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STATE SECURITIES ACTS COMPLIANCE ISSUES FOR TERTIARY MARKET LIFE SETTLEMENT POLICY TRADERS

In this article, the authors begin by describing how life settlement transactions work for life settlement providers and investors. They then examine whether non-fractionalized life settlement investments are securities under the Supreme Court's four-part Howey test for investment contracts, and the circuit court decisions applying the test to these investments. They close with application of state blue sky laws to resales of life settlement policy investments.

By Brian T. Casey and Ryan J. Last *

The secondary market continues to grow for investments in in-force life insurance policies as an alternative asset with low correlation to market changes in valuations and investment returns in stocks, bonds, and other traditional financial products. Once an investor has acquired an in-force life insurance policy in the secondary market following a regulated transaction through a state licensed life settlement provider, the policy may later be sold by that investor in a resale transaction, either alone or as part of a portfolio of similar policies, to another investor in what the life settlements investment industry calls the tertiary market. The tertiary market for non-fractionalized life insurance policies that are not variable life insurance policies is largely unregulated.[1] Under federal securities laws, tertiary market trades of the entire ownership and beneficiary rights of a non-variable (i.e., fixed) life insurance policy generally are not a securities transaction. However, some state blue sky securities laws treat these transactions as the offer and sale of a new security, making the seller subject to securities fraud risk and requiring it to rely upon an exemption from registration at the state level.

HOW LIFE SETTLEMENT TRANSACTIONS WORK

A life settlement, or secondary market life insurance transaction, is a fairly straightforward transaction: the

[1] Variable life insurance policies are securities because the policyholder bears the investment risk of the assets in which the policy's premiums, after deductions for mortality and

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administration expenses, are invested, which affects the amount of the policy's death benefit.

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sale by an original owner of a life insurance policy for a cash amount more than the policy's cash surrender value but less than its death benefit. These transactions are now regulated in about 46 states through life settlement acts (sometimes called viatical settlement acts) contained in state insurance codes and founded upon two model life settlement acts designed for consumer protection.[2] Buyers of life insurance policies from original policyholders, known as life settlement providers, are licensed, and their transaction documents are filed with, and approved by, state insurance departments.

Most life settlement providers do not buy life insurance policies for their own accounts; rather, they have investor clients that fund the life settlement purchase and immediately purchase policies from life settlement providers upon the closing of the state insurance law regulated life settlement transaction. Thereafter, investors may sell or buy life settlement policies in transactions with other investors in the largely unregulated tertiary trading market as part of their portfolio management.

LIFE SETTLEMENTS INVESTORS

The majority of investors in life settlement policies are institutional in nature, being private investment funds or some form of financial institution. Most of these private investment funds are not regulated as investment companies under the Investment Company Act of 1940 because their business does not involve the buying and selling of securities in any significant way, as they limit their investments to non-fractionalized, non-variable policies. In addition, some fund managers are registered investment advisers under the Investment Advisers Act of 1940.

Another, smaller segment of investors in life settlement policies are "fractionalizers" that purchase life settlement policies either directly from life settlement providers or in the tertiary market, and then sell fractional interests in the death benefit of a life settlement policy, either directly or through trust interests, to individual or retail investors, who typically, but not always, are accredited investors under the federal securities laws. These transactions have drawn the attention of federal and state securities regulators over the years and spurred the expansion of the statutory definition of a security under many state blue sky laws to include life settlement investments.

BACKGROUND ON CLASSIFICATION OF LIFE SETTLEMENT INVESTMENTS AS SECURITIES

The Federal Securities Act

The federal Securities Act of 1933 (the "Securities Act") provides that a security, "means any note, stock, treasury stock, security future, security-based swap, 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 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 in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."[3]

The Life Insurance Exception

Importantly, the long list of the types of investments contained in the definition of a "security" in the Securities Act does not include "insurance policies" or "life insurance policies."[4] The Securities Act also

[2] National Association of Insurance Commissioners (NAIC), Viatical Settlements Model Act (readopted in July 2009); National Conferment of Insurance Legislators (NCOIL), Life Settlements Model Act (readopted in March 2014).

