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Alert | Financial Services Litigation/Securities Litigation

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Illinois Supreme Court Rules Annuities Are Not Securities Under Illinois Securities Act

On March 21, 2019, in *Van Dyke v. Jesse White*, the Illinois Supreme Court issued a long-awaited opinion relating to Illinois Securities Department (Securities Department) authority to regulate annuities under the Illinois Securities Law of 1953 (Act). The top Illinois court held that annuities do not fall under the Act's definition of "security," which judgment will shield insurance producers and financial advisors who sell annuities from the Security Department's jurisdiction. However, it held those who "act as investment advisors" in connection with the sale of annuities still fall under the Securities Department's purview.

In this GT Alert, we examine the Illinois Supreme Court's analysis and holding that annuities do not fall under the Securities Department's jurisdiction.

Background

The Securities Department audited Richard Lee Van Dyke following complaints from the adult children of one of his deceased clients. Van Dyke was registered with the Securities Department as an investment advisor and licensed by the Illinois Department of Insurance as an insurance producer. The auditors reviewed Van Dyke's insurance files, as opposed to his investment files, and subsequently alleged that he had defrauded 21 clients. Specifically, the Securities Department claimed Van Dyke liquidated the clients' indexed annuities and replaced them with other annuities, from which Van Dyke purportedly earned $312,278 in commissions while his clients paid $263,822 in surrender charges, penalties, and other fees.

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The Securities Department initiated administrative proceedings alleging Van Dyke violated Section 130.853 of its administrative regulations, which prohibits investment advisors from effectuating "any transactions of purchase or sale that are excessive in size or frequency or unsuitable." The Securities Department also charged Van Dyke with violating Sections 12(A), (F), (G), (I), and (J) of the Act. These sections, other than 12(J), expressly implicate transactions involving "securities." Section 12(J) makes it unlawful, generally, to employ any device, scheme, or artifice to defraud any client while acting as an investment advisor.

Van Dyke moved to dismiss, arguing the Securities Department had no jurisdiction over him because the Act expressly excludes annuities from the definition of a security and because he was not acting as an investment advisor at the time of the transactions. Moreover, during the Securities Department's administrative action, the Department of Insurance filed a separate action based on the same annuity transactions. Without an admission of fault, Van Dyke settled the insurance action for $6,000.

Following an administrative hearing with the Securities Department, the secretary of state issued a final order finding Van Dyke committed fraud by offering unsuitable annuities. The secretary revoked Van Dyke's investment advisory registration, permanently prohibited him from selling securities in Illinois, and fined him $300,000 plus costs of the investigation. The circuit court affirmed the administrative order, and Van Dyke appealed. On appeal, Van Dyke argued the Securities Department had no jurisdiction over the sale of indexed annuities because they are not "securities" under the Act and fall under the authority of the Department of Insurance, not the Securities Department.

The appellate court agreed but held that Van Dyke was nevertheless acting as an investment advisor and thus subject to the Securities Department's jurisdiction under Section 12(J). At the same time, the appellate court found the Securities Department did not prove Van Dyke violated Section 12(J) in the sale of replacement annuities or perpetrated a fraud on his clients. Accordingly, it reversed the secretary of state's final order.

The secretary of state appealed to the Illinois Supreme Court, arguing the sale of indexed annuities falls under the definition of a security under the Act, and that it put forth sufficient evidence Van Dyke committed violations of the Act. Van Dyke sought cross-relief, maintaining section 12(J) of the Act did not apply because he was acting as an insurance producer, not an investment advisor.

Annuities Are Not Considered "Securities" Under the Act

The Illinois Supreme Court began its review by examining the language of the Act. Section 2.1 sets forth the definition of a "security" and provides, in relevant part:

> 'Security' means any note, treasury stock … investment contract, … face-amount certificate, … or, in general, any interest or instrument commonly known as a 'security'.

Moreover, Section 2.14 defines "face amount certificate" to include "any form of annuity contract (other than an annuity contract issued by a life insurance company authorized to transact business in this State)." Thus, Sections 2.1 and 2.14 plainly establish that any form of an annuity contract issued by an authorized insurer is not included within the classification of "face-amount certificate" set forth in the definition of a "security."

