NASAA BROKER-DEALER SECTION

E&O INSURANCE SURVEY REPORT

DECEMBER 2019

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION

Introduction

The thorny issue of unpaid arbitration awards remains a key focus for the North American Securities Administrators Association ("NASAA"). Successful investors who receive a monetary award in arbitration should be able to collect that award. Certain states have tried to address aspects of this problem by creating restitution funds that in certain instances would provide some recovery toward an unpaid award.[1] In addition, at least one state requires that financial professionals carry Errors & Omissions ("E&O") insurance.[2] The NASAA Broker-Dealer Section Committee and its Market and Regulatory Policy and Review Project Group ("Project Group") is studying the feasibility of E&O insurance as a potential solution. Time and time again, suggestions of E&O coverage as a potential solution have met with resistance on the grounds that it is too expensive and too difficult for smaller firms to obtain. To that end, in July 2018, the Project Group, under the direction of the NASAA Broker-Dealer Section, compiled an in-depth survey to determine whether broker-dealers carried E&O insurance and, if so, the scope of coverage.

While NASAA recognizes that E&O insurance is unlikely to provide a complete solution, it is exploring the viability of this type of insurance in the broker-dealer industry as a means of recovery for at least some investors who have succeeded in arbitration and obtained a monetary award against a broker or brokerage firm. [3] As explained below, the survey results reveal that the majority of the responding firms had E&O insurance and that their policies have paid claims. Further, the results of the survey contradict the blanket assertion that E&O insurance is too expensive or too difficult for smaller firms to obtain.

This report analyzes the information obtained from the survey in the context of the unpaid customer arbitration award data released by the Financial Industry Regulatory Authority ("FINRA"). The firms were selected based on size and location with an emphasis primarily on small to mid-sized firms.[4] Given the limited amount of data available, the Project Group was unable to analyze the types of customer claims that are unpaid or the number of claims that alleged fraud but prevailed under an alternate theory covered by E&O insurance. The Project

[1] *See* e.g., 9 V.S.A.§5616 (Vermont); Ind. Code 23-20-1 (Indiana); Mont. Code Ann. 30-10-1001 (Montana)

[2] *See* e.g., ORS 59.175 and OAR 441-175-0185 (Oregon)

[3] How this issue relates to investment advisers is an area for further review.

[4] Firm size was determined based on data contained in the CRD system operated by FINRA. "Small Firm" means any broker or dealer which has at least one and no more than 150 registered persons. FINRA Manual, Article I (jj). "Mid-Sized Firm" means any broker or dealer which has at least 151 and no more than 499 registered persons. FINRA Manual, Article I (z).

Group appreciates the cooperation of the 64 firms that provided the information compiled in this report.

Background

In 1987, the Supreme Court held that the Federal Arbitration Act established a federal policy favoring arbitration which, in essence, required courts to rigorously enforce arbitration agreements. *Shearson/American Express v. McMahon*, 482 U.S. 220, 225 (1987). Since then, most broker-dealers have required customers to agree in writing to arbitrate disputes concerning their accounts. As of April 2019, 716 customer arbitrations had been filed for this year.

The genesis of the problem of customers being unable to recover an arbitration award is not clear. In 2017, however, FINRA released snapshot data regarding unpaid arbitration awards from the time period of 2013 to 2017. *See* Statistics on Unpaid Awards, https://www.finra.org/arbitration-and-mediation/statistics-unpaid-customer-awards-finra-arbitration, last viewed July 28, 2019.

In the five-year period addressed in the FINRA data, approximately one-third of customer arbitration awards went unpaid as depicted in the chart below. *See id*.

Year	Cases With Damages Issued	Cases With Unpaid Awards	% Unpaid
2013	212	63	30%
2014	177	44	25%
2015	190	41	22%
2016	158	44	28%
2017	151	51	34%

Moreover, the unpaid customer awards constituted a significant dollar amount of the awards as depicted in the chart below. *Id*.