[3] 15 U.S. Code Section 77b.

[4] *Id*.

provides that it does not apply to "[a]ny insurance or endowment policy or annuity contract or optional annuity contract, 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."[5] However, the U.S. Supreme Court has found that some insurance-related products that are marketed and called insurance policies, are not, in fact, exempted insurance policies for purposes of the Securities Act, but are rather investment contracts under the Securities Act.[6] In particular, the Court has determined that life insurance policies where a policyholder is not promised a fixed return (death-benefit amount or cash surrender value), thereby not requiring the company that issues the policy to bear a significant investment risk when issuing the policy, such as variable annuities, should be treated as investment contracts instead of insurance policies exempt from the application of the Securities Act.[7] Similarly, the Court found that when a company issues a life insurance policy or annuity but the insurer does not offer a fixed crediting rate and instead "promises to serve as an investment agency and allow the policyholder to share in its investment experience," the insurance-related product should be treated as an investment contract under the Securities Act instead of an exempted insurance policy.[8]

The Court's in-depth analysis and discussion separates new types of life insurance and annuity products that contain variable payments to policyholders and involve investment risks borne by the policyholder from the definition of traditional insurance policies.[9] This supports the conclusion that while traditional (fixed) life insurance policies or annuities are not securities and, therefore, are not subject to the securities laws, variable life insurance policies and annuities are likely to be determined to be securities for purposes of the federal securities laws.

Investment Contracts

In addition to considering case law and the SEC's positions with respect to the specific life insurance policy exception under the securities laws, we must also consider whether the offer and sale of a life insurance policy in a secondary or tertiary transaction is considered to be an "investment contract" under the four-part test the U.S. Supreme Court sets forth in *SEC v. W.J. Howey Co.*[10] The Court in *Howey* held that an investment contract is a security under the Securities Act if the investors: (1) invest money, (2) in a common enterprise, (3) with the expectation of profits, which (4) depends on the efforts of others.[11]

In *SEC v. Life Partners, Inc.*, the District of Columbia Circuit Court of Appeals held that even though viatical settlements are not life insurance contracts, they are not securities under the Securities Act because they fail to meet the test set forth in *Howey*.[12] In applying the *Howey* test, the court found that by bringing multiple investors together to purchase life insurance contracts, the fund satisfied the first and third prongs of the *Howey* test requiring an investment of money and a common enterprise. The court further found that these viatical settlements involved the purchase of a life insurance policy at a lower price than its death-benefit payment and that the purchaser expected to make a profit by doing so, satisfying the second prong of the *Howey* test. However, the court held that the life settlement interests did not meet the final prong of the *Howey* test because the profits were not generated entirely by the effort of others. The court found that the profits were generated passively by an insured dying, and that any efforts by the company prior to the creation of the investment or clerically done after the creation of the investment contract were not relevant in determining how the profits were generated because the efforts before creation and clerical efforts were represented in the initial price of the investment and did not affect the value of the investment contract once it was created. In essence, eventually the insured will pass away, potentially making the investment profitable, but not requiring the efforts of the promoter, Life Partners.

In *SEC v. Mutual Benefit Corp.*, however, the Eleventh Circuit Court of Appeals found that an investment in a fractionalized viatical settlement was an investment contract that met all four prongs of the

[5] 15 U.S.C. § 77c(a)(8).

[6] *SEC v. United Benefit Life Insurance Company* (UBLIC), 387 U.S. 202 (1967) (holding certain accumulation provisions in a "Flexible Fund" insurance-related product made it an investment contract under the Securities Act); *SEC v. Variable Annuity Life Insurance Co.* (VALIC), 359 U.S. 65 (1959) (holding variable annuities are investment contracts under the Securities Act).

[7] *VALIC*, 359 U.S. at 65.

[8] *UBLIC*, 387 U.S. at 202.

[9] *VALIC*, 359 U.S. 202; *UBLIC*, 387 U.S. 65.

[10] 328 U.S. 293 (1946).

[11] *Id*. at 298-99.

[12] 87 F.3d 536 (U.S. App. D.C. 1996).

