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The *Cutter* Case and What It Means

By Justin Chretien

In December 2023, the federal court in Boston denied Cutter Financial Group's Motion to Dismiss and the case[1] is headed for trial. Given what was at stake, one might think this is a real setback for insurance producers and distributors. That should not be the case, however, it could be.

The Complaint

Let's review the Amended Complaint filed last June. Jeffrey Cutter is a registered investment adviser representative who owns and operates a registered investment advisory firm, Cutter Financial Group (CFG), in Massachusetts. CFG has six employees, three of whom are investment advisory representatives (advisers). CFG manages approximately $193 million in client assets. Most clients are retail investors of retirement age.

Jeffrey Cutter also is licensed in Massachusetts as a life insurance agent and owns and operates his own life insurance agency. As such, he is "dual-hatted" as both an investment adviser and a licensed insurance agent. Historically, securities have always been subject to federal regulation, while insurance products have always been subject to state regulation.

The Securities and Exchange Commission (SEC) alleges that Cutter and his firm violated the antifraud provisions of the Investment Advisers Act of 1940 (Advisers Act), Section 206, by engaging in fraud involving both securities and insurance products (that is, fixed indexed annuities or FIAs). That is, he violated the fiduciary standard of care imposed on advisers by the Advisers Act when he advised clients to sell securities and buy annuities without proper disclosure of the commissions and other compensation he would receive for the purchase of the fixed indexed annuities.

For our purposes, the alleged violations can be broken down into three categories:

1. That Cutter allegedly did not disclose commissions and other compensation paid by annuity companies when he recommended to clients that they allocate a portion of their assets to purchase annuities. Cutter allegedly used a "three-bucket" approach for allocating client assets where one bucket was for annuities and two buckets were for managed accounts. When recommending a client allocate a portion of assets to purchase annuities, which typically came from assets in the other buckets, he allegedly failed to disclose the commissions and other compensation he would receive from the purchase of annuities.
2. That he allegedly recommended clients replace their annuities with other annuities without disclosing the commissions and other compensation he would receive, often resulting in surrender charges, loss of annuity bonuses, and other financial consequences to the clients.

3. That he misrepresented the justifications he provided to the life insurance companies when replacing a client's annuity with another annuity.

The Motion to Dismiss

In July 2023, Cutter filed its motion to dismiss the Amended Complaint. Cutter raised both factual and legal arguments. For our purposes, we will focus on the legal arguments.

Cutter argued that the SEC cannot bring sales practice claims based on the sale of insurance products as opposed to securities. Specifically, that the SEC does not have the authority under the Advisers Act to charge a failure to provide disclosures related to fixed indexed annuities, only securities, and that the fiduciary standard of the Advisers Act does not apply to transactions in FIAs, only securities. And that insurance sales practices are subject only to state regulation.

Further, when financial professionals wear two hats, the applicable standards depend on the capacity in which one is acting at the time. If a dually-registered professional is providing advice regarding the sale of securities, the Advisers Act fiduciary standard should apply. But if the professional is providing advice regarding the purchase of FIAs, the standard of the National Association of Insurance Commissioners (NAIC) Suitability in Annuity Transactions Model Regulation (Model 275) should apply, which applies a best interest standard and has different disclosure obligations than the Advisers Act. So, Cutter and the insurance industry as a whole were justifiably shocked that the SEC charged the firm with violations of the Advisers Act fiduciary obligations with respect to FIA transactions.

Cutter also cited to the historical separation between the regulation of securities and the regulation of insurance products, including the McCarran-Ferguson Act of 1945, which generally precludes application of federal law over state law regarding insurance and, more recently, the Dodd-Frank Act, which states clearly that FIAs are to be regulated as insurance products, not securities.

Cutter also argued, as a factual defense, that its Form ADV and Form CRS disclosures provided notice to clients about the difference in compensation arising from insurance sales and that the practice represented a conflict of interest, so there was no failure to disclose.

The SEC's Opposition to the Motion to Dismiss

The SEC argued in its opposition filed two weeks later that the Advisers Act—specifically Section 206—is not limited to conduct in connection with securities and that the antifraud rules apply to the entire adviser-client relationship, whether it involves securities or not. Further, that the allegations deal with Cutter's actions as an adviser, not separately as an insurance agent. And that the sales of the annuities were intertwined with investment advice.

The NAFA *Amicus*

In September 2023, the National Association for Fixed Annuities (NAFA) filed an *Amicus* brief in support of Cutter's Motion to Dismiss.[2] NAFA made a number of legal arguments that strengthened and broadened the arguments made by Cutter. NAFA set forth the long history of the dichotomy between securities regulation and insurance regulation that goes back more than 150 years. In sum, that insurance regulation has been historically a state affair and that the McCarran-Ferguson Act and Dodd-Frank codify this dichotomy. And further, that SEC regulation of indexed annuity transactions is unnecessary in light of comprehensive state regulation; would contravene the efforts of state regulators to achieve a national standard based on the NAIC model; implicates the Major Questions doctrine because of its likely impact; and would introduce uncertainty into the marketplace

and disparate treatment of consumers and insurance producers depending on whether the producer is also an investment adviser.

