ATTORNEY GENERAL OPINION 02-2

To: The Honorable Stan Hawkins
P. O. Box 367
Ucon, ID 83454

The Honorable David Callister
7011 Holiday Drive
Boise, ID 83709

Per Request for Attorney General's Opinion

QUESTION PRESENTED

You inquire whether the National Securities Markets Improvement Act of 1996 ("NSMIA") (Public Law No. 104-290, 110 Stat. 3416, codified in part at 15 U.S.C. § 77r) preempts Idaho Code § 41-2819 under the circumstances relevant to your inquiry and set forth below. Idaho Code § 41-2819 requires an insurance holding company to obtain a solicitation permit from the director of the Department of Insurance prior to soliciting in Idaho for the sale of its securities, even for an exempt private offering of its federally covered securities pursuant to Rule 506 of Regulation D promulgated under the Securities Act of 1933.

CONCLUSION

Insofar as Idaho Code § 41-2819 requires that an insurance holding company obtain a solicitation permit from the director prior to soliciting Idaho investors for an exempt private offering of its federally covered securities pursuant to Rule 506 of Regulation D promulgated under the Securities Act of 1933, it appears to be preempted by NSMIA.

ANALYSIS

Idaho Code § 41-2819 explicitly applies to insurers and insurance holding corporations, as well as others similarly situated. The statute prohibits such an entity from soliciting or receiving funds in Idaho in exchange for its securities until the company has been granted a solicitation permit. Idaho Code § 41-2819(1). Subsection (2) of Idaho Code § 41-2819 provides:

> The director shall issue such a permit unless he finds:
>
> (a) That the funds proposed to be secured are inadequate or excessive in amount for the purposes intended, or

(b) That the proposed securities or the manner of their distribution are inequitable, or

(c) That the offering or issuance of the securities would be unfair to existing or prospective holders of securities of the same insurer, corporation, syndicate, organization, or entity.

The NSMIA provides exemptions from the applicability of certain state laws. Section 18(a) of the Act (15 U.S.C. § 77r(a)) provides in part:

Except as otherwise provided in this section, no law . . . of any State . . .

(1) requiring, or with respect to, registration or qualification of securities, or registration or qualification of securities transactions, shall directly or indirectly apply to a security that—

(A) is a covered security; or

(B) will be a covered security upon completion of the transaction;

. . .

(3) shall directly or indirectly prohibit, limit, or impose conditions based on the merits of such offering or issue, upon the offer or sale of any security described in paragraph (1).

Securities offered pursuant to Rule 506 of Regulation D promulgated under the Securities Act of 1933 qualify as covered securities under 15 U.S.C. § 77r(b)(4)(D).

Read in its most broad sense, the prerequisite of a solicitation permit in Idaho Code § 41-2819(1) might be construed as a law "requiring or with respect to" the registration or qualification of securities as set forth in section 18(a)(1) of the NSMIA. Even if such a broad reading stretches the language too far, the solicitation permit requirement for subsequent financing contained in Idaho Code § 41-2819(1) falls within the scope of NSMIA section 18(a)(3) by placing limits on the offering of securities.

The McCarran-Ferguson Act enacted by Congress in 1945 reserves to the states the regulation and taxation of insurance and provides, in essence, an anti-preemption provision. 15 U.S.C. § 1012. The McCarran-Ferguson Act provides, in part:

> No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, . . . unless such Act specifically relates to the business of insurance . . . .

The Supreme Court has stated that the above quoted "first clause" of 15 U.S.C. § 1012(b) "was intended to further Congress' primary objective of granting the States broad regulatory authority over the business of insurance." United States Department of Treasury v. Fabe, 508 U.S. 491, 505, 113 S. Ct. 2202, 2210, 124 L. Ed. 2d 449 (1993). As set forth in Fabe, the McCarran-Ferguson Act overturned the normal rules of preemption, which provide simply that inconsistent state laws are preempted by federal laws.

It seems clear that section 18(a)(1) or (3) of the NSMIA would be construed to invalidate, impair, or supersede Idaho Code § 41-2819. Thus, under the McCarran-Ferguson Act, preemption may occur: (1) if NSMIA specifically relates to the business of insurance, or (2) even if it does not, if Idaho Code § 41-2819 was not enacted "for the purpose of regulating the business of insurance."

While there are references in the NSMIA and other securities acts indicating that the NSMIA applies to variable annuities, hybrid products containing attributes of securities and insurance products,[1] the NSMIA itself does not seem "specifically related to the business of insurance" as opposed to securities regulation. *See* Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 116 S. Ct. 1103, 134 L. Ed. 2d 237 (1996) (federal statute that permitted certain national banks to sell insurance in small towns specifically referred to insurance). Recognizing direct conflict between the NSMIA exemption provisions concerning applicability of state law to covered securities and Idaho Code § 41-2819 and despite that the NSMIA does not appear to be specifically related to the business of insurance on its face, Idaho Code § 41-2819 may still be preempted under the McCarran-Ferguson analysis if it is not a law enacted "for the purpose of regulating the business of insurance".

In Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453, 462, 89 S. Ct. 564, 569, 21 L. Ed. 2d 668 (1969), the United States Supreme Court ruled that the Arizona law that required the Arizona Director of Insurance "to find that the proposed merger would not 'substantially reduce the security of and service to be rendered to policyholders'" before he approved the proposed merger clearly related to the business of insurance. The Court in National Securities, Inc., held that the McCarran-Ferguson Act did not bar a federal remedy that affected a matter that was subject to state insurance regulation. In this case, the Securities and Exchange Commission (SEC) sought remedies based on allegedly fraudulent conduct on behalf of the proponents of the merger. The Supreme Court determined there was no conflict between the statutes and that allowing the SEC to pursue remedies under federal law did not effectively

"invalidate, impair, or supersede" the Arizona statute. However, there is some discussion in National Securities, Inc., indicating laws that regulate the relationship between a stockholder and the company in which stock is owned are not insurance regulation but rather securities regulation. *Id*., 393 U.S. at 460, 89 S. Ct. at 569.