Howey test under the Securities Act.[13] The court said, "[w]hile 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. Significant pre-purchase managerial activities undertaken to ensure he success of the investment may also satisfy *Howey*."[14] Applying this rationale, the court looked at the significant work by the promotor/issuer that went into its choosing the life insurance policies to purchase, evaluating the medical status of the insured after the policy was purchased, paying the premiums required to keep the policy in-force, and managing escrow funds held for future premium payments.

In 2019, the U.S. Court of Appeals for the Fifth Circuit addressed the *Life Partners* and *Mutual Benefit* cases in the *Matter of Living Benefits Asset Management, LLC*.[15] In *Living Benefits*, the court considered whether an origination contract under which Living Benefits, a licensed life settlement provider, would provide advice to its clients on the acquisition and ownership of non-variable, non-fractionalized, life insurance policies and in certain instances source and assist in purchasing such policies on behalf of its client. The court considered whether such non-fractionalized life settlements met the definition of an investment contract under the *Howey* test, and determined that "there is a distinction between fractionalized and non-fractionalized life settlements, but it is not one that changes" the outcome of the *Living Benefits* case.[16] Because the court viewed the life settlement transaction as a security under *Howey*, Living Benefits was determined to be advising on securities and thus required to register as an investment adviser under the Investment Advisers Act of 1940. Because Living Benefits was not so registered, its customer was allowed to void the origination agreement because the Investment Advisers Act of 1940 enables a customer that contracts with an investment adviser that is required to be, but is not, registered as such with the SEC to void such a contract.[17]

The Fifth Circuit noted the investments in life settlement transactions met the first two prongs of the *Howey* test (i.e., an investment of money with an expectation of profits). The court also determined that the "efforts of others" prong had been met as the purchaser was dependent upon the promoter for significant actuarial analysis with respect to whether to purchase the life settlement. The *Living Benefits* court instead focused on the second prong of the *Howey* test (i.e., the "common enterprise" prong). The defendant argued that because there was only a single plaintiff receiving advice with respect to life settlements, there could not be any "common enterprise."[18] However, the court held that the fact that a transaction involved a single investor did not prevent a transaction from involving an investment contract. In addition, the court noted that while *Life Partners* contemplated some difference between fractionalized life settlements and non-fractionalized life settlements, the Fifth Circuit did not address this point, as it was not relevant to the vertical commonality element at issue. Ultimately, the court found that the single investor client was advised on securities transactions even though the origination contract was between Living Benefits and a single purchaser, and the purchaser was advised on non-fractionalized life settlements transactions. This was because the purchaser would have depended on the adviser to ascertain the value of its secondary life insurance policy investments and conduct negotiations on its behalf as part of the investment origination agreement, and that Living Benefits was acting to advise the purchaser on the secondary life insurance policy purchase transactions for the purchaser, rather than having acquired the policies as a principal and having acted as a seller of the policies to the purchaser.

APPLICATION OF HOWEY TEST TO NON-FRACTIONALIZED TERTIARY LIFE SETTLEMENT INVESTMENTS

- *An Investment*: The seller of a life settlement policy is not investing any money. Rather it receives money paid by the buyer in exchange for the sale of the life settlement policy. In that way, the buyer may be seen as investing money in a life settlement policy, meeting the first prong of the *Howey* test.

- *Expectation of Profit*: When the buyer purchases a life settlement policy, it pays a price that is less than the death-benefit payment with the expectation of making a profit when the insured dies. In this way, the second prong (i.e., expectation of profits) of the *Howey* test may be said to be met.

[13] 408 F.3d 737 (U.S. App. 11th 2005).

[14] *Id*. at 744.

[15] *IN RE: Living Benefits Asset Management, LLC* ("LBAM"), 916 F.3d 528 (5th Cir. 2019).

[16] *Id*. at 542.

[17] 15 U.S.C. § 80b-3(a); § 80b-15(b).

[18] *LBAM*, 916 F.3d at 542.