Year	Total Award Amount	Total Unpaid Award Amount	% Unpaid
2013	$181M	$75M	41%
2014	$66M	$33M	50%
2015	$203M	$24M	12%
2016	$119M	$14M	12%
2017	$84M	$21M	25%

According to FINRA, many unpaid customer awards are against firms or individuals whose FINRA registrations have been terminated, suspended, cancelled, or revoked, or that have been expelled from FINRA. *Id.* FINRA generally refers to these firms and individuals as "inactive." *Id*.

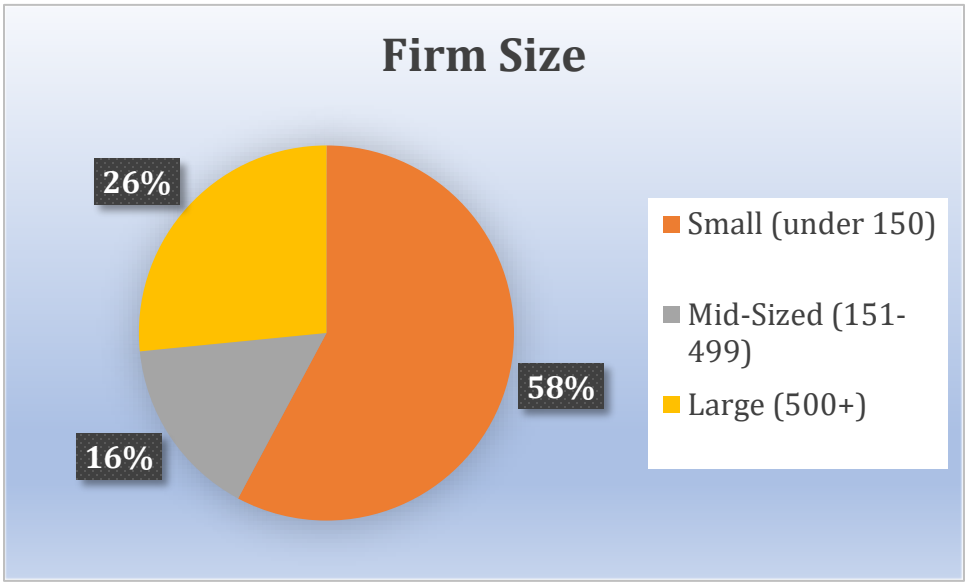
Year	% Unpaid by Firms Inactive at the Time the Claim was Filed	% Unpaid by Individuals Inactive at the Time the Claim was Filed
2013	39%	25%
2014	36%	36%
2015	8%	21%
2016	21%	36%
2017	10%	52%

Both a firm and an individual may be inactive at the time the claim is filed. *Id*. Figures in the chart above for the firms and individuals may overlap. *Id*.

The Survey

While developing the survey, the Project Group spoke with industry representatives, insurance carriers, and other market participants. These conversations provided context to guide the Project Group when drafting the survey questions. Based on the information collected from external sources, the questions sought specific information about demographics and E&O insurance coverage. The survey further sought information pertaining to all aspects of coverage including the cost of coverage, claims paid, and coverage limitations. The survey also requested redacted copies of insurance policies and the results were compiled anonymously.

The majority of the 64 firms selected for the survey were small firms as FINRA statistics revealed that unpaid customer arbitration awards against firms are primarily attributed to small firms. *See* Discussion Paper-FINRA Perspectives on Customer Recovery, https://www.finra.org/sites/default/files/finra_perspectives_on_customer_recovery.pdf, pg.7, last viewed on August 1, 2019. The following chart illustrates the breakdown of the firms surveyed by size.



