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By Bayard Bigelow, III, MBA, CPA

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About The Author

Bayard "Bud" Bigelow, III, MBA, CPA is President and Chief Executive Officer of The Cambridge Alliance, LLC, which represents an E&O program for Financial Planners and Registered Investment Advisors. This insurance program is exclusively endorsed by the ICFP for its members, and is exclusively recommended to the members of the IAFP.

Professionals interested in obtaining information about the program may contact:

**THE CAMBRIDGE ALLIANCE, LLC
P. O. Box 64998
Burlington, VT 05406
TEL: (800) 691-1515
FAX: (802) 864-9369**

The Perils Of Group Sponsored Broker / Dealer E&O Insurance Programs

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Many broker / dealers enter into contractual arrangements with a property / casualty insurer to provide insurance protection against their negligence or that of their registered representatives. Our experience has been, however, that neither the broker / dealer itself nor its registered representatives understand the implications of the insurance decisions made by the broker / dealer. The purpose of this article is to explore those ramifications more fully.

THE RELATIONSHIP

The relationship between the broker / dealer and its registered representatives is that of principal and agent. Accordingly, it is widely held that the principal may be called upon and be held legally responsible for the acts of its agent(s). The insurance mechanism by which the principal obtains insurance for the negligent acts of its agent, however, is quite different for broker / dealers than it is for almost any of the professions. It differs in the sense that the broker / dealer will sponsor a "group" insurance program, typically requiring that all of its registered representatives purchase insurance as a condition of appointment. In many other professional arrangements of this nature including property / casualty insurers and their agents, hospitals and doctors as well as other principal / agent relationships, the principal only requires that insurance be in place, but does not require that the "agent", broadly defined, participate in an insurance program bearing the approval of and endorsement by of the principal.

The motivation of the broker dealer to sponsor a group errors and omissions ("E&O") insurance program is completely understandable – the broker / dealer needs assurance that its registered representatives can demonstrate financial responsibility if their mutual client presents a claim. What is typically less clear to the broker / dealer, however, is that through the act of sponsorship of the insurance program, the broker / dealer may in essence be assuming the role of the insurer of last resort if the program turns out to be inadequate to meet the needs of its registered representatives – in essence, the broker / dealer may be implicitly warranting that its sponsored insurance program is adequate.

The mechanism by which these programs are marketed only compounds the problem – the insurance broker will typically inform the insured registered representatives through an insurance brochure which, at a minimum, cannot be thought of as full disclosure; and, may turn out to be quite misleading to the registered representative.

It is typically clearly stated in the insurance contract that the broker / dealer is the "First Named Insured". As such, the broker / dealer is responsible for payment of premium, receipt of various notices under the policy and negotiation of the very terms of the contract itself. In essence, the very wording of the contract itself as well as the relationships defined within the contract will assign responsibilities to

the broker / dealer which it may well be ill equipped to satisfy.

The very design of the insurance program itself may turn out to be inadequate, principally because of the relationship between the broker / dealer and its registered representatives. Let's examine some of these structural problems.

- ❑ "Marketing" to the registered representatives
- ❑ Scope of coverage
- ❑ Prior acts and tail coverage
- ❑ Aggregate limits
- ❑ Conflicts of interest

"MARKETING" TO THE REGISTERED REPRESENTATIVES

The annual renewal of the group policy is typically marked by the mailing of an announcement to the registered representatives of the features of the current program. The mailing may include a letter identifying how inexpensive this year's program is, together with a summary of its salient features. While these mailings are made by the insurance broker, they prominently feature the tacit and implicit approval of, and the endorsement by, the broker / dealer. Further, the registered representative will typically receive no further explanatory information, although he or she may receive a certificate of insurance. Apart from leaving the registered representative with no choice, such documents fall far short of representing complete disclosure – they are analogous to the registered representative supplying only a summary, rather than the full prospectus, to an investor interested in a particular security.

In the brochure itself it is typically stated that the brochure does not represent all of the relevant terms and conditions of the policy; and that the terms and conditions and the policy shall govern in determining the extent of coverage. Those who ignore this or similar warnings do so at their peril.