- *Common Enterprise Investment*: In applying *Howey's* common enterprise prong, none of the three "common enterprise" formulations appear to apply to the sale of an entire (that is, non-fractionalized) life settlement policy. First, there is only a single investor (i.e., the buyer). Second, there is no strict vertical commonality which depends on the existence of an economic parallel between the two parties' risks and rewards, an analysis of which would require casting the owner of the life settlement policy as a promoter, which is inapposite. Further, as to the economic fortunes of the promoter and the investor, there is no link at all. Once the cash payment has been made to the seller of the life settlement policy, the transaction is complete, as the owner of the life settlement policy no longer has any economic interest in the transaction. Third, there is no broad vertical commonality in which the investor's realization of profits is inextricably tied to the promoter's effectiveness and skill. The difficulty of recognizing the seller of the life settlement policy as a promoter is evident, but it is sufficient to observe that the buyer's prospect for profit is generally in no way dependent on the prior owner's (i.e., the seller's) expertise in any field. Therefore, the buyer's purchase of the life settlement policy likely fails the third prong of the *Howey* test.

- *Profit Derived from Efforts of Others*: When considering whether the sale of a life settlement policy would meet the fourth prong of the *Howey* test, it is important to note that the Eleventh Circuit's holding in *Mutual Benefit* has not been considered in most other federal judicial circuits.[19] The Supreme Court in *Howey* requires the necessary work to earn profits done "solely" by the efforts of others. *Mutual Benefit* cites the dissenting opinion in *Life Partners* as its support for considering the work done prior to the creation of the investment contract. The *Life Partners* opinion points out, however, that the dissenting opinion cannot cite any precedent for considering the work that is done prior to the signing of the investment contract in evaluating the third prong of the *Howey* test. Moreover, the facts in *Mutual Benefit* not only involved a company that was fractionalizing life insurance policies to sell to investors, but that company was doing a significant amount of work verifying the medical status of the insured *after* the policy was purchased, was having to do a significant amount of work to manage the escrow funds because it had not been very successful in predicting the average life span of the majority of insureds, and was not being honest with its investors. For that reason, even if the buyer of a life settlement policy is viewed as the investor in a transaction, the factual distinctions from *Mutual Benefit* and *Life Partners*, as described immediately above, regarding the *Life Partners* dissenting opinion as indicating that the fourth prong of the *Howey* test likely fails.[20] In the case of a resale of an entire policy that is not fractionalized, the buyer's expectation of profits is in no way dependent on the seller's efforts, and usually the buyer acquires complete control of the policy and becomes responsible for managing the investment. Such a transaction is distinguishable from the facts of the *Mutual Benefit* case in that the seller will not have made any alterations to the life settlement policy (i.e., it will not be fractionalizing it), and as such, all that could fairly be said to have done is the purchase and sale of the life settlement policy. In light of these factors, a court would likely determine that the sale of life settlement policy would fail the fourth prong of the *Howey* test, assuming the seller has no further involvement of the management of the policy.

In interpreting *Howey*, various courts require that to demonstrate the existence of a "common enterprise," there must be a showing of "horizontal commonality" or "vertical commonality." "Horizontal commonality" focuses on the relationship among investors and requires a pooling of investors' contributions and distribution of profits and losses on a pro-rata basis among investors.[21]

[19] *SEC v. International Loan Network Inc.*, 968 F.2d 1304 (D.C. Cir. 1992) (requiring profits to be generated "predominantly" from efforts of others); *Goodman v. Epstein*, 582 F.2d 388 (7th Cir. 1978) (profits predominately from others efforts); *SEC v. Koscot Interplanetary, Inc.*, 497 F.2d 473 (5th Cir. 1974) (clerical efforts not enough); *SEC v. Glenn W. Turner Enterprises, Inc.*, 474 F.2d 476 (9th Cir. 1973) (efforts of others must be significant); *McCown v. Heiler*, 527 F.2d 204 (10th Cir. 1975) (promoter had to work to improve the lots of the investors to generate profit).

[20] We note that if the owner of the life settlement policy is viewed as the "investor," then the analysis of the first two prongs of the *Howey* test above changes, and each of those prongs fail. Analyzing from that perspective, the owner of the policy is not "investing money" with "the expectation of profits."