The Securities Department did not dispute this point but argued the appellate court erred in failing to consider whether the indexed annuities were securities because they constitute "investment contracts." The Securities Department contended that "investment contracts" have been construed by federal courts

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interpreting the Securities Act of 1933 (Federal Securities Act) to include a contract whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or third party. According to the Securities Department, the indexed annuities at issue in the case were investment contacts.

The Illinois Supreme Court disagreed. It noted that while the statutory regime at issue is similar to the Federal Securities Act, it is "fundamentally different in several key respects." In particular, unlike the Federal Securities Act, the Act includes "face-amount certificates" in the definition of a security. The Supreme Court found this to be significant because the definition of a "face-amount certificate" specifically excludes annuities issued by a life insurance company. Therefore, the Supreme Court held that the Securities Department's reliance on the "catch-all" phrase of "investment contact" was improper because of the specific exclusion of annuities issued by a life insurance company. The express provisions excluding insurance annuities takes precedence over the generally descriptive term "investment contract."

Additionally, the Illinois Supreme Court cited to the Illinois Insurance Code, which provides:

> Notwithstanding any other provision of law, the Director [of Insurance] has *sole authority* to regulate the issuance *and sale* of variable contracts, and to promulgate such reasonable rules and regulations as may be appropriate to carry out the purposes and provisions of this Article.

(Emphasis in opinion). The Illinois Supreme Court found this provision applies to the regulation of companies that issue variable contracts as well as sales to individual buyers. Because regulation of the insurance industry falls under control of the states, there is no corollary to the Federal Securities Act. Furthermore, because "the Department of Insurance regulates both traditional and variable annuities as insurance products, it would be incongruous for indexed annuities — a hybrid of the two — to be subject to regulation under the Act."

The Illinois Supreme Court ultimately held that "our statutory regime demonstrates the legislature's intent that annuity contracts issued by authorized insurers are insurance products and not securities because they fall within the exclusion from face amount certificates and are not investment contracts under section 2.1." As a result, the purchase of the indexed annuities at issue could not form the basis of a violation of Sections 12(A), (F), (G), or (I) of the Act, which expressly require transactions of securities.

Section 12(J) Applies to Investment Advisors Who Sell Annuities

Although the Illinois Supreme Court found indexed annuities do not qualify as securities, it did find that the Securities Department has the authority to bring an administrative action under Section 12(J) of the Act when annuities are sold by investment advisors.

Section 12(J) provides that it is a violation for a person:

> When acting as an investment adviser, … by any means or instrumentality, directly or indirectly:
> (1) To employ any device, scheme or artifice to defraud any client or prospective client.

Section 12(J) contains no reference to or requirement for a sale of a security in connection with the prohibited conduct. Moreover, this section is "virtually identical" to the antifraud provisions found in Section 206 of the federal Investment Advisers Act of 1940. Federal courts have also found Section 206 does not require that the challenged transaction involve a security to prove a violation. As such, the Supreme Court held all that is required under the Act is that Van Dyke was "acting as an investment advisor."

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In response, Van Dyke argued that at the time of the transactions he was not acting as an investment advisor but rather as an insurance producer. The Illinois Supreme Court disagreed, finding that the manifest weight of the evidence established that Van Dyke provided investment advice when he recommended the purchase of various financial products, including securities and indexed annuities. Moreover, the record indicated Van Dyke identified himself as an investment adviser, and there was no evidence he informed his clients he was acting as an insurance producer under the Insurance Code when he sold the indexed annuities. Because Van Dyke was acting as an investment adviser, his conduct fell within the purview of section 12(J).

The Illinois Supreme Court then engaged in a case-specific analysis to determine whether Van Dyke engaged in a device, scheme, or artifice to defraud his clients. The court found that the Securities Department's evidence and expert testimony failed to establish Van Dyke actually violated the Act or perpetrated a fraud on his clients. Accordingly, the Supreme Court held the appellate court properly reversed the secretary of state's final order against Van Dyke.

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