From time to time, the registered representative may wish to obtain additional information about the terms and conditions of the insurance program under which he or she is provided with coverage. Quite logically, the registered representative will turn to the compliance department of the broker / dealer. A registered representative making such an inquiry may find that the compliance department suddenly becomes uncooperative, or perhaps even hostile, apparently assuming that the mere act of inquiry masks some tip-of-the-iceberg like potential claim.

Now imagine that the worst happens – an investor claim is brought against both the registered representative and the broker / dealer. The claim is settled against the broker / dealer but, because of some of the features of the policy, coverage is not available to the registered representative, who must pay dearly. The registered representative in turn initiates legal action against both the insurance broker and the broker / dealer regarding the insurance program. It is pointed out during the depositions that the broker / dealer required participation; that it informed its registered representatives of the many features of the program not generally available with other programs; that the program summary was silent on the features of the policy which

resulted in the denial of coverage received by the registered representative; that the registered representative believed that the coverage was adequate because it was so thoroughly approved and endorsed by the broker / dealer; and that the registered representative actually made inquiry about the policy long before the claim ever arose and was roundly rebuffed by the compliance department. We believe this makes the point – the relationship should be one of full and unqualified disclosure so that the registered representative may make an informed decision.

SCOPE OF COVERAGE

The broker / dealer itself naturally will wish to insure the activities of its registered representatives that are transacted through the broker / dealer. This view of precisely what needs to be insured through the broker / dealer stems from an age when most, if not all, of its registered representatives were employees and had been trained extensively in the company's in-house training programs. As such, the registered representative would initiate securities transactions and little else. But today's world differs significantly and continues along a path which is likely to lead to quite different relationships with registered representatives. With the rise of the financial planning profession, as well as attendant growth in the number of RIA's, the typical registered representative today is an independent contractor, and engages in many activities away from the broker / dealer. Such activities might include financial planning; asset allocation; investment management, either with or without discretionary authority; sales of life products including life, health, and disability insurance, as well as annuities; and a variety of other services including accounting or legal services, trust services, third party pension plan administration, actuarial services, as well as others. While no single policy could possibly encompass all of these services, it is certainly true that a policy narrowly focused on security sales will fall short of the mark. In short, the "one size fits all" approach implicit in the design of these group programs sows the seeds of dissatisfaction, not to mention potential liability, for the sponsoring broker / dealer, particularly if the program is mandatory.

PRIOR ACTS AND TAIL COVERAGE

Just as with the issues surrounding coverage scope, implicit in the design of a group program is that it be made available only while a registered representative is a member of the sponsoring group. This is predicated on the assumption that the business and the insurance relationships span a career. But reality is quite a bit different – the movement of registered representatives from one broker / dealer to another, or from a commission based practice to a fee-only practice is becoming increasingly commonplace. To their surprise, again, the registered representatives will find out that the insurance does not trail along behind and, worse still, that coverage may not be available at all for services rendered while acting as a registered representative of the previous broker / dealer. Nevertheless, it is in the apparent best interest of both the previous broker / dealer and the new broker / dealer for the registered representative to have insurance available against any claims that might be

brought by an investor involving either broker / dealer – absent insurance coverage for the registered representative, the broker / dealer may become, *de facto*, the insurer of last resort. This concern after all is what made it desirable for either broker / dealer to sponsor an insurance program in the first place – the intent to protect their own entities by making sure that the registered representatives, who were their agents, could demonstrate financial responsibility.

AGGREGATE LIMITS

The next problem that the broker dealer faces is the amount of limits to purchase. The certificate issued to the registered representative will typically state three limits – the per claim limit for the registered representative; the aggregate limit for the registered representative; and the program or account aggregate limit. The per claim limit for the registered representative is the most the carrier will pay on behalf of the registered representative for a single claim, generally inclusive of defense costs. The aggregate limit for the registered representative is the most that the carrier will pay on behalf of the registered representative for any and all claims made against the registered representative, regardless of the number of such claims. The program or account aggregate limit is the most that the carrier will pay under the policy regardless of the number of such claims or who they were made against. All registered representatives, as well as the broker dealer itself, will typically share the program or account aggregate limit.