[21] *Stenger v. T.H. Love Galleries, Inc. and R.H. Love*, 741 F.2d 144 (7th Cir. 1984); *Newmyer v. Philatelic Leasing*, Ltd., 888 F.2d 385, 394 (6th Cir. 1989). "Horizontal commonality" is the tying of each individual investor's fortunes to the fortunes of the other investors by the pooling of assets, usually combined with the pro-rata distribution of profits. *See, e.g.*, *Hart v. Pulte Homes of Michigan Corp.*, 735 F.2d 1001, 1004 (6th Cir.

By its terms, this test excludes transactions involving only one investor. "Vertical commonality" focuses on the relationship between an investor and the promoter and not the individual investors.[22] It requires the mutual dependence of the fortunes of the investor and the promoter, and that the fortunes of the investor be "interwoven with and dependent on the efforts and success of those seeking the investment or of third parties."[23]

SEC'S LIFE SETTLEMENTS TASK FORCE REPORT

In 2009, the SEC established a Life Settlement Task Force to examine emerging issues in the life settlements market and advise whether market practices and regulatory oversight could be improved. The Task Force concluded that "since the cases brought by the SEC to date involved the sales of fractional interests in life insurance policies or groups of policies, it is unclear whether a federal court would hold that the sale of a single insurance policy wholly to one investor would constitute an offer or sale of a security under the Securities Act." It also suggested ". . . that the Commission consider recommending to Congress that it amend the definition of "security" under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940 to include life settlements. The amendment would clarify the status of life settlements under the federal securities laws and provide for a more consistent treatment of life settlements under both federal and state securities laws." That recommendation to Congress was never given by the SEC.

APPLICATION OF STATE BLUE SKY LAWS TO LIFE SETTLEMENT INVESTMENTS

When state insurance regulators were developing the initial laws regulating viatical settlements in [2003], state securities regulators had not then addressed the investment component of life settlements. As a result, the early viatical settlement laws contained some securities regulatory elements, notwithstanding that was not the domain of state insurance regulators. Indeed, the National Association of Insurance Commissioners Viatical Settlements Model Act provides that:

> Certain viatical settlement advertisements are deemed false and misleading on their face and are prohibited. False and misleading viatical settlement advertisements include, but are not limited to, the following representations: (1) "Guaranteed," "fully secured," "100 percent secured," "fully insured," "secure," "safe," "backed by rated insurance companies," "backed by federal law," "backed by state law," or "state guaranty funds," or similar representations; (2) "No risk," "minimal risk," "low risk," "no speculation," "no fluctuation," or similar representations; (3) "Qualified or approved for individual retirement accounts (IRAs), Roth IRAs, 401(k) plans, simplified employee pensions (SEP), 403(b), Keogh plans, TSA, other retirement account rollovers," "tax deferred," or similar representations; (4) Utilization of the word "guaranteed" to describe the fixed return, annual return, principal, earnings, profits, investment, or similar representations; (5) "No sales charges or fees" or similar representations; (6) "High yield," "superior return," "excellent return," "high return," "quick profit," or similar representations. . .[24]

With respect to state securities laws, roughly 48 states treat certain types of life/viatical settlement investments as securities under state laws. A majority of states expressly include a life/viatical settlement investment directly in their statutory definitions of a security. Some of these states expressly include non-fractionalized sales and others expressly include the tertiary sale of a life/viatical settlement policy as a security.

For example, in Michigan, the definition of a "security" includes "an investment in a viatical or life settlement agreement."[25] Unlike other state securities laws, Michigan's securities law does not carve out any exclusions of a "viatical or life settlement agreement"

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1984); *Salcer v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 682 F.2d 459, 460 (3d Cir. 1982) (investment must be "part of a pooled group of funds"); *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274, 276 (7th Cir. 1972) (success or failure of other contracts must have a "direct impact on the profitability of plaintiffs' contract"), cert. denied, 409 U.S. 887, 93 S.Ct. 113, 34 L.Ed.2d 144 (1972).