The Supreme Court has identified three criteria relevant to whether activity constitutes the business of insurance for purposes of McCarran-Ferguson Act preemption. They are: "*first*, whether the practice has the effect of transferring or spreading a policyholder's risk; *second*, whether the practice is an integral part of the policy relationship between the insurer and the insured; and *third*, whether the practice is limited to entities within the insurance industry." Union Labor Life Insurance Co. v. Pireno, 458 U.S. 119, 129, 102 S. Ct. 3002, 3008, 73 L. Ed. 2d 647 (1982). Most recently, the United States Supreme Court indicated that the three McCarran-Ferguson criteria are "guideposts," all of which need not be met to withstand preemption. *See* Rush Prudential HMO, Inc. v. Moran, 122 S. Ct. 2151 (June 20, 2002).

The majority in Fabe indicated its belief that not only does the writing of an insurance contract fall within the scope of the business of insurance, but so does the actual performance of an insurance contract. The Court in Fabe found that the portion of the Ohio liquidation priority statute affecting policyholder interests and the administrative expenses in the liquidation of an insurer was enacted for the purpose of regulating the business of insurance. But to the extent the statute is designed to advance the interests of other creditors, the statute was not enacted for the purpose of regulating the business of insurance. Fabe, 508 U.S. 508, 113 S. Ct. 2212.

Facially, Idaho Code § 41-2819 does not satisfy the first two McCarran-Ferguson criteria. The third criterion may be satisfied because the statute is limited to insurers or insurance holding companies. But, potential or actual investors may or may not be policyholders. The three bases of denial pursuant to Idaho Code § 41-2819(2) appear to be directed more toward the protection of existing or prospective shareholders, not policyholders, of the company. Moreover, Idaho Code § 41-2819(5) provides, "This section is supplemental to other laws of this State applicable to the sale of securities". This provision tends to undermine arguments that Idaho Code § 41-2819 should not be applied because other Idaho securities laws might apply to protect potential Idaho investors by their own terms, because Idaho Code § 41-2819 is expressly supplemental, or in addition, to other Idaho securities laws. Subsection (5) provides additional insight, however, into the Idaho Legislature's purpose in enacting Idaho Code § 41-2819. The law creates, in essence, additional securities protection for existing and potential investors where the securities to be sold are those of an insurance company or insurance holding company. While the legislature's desire to provide a second layer of oversight to protect existing or potential investors appears in the insurance code and is thus unique to Idaho's regulation of the business of insurance, Idaho Code § 41-2819 does not truly relate to a practice that "is limited to entities within the insurance industry."

Recent case law also indicates that the Ninth Circuit Court of Appeals would likely view the NSMIA as preempting Idaho Code § 41-2819 under the circumstances presented. *See, e.g.* Patenaude v. Equitable Life Assurance Society of the United States, 290 F.3d 1020, 1028, n.8 (even if the California Insurance Code, as opposed to the California Business and Professional Code, had an express statute that was in conflict with a companion federal securities act of NSMIA, the state law would likely be preempted).

One could argue that there is a general insurance business purpose supporting Idaho Code § 41-2819, such as advancing general oversight of financial solvency of insurance holding companies, and therefore ultimately insurers, which is thus related to the performance of insurance contracts. Realistically, a federal court would conclude that Idaho Code § 41-2819, requiring an insurance holding corporation to obtain a solicitation permit prior to soliciting or receiving funds in Idaho in exchange for its securities, falls outside the scope of legislation enacted for the purpose of regulating the business of insurance. Therefore, insofar as Idaho Code § 41-2819 requires an insurance holding company to obtain a solicitation permit for subsequent financing prior to soliciting investors for federally covered securities under a Rule 506 of Regulation D offering, a court of competent jurisdiction would likely find it is preempted by NSMIA.

AUTHORITIES CONSIDERED

1. Idaho Code:

Idaho Code § 41-2819.

2. Federal Statutes:

15 U.S.C. § 77r.
15 U.S.C. § 1012.
National Securities Markets Improvement Act of 1996 (Public Law No. 104-290, 110 Stat. 3416).

3. Cases:

Barnett Bank of Marion County, N.A. v. Nelson, 517 U.S. 25, 116 S. Ct. 1103, 134 L. Ed. 2d 237 (1996).

Patenaude v. Equitable Life Assurance Society of the United States, 290 F.3d 1020 (9th Cir. 2002).

Rush Prudential HMO, Inc. v. Moran, 122 S. Ct. 2151 (June 20, 2002).

Securities and Exchange Commission v. National Securities, Inc., 393 U.S. 453, 462, 89 S. Ct. 564, 21 L. Ed. 2d 668 (1969).

Union Labor Life Insurance Co. v. Pireno, 458 U.S. 119, 129, 102 S. Ct. 3002, 3008, 73 L. Ed. 2d 647 (1982).

United States Department of Treasury v. Fabe, 508 U.S. 491, 113 S. Ct. 2202, 124 L. Ed. 2d 449 (1993).

DATED this 28th day of June, 2002.

ALAN G. LANCE
Attorney General

Analysis by:

THOMAS A. DONOVAN
Deputy Attorney General
Intergovernmental & Fiscal Law Division

---

[1] *See, e.g.,* Patenaude v. Equitable Life Assurance Society of the United States, 290 F.3d 1020, 1025-26 (9th Cir. 2002).