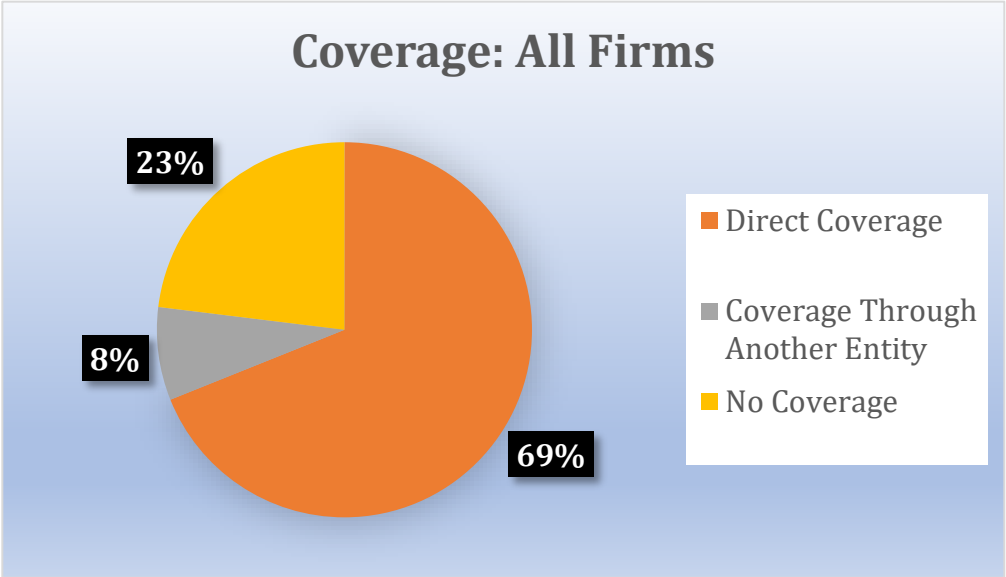
Though the focus of the survey was on small firms, the net capital of the surveyed firms varied widely. One firm reported less than $18,000 net capital; 8% of firms reported net capital in excess of $100 million; and one firm reported net capital in excess of $1.9 billion.

E&O Insurance Survey Results

The Project Group analyzed the results and reviewed the policies provided by the firms. The results are discussed below.

Number of Firms with E&O Insurance Coverage

As illustrated in the following chart, 77% of the firms surveyed carried E&O insurance. Specifically, 69% of the firms purchased E&O insurance policies directly from private carriers while 8% of the firms either had coverage through a related entity or were self-insured. Twenty-three percent of the firms surveyed had no E&O insurance coverage at all. Interestingly, 3% of the firms that did not have coverage provided coverage for its representatives.



While 23% of all firms surveyed did not have E&O coverage, a higher percentage of small firms were not covered. Forty percent of the small firms surveyed did not have E&O insurance coverage. The firms without coverage gave various reasons for not purchasing coverage. Only 4% cited cost as the reason for not purchasing an E&O insurance policy. Additionally, 25% stated that their business model did not lend itself to insurance coverage. For instance, one firm stated it only sold direct participation programs (DPPs), and insurance carriers will not cover DPPs. Another firm stated it only conducted business in governmental bonds, worked closely with counsel, and never received a complaint.

Premiums

The Project Group sought information regarding the cost of E&O insurance for brokerage firms. The survey revealed a wide range in premiums. Seventeen percent of the brokerage firms surveyed reported annual premiums under $100,000, while 4% had premiums exceeding $1 million.

In general, the diversity of the firms and the type and amount of coverage purchased made comparing the cost of coverage difficult. According to the insurance carriers, several factors affect cost, including firm size, the lines of business, and the amount and extent of coverage provided. The lowest premium of $3,493 reported on the survey was obtained by a broker-dealer with two representatives that had a net capital of $32,277. Another firm with a net

capital of $68,346 and one representative had a premium of $10,000. The following chart illustrates additional examples of the cost of coverage.