[22] *SEC v. Unique Financial Concepts, Inc.*, 196 F.3d 1195, 1199 (1999).

[23] *Villeneuve v. Advanced Business Concepts Corp.*, 698 F.2d 1121, 1124 (11th Cir. 1983), aff'd en banc, 730 F.2d 1403 (1984).

[24] National Association of Insurance Commissioner Viatical Settlement Model Act, Section 13, D.

[25] Michigan Securities Act Section 451.2102c(c).

that would otherwise possibly exempt such an agreement in the tertiary market as a security. In Wisconsin, the definition of a "security" includes any "life settlement investment or similar agreement."[26] A life settlement investment means "the entire interest or fractional or pool interest in a life insurance policy or certificate of insurance or in the death benefit thereunder that is the subject of a life settlement," but does not include "the assignment, transfer, sale, devise or bequest of a death benefit, life insurance policy, or certificate of insurance by the owner to a [life settlement] provider. . .; and (b) the exercise of accelerated benefits pursuant to the life insurance policy or certificate, and consistent with applicable law."[27] Wisconsin's blue sky securities laws exclude a life settlement investment as a security in the secondary market, but not a life settlement investment in the tertiary market. Tennessee's blue sky securities law expressly defines a "security" to include a "life settlement investment."[28] While this state's blue sky securities law includes several exceptions to types of life settlement investments that are not considered securities;[29] such exclusions are not applicable to a tertiary policy resale. For that reason, Tennessee is another state where a tertiary resale of a life settlement investment would be considered a security pursuant to the blue sky securities laws, but not federal securities laws. In Iowa a "security" is defined to include a "viatical settlement investment contract."[30] A "viatical settlement investment contract" under Iowa law means a "contract entered into by a viatical settlement purchaser, to which the viator is not a party, to purchase a life insurance policy or interest in the death benefits of a life insurance policy, which contract is entered into for the purpose of deriving economic benefit."[31] This is another example where the purchase of a viatical investment in the tertiary market would be treated as a security under state blue sky securities law, but likely not under federal securities laws. In other words, under a strict, literal interpretation of some state blue sky laws, the sale of a whole policy to an investor that assumes complete control over the policy is the sale of a security under the state's securities statute. However, we are not aware of any state court or securities commission that has expressed that view or interpretation.

In sum, some of these state laws exempt the life settlement/secondary market transaction from the definition of a security. However, not all state securities laws that exempt secondary market transactions also exempt tertiary trades. Thus, if a tertiary non-fractionalized trade presumptively meets the statutory definition of a security and there is no available exemption, that trade involves the purchase/sale of a security. For most life settlement investment funds, this is not an issue because either the funds are located offshore and selling non-fractionalized life insurance policies to a buyer also located offshore or a U.S. fund is selling non-fractionalized life insurance policies to another U.S. fund located in Delaware or New York where only the *Howey* investment contract test is in play under state law.[32] However, for tertiary market sellers of non-fractionalized life insurance policies to residents in states that treat tertiary resales of life settled policies as securities, exemption from registration and securities anti-fraud laws should be considered.

CONCLUSION

The offer and sale of the entirety of an in-force non-variable life insurance policy (i.e., a non-fractionalized policy) in the life settlements tertiary trading market is not a security under federal securities laws save in the Fifth Circuit. However, under some states blue sky securities laws such a transaction is regulated as the issuance and purchase of a security. Accordingly, where the purchaser of a tertiary market life settlement policy resides in one of these states, regardless of whether the purchaser is an investment fund or retail investor, the tertiary market seller is subject to state securities laws registration and anti-fraud rules and should comply with them by effecting the sale under an exemption from registration (or registering the sale) and providing the purchaser with proper and complete written risk factor disclosures. ■

[26] Wisconsin Securities Act Section 551.102(28).

[27] Wisconsin Securities Act Section 551.102(17m).

[28] Tennessee Securities Act Section 48-1-102(20).

[29] *Id*.

[30] Iowa Securities Act Section 502.102(28).

[31] *Id*. (31A).

[32] New York General Business Statute Article 23A; Delaware Securities Act Section 73-103(23).