Securities Act. The exemption, newly created Section 4(a)(6) of the Securities Act, was created in Title III of the JOBS Act which was signed into law in April 2012. The exemption permits a United States issuer to sell up to $1 million in securities each year without registration under the Securities Act, subject to the requirements and limitations summarized below. The exemption will be effective after the SEC publishes its final regulations, and they become effective.

- No investor may invest more than $100,000 per year in all (not just any) CrowdFunding transactions and, depending on an individual's net worth, that limit may be lower.
- The issuer must use an SEC registered broker-dealer or an SEC registered funding portal (which must also be a FINRA member) (a "B-D/Portal"); *i.e.*, the issuer may not raise the funds with its own personnel.
- Both the issuer and the B-D/Portal have separate, specific disclosure requirements to potential investors, and the disclosure documents, which include financial statements (in some cases audited) or tax returns of the issuer, must be filed with the SEC.
- The issuer must set an announced funding target, and any funds raised must be held by a third party (not the B-D/Portal) in escrow to be released to the issuer only after the target is achieved. Investors have certain limited rescission rights, and the issuer has an obligation periodically to inform investors during the offering process about how close the issuer is to achieving the funding target.
- The B-D/Portal disclosure obligations to potential investors include general "investor education information." In addition, the B-D/Portal must conduct its own background checks on each officer, director and 20% or more owner of the issuer.
- Certain so called "bad-boy" acts will disqualify an issuer from a CrowdFunding offering.

- The issuer must file annual financial statements with the SEC and furnish those financial statements to its investors. Whether those annual financial reports must be audited has yet to be determined by the SEC.

A CrowdFunding program that complies with the federal requirements would be exempt from the application of state security registration laws as a 'covered security' under Section 18(b)(4)(C) of the Securities Act.

The Life Settlement Industry – Life Settlement Funds and Fractionalized Interests

(in the death benefits payable under a non-variable, in-force life insurance policy).

Life Settlement Funds Formed in the United States

Most, if not all, life settlement funds formed in the United States are a form of closed-end hedge fund in which the investors, for example, become limited partners in a partnership or members of a limited liability company that invests in a pool of non-variable, in-force life insurance policies. Traditionally, sales to investors in the United States have been through representatives of the issuer and registered FINRA broker/dealer/sales representatives. These offerings have been conducted as offerings not required to be registered under Section 5 of the Securities Act pursuant to the safe harbor registration exemption provided under Rule 506 of Regulation D adopted by the SEC and sold only to accredited (high net worth) investors as that term is defined in Rule 501 of Regulation D. The issuer under a Rule 506 offering is not limited to a cap of $1 million or otherwise for the offering, and investors in the Rule 506 offering are not limited as to the amount they may invest. The issuer relying on the Rule 506 registration exemption is not required to file anything with the SEC (other than a Form D for informational purposes post-sale),and the issuer is not required by the SEC to furnish annual financial statements to investors post sale. During the Rule 506 offering, the issuer is not required to set a minimum targeted raise amount, nor is there any escrow requirement, nor do the Rule 506 offering investors have statutory rescission rights under Rule 506 or Regulation D. Any broker-dealer involved in the Rule 506 offering is not required to furnish materials to investors (as long as the issuer furnishes offering documents that include risk factors), nor does the broker-dealer have an obligation to file materials with the SEC (although in certain circumstances there may be a requirement that the broker-dealer file some offering documents for informational purposes with FINRA).

Most certainly, the CrowdFunding shoe does not readily fit a life settlement fund offering in the United States. As a practical matter, any such offerings should be conducted under Rule 506 of Regulation D with accredited, high net worth investors only.

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Fractionalized Interests in Life Insurance Policies and Death Benefits

In these transactions, an issuer buys an in-force life insurance policy and then fractionalizes the death benefits by sales to investors of the right to receive a portion of the death benefit paid under the life insurance policy when it 'matures.' Typically, although not always the case, the investors are not accredited investors as defined under Rule 501, and the sales force is frequently comprised of licensed life insurance agents, not licensed FINRA licensed sales representatives associated with an SEC registered broker-dealer. There is an initial question of whether a fractionalized program involves a security as that term is defined under the Securities Act. The only two federal Circuit Courts of Appeal that have examined the question are split (virtually all federal District Courts that have examined the issue, including those applying state law, have concluded that pooled or fractionalized life insurance policies and/or death benefits are securities for state and federal security law purposes), so let's assume for the purposes of this brief note that the most recent case from the Eleventh Circuit represents the majority view and that the fractionalized life insurance policy/death benefit program does involve the sale of a security as defined under the Securities Act. That means that the investment interests issued in connection with a fractionalized program would most likely be required to be registered under Section 5 of the Securities Act, but for the application of the intrastate offering exemption from registration provided in Section 3(a)(11) of the Securities Act and Rule 147 issued by the SEC as a Section 3(a)(11) safe harbor for sales by a company organized, operating and whose assets are primarily in a single state and with respect to which

all of the investors in the offering are residents of that state. In some limited instances, fractionalized death benefit interest programs have been offered in exempt Rule 506 offerings. The Rule 147 Securities Act registration exemption, unlike the exemption provided by Rule 506 under Regulation D, does not preempt state security registration laws, and many or most state laws require state registration of these programs. There are exceptions, however. Case law in Texas, at least for now, is that sales of these fractionalized interests are not securities under Texas Blue Sky laws, but you will receive a different answer if you put that question to the Texas State Securities Board. Florida would not require registration for this program if all of the purchasers are accredited investors as defined under Rule 501, and California has its own registration exemption under what is known as the "Q" exemption.

So here's the potential opportunity. If an issuer of fractionalized life insurance policy death benefits was willing to grow its investor base at only $1 million per year (or add that to its existing base), and assuming the issuer is willing to provide annual audited financials to its investors and the SEC, to offer its program only through an SEC registered B-D/Portal and to forego advertising and general solicitation, it could establish a nationwide CrowdFunding program which would not be required to be registered under either federal or state securities laws.

Another potential opportunity might be for a company to create a series limited liability company, for example, where each series within the LLC would fractionalize the death benefit payable under just a single life insurance policy such that the offering proceeds for each series within the LLC would not exceed $1 million on the assumption that the fractionalization program for each policy represents a different security for purposes of the CrowdFunding $1 million per year security offering limitation. Such a structure would not be immune to legal challenge (possibly under an integration theory), and in any event, might involve unmanageable administrative burdens and costs.

Of course, neither approach would be a risk free proposition; for example, the CrowdFunding exemption does provide investors with certain rescission rights and civil remedies under the Securities Act which are not present in a properly constructed Rule 506 offering, and, in any event, just as there is with respect to a Rule 506 offering, for example, there is exposure in a CrowdFunding transaction to civil liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 issued by the SEC. However, as mentioned, there is exposure to that liability now associated with any public or private securities offering of fractionalized life settlement interests (assuming the fractionalized interests in the death benefits payable under in-force, non-variable life insurance policies are federal securities).

For now, we don't have all the answers, only issues to be clarified by the SEC; the SEC has not published its CrowdFunding regulations, and no CrowdFunding program that raises equity/investment capital is permitted yet under federal law. Some states, like Georgia, have already passed their own crowdfunding statutes, but we recommend waiting for the SEC's guidance before joining the crowd. When that guidance arrives, and we expect it shortly, we are well-prepared to design and implement a successful CrowdFunding strategy for our life settlement issuers and crowdfunding portal clients.

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