The adequacy of the program or account aggregate limit to either the broker / dealer or the registered representative(s) may depend upon the nature of investments sold; the nature and extent of the broker / dealer's compliance controls; the level of expertise of the registered representatives; the claims experience of the broker / dealer; the state of the economy; as well as several other factors. While the broker / dealer itself may be able to exercise control over several of these variables through its management practices, the individual registered representative has significantly less control. Suppose, for example, that the broker / dealer purchases coverage with a small aggregate limit, shared among all of its hundreds of registered representatives during a period of economic turmoil. The policy responds, but the program or account aggregate limit is fully depleted long before all claims reported during the year have been settled. Again, as with the other issues, the broker / dealer has unnecessarily exposed itself to liability, not only from investor claimants, but from the possible claims of its registered representatives as well.

CONFLICTS OF INTEREST

The last issue has to do with the clear conflicts of interest which may develop when the carrier and the broker / dealer respond to an investor's claim. To whom is a duty of care owed by the insurer – is it owed to the broker / dealer, since after all, the broker / dealer is the First Named Insured and responsible for placement of the coverage? Or is the duty owed to the registered representative? It is clear that there exists a conflict of interest arising from the capacities in which each acts. It is not clear how the carrier is to resolve that conflict or what

the ramifications are to the sponsoring broker / dealer. Equally, it is unclear as to how well the interests of the registered representative are dealt with.

PARTIAL SOLUTIONS – THE PROPERTY CASUALTY MODEL

Property / casualty insurers have a relationship with their agents which closely parallels the relationship between the broker / dealer and its registered representatives. To protect their interests, the property / casualty insurers, possibly without exception, require that the agents who represent them carry E&O insurance. In nearly all instances, however, these same property / casualty insurers do not become involved in the formation of a specialized E&O facility for the benefit of their agents. Even among those relatively small number of carriers who write property / casualty agent's E&O insurance, there is rarely any attempt made to induce agents to buy either their policy or, for that matter, anyone's specified policy. The insurer as principal is freed from the burden of recommending any particular policy and from the corresponding responsibility. Likewise, agents are free to choose for themselves the coverage that best meets their needs. In essence, the insurance decision is separate and apart from, and therefore unbundled from, the contractual principal / agent relationship. Further, in this unbundled world, the problems of sponsored programs, particularly mandatory programs, are not present. The agent chooses the scope of coverage which best meets his needs; the availability of prior acts is tied to the agent / agency and not to its inclusion as a member of a specified group; the agent is free to choose whatever limit suits his or her needs; the limit belongs to each separate insured, unshared with others; and, finally, the carrier providing coverage has no divided loyalties, as it represents only one of the two parties who in the principal / agent relationship.

SUMMARY

The analogies between property / casualty agents and registered representatives of broker / dealers seem clear – the advice we would give to broker / dealers is:

- Wherever possible seek to “unbundle” coverage by allowing registered representatives to substitute acceptable alternatives. As a party having a financial stake in the coverage purchased by its registered representatives, the broker / dealer should identify minimum acceptable limits and quality of carrier as determined by the carrier's AM Best ratings.
- In certain situations alternative coverage may not be available. These would include employed registered representatives, or independent contractors who act solely in the capacity of registered representatives. In these cases, insurance should be made available by the carrier, since no other acceptable alternative may exist.
- Finally, there may be situations where other alternatives exist but the policy offered by the insurer may provide coverage not otherwise available – such as for certain exotic investments which might be on the broker / dealer's approved list. Again, in these instances, the option should be made available to the individual registered representative to make the

decision which best suits his or her needs. Simultaneously, the principal is relieved of the burden of providing the “best” program, or even an adequate program, for its registered representatives.

Finally, we come to the issue of what represents “best” practice in dealing with insurance issues. The group sponsor should insist upon full disclosure of the coverage provided. Many carriers insuring the financial advisory professions, in all of their forms, will provide policy specimens. This should be done as a matter of course. Further, the insurance broker should be responsible for marketing the product to the registered representatives, without reference to the adequacy of the program in meeting the needs of any individual situation, and without the tacit endorsement of the sponsor.

These measures may seem foreign to those responsible for making the insurance decisions for a broker / dealer – with changes occurring rapidly in the services that a registered representative provides, as well as the growth of the financial planning profession and closely related professions, any group sponsoring an E&O insurance program for the benefit of its agents must be aware of the potential liability that arises if the program design turns out, in the face of a series of actual claims, to be inadequate.