The Order Denying the Motion to Dismiss

In December 2023, the court denied Cutter's motion to dismiss.[3] As an initial matter, the court was considering not the merits of the case, but whether there was subject matter jurisdiction. When a court does this, it must not only accept the facts that are presented by the plaintiff as true, it must also make all reasonable inferences in favor of the plaintiff and in finding jurisdiction. So, the denial of the motion does not mean that Cutter will lose, only that there is jurisdiction to hear the case.

In addition, the standard for a motion to dismiss is incredibly high: "a federal claim will only be deemed insufficient to confer subject matter jurisdiction in 'only the most extreme cases,' where the claim is 'wholly insubstantial and frivolous.'"[4] In this case, the court had to look at whether the SEC stated a plausible claim under the Advisers Act or an insubstantial or frivolous one.

In ruling on the motion, the Court had to accept as true the factual allegation that Cutter did not disclose various incentives that might influence his recommendations of annuities over other investments or of the adverse consequences of his advice; that the decision to replace annuities was not motivated by the customer's changed circumstances but by Cutter's desire to make more money; and that he lied to the life insurance companies about the justifications for annuity replacements. Of course, none of the allegations have been proven.

The Court's Findings

The court found that the SEC had plausibly alleged that Cutter was acting as an investment adviser because he was a registered investment adviser who provided investment advice to the same clients. Further, that any limits to his fiduciary duties would require full and fair disclosure and informed consent, which is contrary to the factual allegations in the complaint that are assumed to be true. On the other hand, if Cutter is able to prove at trial that he provided full and fair disclosure to his customers and had informed consent from them that he was not acting as a fiduciary with respect to the purchase of annuities, the Court may find that he was not acting as a fiduciary when he provided advice regarding the annuities. It is arguable that CFG's Form ADV and Form CRS in effect at the time provided such disclosures.

Further, the court also found that the Advisers Act requires full disclosure of all material conflicts of interest. Here, that means that the material omission "is not merely that Cutter obtained any commission for the sale of FIAs, but that the up-front commission rate Cutter earned from annuities *was higher* than the fee he earned when he advised clients to invest their funds in a money management account."

Thus, the Court did not hold that disclosures must include *the amount of compensation* from the annuities, just that it was *higher* than his investment advisory fee. That creates the conflict of interest that must be disclosed.

Of course, there are disclosures along those lines in the Form ADVs that were filed. But, the court states, these disclose "merely hypothetical" conflicts and not "that Cutter in fact did earn commissions or that those commissions were earned at a higher rate than other investment options he could have recommended to plaintiffs." In other words, the court is holding that Form ADVs setting forth hypothetical conflicts, such as the adviser "may receive compensation" from other investment options that would create a conflict, are not sufficient when the firm *did receive* compensation that created a conflict.

There also are the disclosures from the life insurance companies, of course, but the court stated that these did not mention that the upfront commission for the annuities is higher than the typical advisory

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fees that Cutter would earn for other investments or that the difference creates a conflict of interest.

Regarding the arguments about McCarran-Ferguson precluding the application of the Advisers Act, the Court held, in essence, that application of the Advisers Act here does not present a direct conflict with any state insurance law or policy and did not impair state law. In other words, the Advisers Act requirements were in addition to, not instead of, state insurance requirements. The Court also cited to Massachusetts' own fiduciary duty rule for investment advisers that runs parallel to the Advisers Act.

Most significantly, the Court stated that the mere fact that the conflict of interest involved annuities and not securities does not bar the claim. Instead,

> [T]he violation of the Advisers Act in this case arises not from the fact that Defendants sold annuities, but rather that Defendants recommended that advisory clients spend a third of their total assets buying FIAs from Cutter without fully and fairly disclosing Cutter's alleged conflict of interest.

The Court thus rejects Defendants' argument that an individual who falls within the "statutory definition of investment adviser need not disclose any conflicts of interest arising from a non-security or can ignore their fiduciary obligations when recommending that clients invest assets in a non-security."

This is the key holding of the Order. That when providing advice to an advisory client regarding the allocation of assets among different buckets, including annuities, the adviser should specifically disclose the conflict arising from the higher compensation associated with the annuities and not rely on the generic disclosures set forth in the Form ADV and CRS and the life insurance company disclosures. It is not clear that the amount of compensation needs be disclosed, just that it is higher, at least in the short term. And hypothetical, generic language in the Form ADV that the adviser "may receive compensation" from other investment options is likely to be insufficient.

Takeaways

As noted above, the Complaint contains three categories of alleged violations. The first is alleged failures to disclose commissions and other compensation paid by life insurance companies when Cutter recommended to clients that they allocate a portion of their assets to purchase annuities.

The court's ruling clearly applies to this scenario, where an adviser is advising as to an allocation of assets between different investment buckets where one bucket is annuities.

What is the takeaway from this holding?

- It is limited to advisers who also are insurance agents and for the insurance marketing organizations (IMOs) or life insurance companies that are responsible for supervising their insurance sales.
- It is limited to situations where the adviser is providing advice regarding the allocation of assets between two or more different buckets, where one bucket consists of fixed annuities.
- The adviser is under a fiduciary duty to fully and fairly disclose any conflicts of interest created by allocating assets as between the different buckets, due to their different compensation schemes.
- The fiduciary duty would not be met by simply complying with insurance disclosure obligations within the insurance bucket and complying with the Advisers Act disclosure obligations within the securities bucket because these separate disclosure obligations don't directly compare the different compensation schemes to show the conflict between the two. The disclosure obligations within the buckets have nothing to do with the disclosure obligations that arise between the buckets.
- The takeaway is that the court has found that it is plausible that there is a fiduciary duty under the Advisers Act to disclose the conflict that

arises from the different compensation schemes. But it is arguable that the Order goes no further than that, and does not extend the standard of care into the annuity bucket. Meaning, that unless the adviser/agent is engaged in allocation of assets between annuities and securities, the Advisers Act standard should not apply to annuity transactions at all.

The second category of alleged violations is that Cutter allegedly recommended that clients replace their annuities with other annuities without disclosing the commissions and other compensation he would receive, often resulting in surrender charges, loss of annuity bonuses, and other financial consequences to the clients.

The order states:

- "No fiduciary duty adheres to Cutter based on his sale of insurance to a customer. . . Instead, the Advisers Act requires that when Cutter advises clients as to the suitability of annuities as part of their investment strategy, he disclose the fact that his investment advice is conflicted by his role as the insurer's agent."
- The takeaway is that, if the advice to replace an annuity is "part of their investment strategy," it would likely be subject to the additional disclosure obligation described above.
- But if the replacement of annuities is not part of advice regarding an investment strategy, it does not involve securities, and should not be subject to SEC scrutiny or the Advisers Act fiduciary standard.
- In any case, the replacement of the annuity would be subject to the disclosure obligations under state law.

The third category of alleged violations is that Cutter misrepresented the justifications he provided to the life insurance companies when replacing a client's annuity with another annuity. The Order is silent on these claims.

- The takeaway here is that, if the alleged misrepresentations are not related to either an allocation of assets or part of an investment strategy, they do not involve securities and should not be subject to SEC scrutiny or the Advisers Act fiduciary standard.
- Instead, the allegations should be referred to state regulators.

One way to look at this is that for the individual buckets—securities, annuities, whatever—each has its own set of rules and standards. Advisers have to comply with the Advisers Act and insurance agents have to comply with state laws. This Order does not change that. It is only when there is an allocation of assets or an investment strategy between the buckets that there arises an additional disclosure obligation due to the differences between the buckets, which creates the conflict.

Conclusion

That is not to say that the case is over or that the Order will stand. Cutter intends to fight and could defeat most or all of the claims. It has arguments for appeal. But the order actually articulates a workable standard in that it appears limited to situations involving asset allocation, which is something that can be supervised by the advisory firm.

Unfortunately, recent experience indicates that SEC Exam Staff believes that Cutter provides some authority and an impetus for SEC Examiners to seek review of the insurance business of investment adviser representatives who also are insurance agents and, in particular, the manner and extent of their disclosures to their insurance clients who are also advisory clients. This is dangerous ground for the SEC, because it treads on McCarran-Ferguson and other law unless there is a nexus to the regulation of securities. Based on *Cutter,* SEC Exam Staff reviews regarding the insurance business of dual-hatted advisers should be limited to their disclosures of conflicts related

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to their allocation of assets to advisory clients who are also insurance clients, including any disclosures associated with the insurance products sold, but no further.

Stay tuned for further developments!

Mr. Chretien is a shareholder at Carlton Fields, P.A., in Washington, DC, and chairs the Securities and Investment Company Industry Group. Mr. Chretien is a litigator with decades of experience handling high-stakes regulatory investigations, formal disciplinary proceedings, and litigation on behalf of FINRA, the SEC, and the US Department of Justice. The views expressed are those of Mr. Chretien and do not necessarily reflect the views of his firm, its lawyers, or its clients.

NOTES

1. Securities and Exchange Commission v. Cutter Financial Group LLC *et al.*, Civil Action No. 1:23-cv-10589 (D. Mass. filed March 17, 2023).
2. Carlton Fields, P.A., filed the *Amicus* brief on behalf of NAFA.
3. Memorandum and Order, Securities and Exchange Commission v. Cutter Financial Group LLC *et al.,* 23-cv-10589-DJC (D. Mass. Dec. 14, 2023) (hereinafter Order).
4. *Id.* (*citing* Toddle Inn Franchising, LLC v. KPJ Assocs., LLC, 8 F.4th 56, 62 (1st Cir. 2021)).

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