# of RRs	Net Capital	Aggregate Limit of Liability	Policy Exclusions	Premium
24	$ 422,547	$2 Million	7	$ 124,853
25	$ 603,484	$2 Million	1	$ 45,215
55	$ 750,000	$3 Million	21	$ 75,225
55	$ 2,200,000	$10 Million	Undisclosed	$ 260,000

Only 9% of the brokerage firms with coverage commented that coverage was expensive. The results suggest firms can obtain some measure of coverage at a reasonable cost.

Insurance Companies Offering Coverage

The Project Group also sought information regarding the number of providers offering E&O insurance. The responding broker-dealer firms identified a total of 28 different carriers, which was a greater number than expected by the Project Group. In addition, the business appeared to be evenly spread among the 28 carriers rather than concentrated among a few providers.

Coverage Limitations

Coverage limitations and exclusions have a material impact on the effectiveness of E&O policies as a remedy for the problem of unpaid awards. Therefore, the survey collected information on coverage exclusions. All the policies reviewed by the Project Group contained specific exclusions from coverage, and those exclusions varied from policy to policy.

None of the policies specifically excluded "arbitration claims," yet most policies excluded many of the claims typically made in arbitration, such as those relating to fraud, sale of alternative products, and unapproved private securities transactions. Notably, some E&O policies excluded specific representatives from coverage.[5] Presumably any arbitration claim arising from these activities or the excluded representatives would not be covered.

[5] The Project Group does not know the specific reason these firms excluded specific representatives; however, in general, a firm may reduce the cost of its policy by excluding a high risk representative from coverage.

Fraud was the most common exclusion from the coverage. Specifically, "activity that is either intentionally dishonest, criminal, fraudulent or a willful violation of law, rule, or regulation" was excluded from all the policies. Furthermore, there were many common exclusions among the policies. Following is a list of the most common exclusions that relate to claims that might be brought by a customer in an arbitration:

- 57% excluded alternative investment products such as commodities, hedge funds, futures, debentures, viaticals, reverse mortgages, and collectibles;
- 50% excluded selling away or other services not considered professional services;
- 39% excluded outside business activities;
- 34% excluded non-traded REITs;
- 32% excluded private securities transactions;
- 25% excluded Regulation D offerings;
- 20% excluded Regulation A+ offerings; and
- 16% specifically excluded annuities.

In addition, when comparing the brokerage firm's business to the E&O insurance policy exclusions the following was observed:

- 29% of the policies purchased by brokerage firms that sell variable life insurance policies or annuities excluded annuities, all insurance products, or both;
- 27% of the policies purchased by brokerage firms that sell private placements of securities excluded Regulation D offerings;
- 8% of the policies purchased by brokerage firms that conduct investment advisory services excluded investment advisory activities.

While some policies excluded a particular business line in which a broker-dealer was engaged, coverage was provided for the broker-dealers other lines of business.

Payment of Claims

Finally, the survey gathered information on payouts under the firms' E&O insurance policies.[6] Of the firms surveyed, 23% reported E&O insurance paying at least one claim during the most recent coverage year. Seventeen percent of the firms reported that an arbitration claim was covered by insurance, and one firm responded that its carrier paid between 11 to 15 customer arbitration claims.[7] Eight percent of the firms had at least one customer complaint (where no arbitration was filed) paid, and one firm had between six and ten customer complaints paid. At least one written demand for monetary relief was paid for in 20% of the firms surveyed. Only 3% of firms had a claim paid due to a trade error.

Conclusion

The survey concluded that over two-thirds of the firms surveyed carry E&O insurance, and at least 28 insurance companies offer policies at varying price points depending on coverage and limitations. Only 4% of the broker-dealers without coverage cited the cost of coverage as the reason and 9% of the broker-dealers with coverage stated that coverage was expensive. While all policies contained exclusions, covered claims are generally being paid. This result suggests the firms surveyed are utilizing E&O insurance to cover at least some claims made in arbitration.

Mandating E&O insurance may provide recovery for at least some investors who successfully obtain a monetary award against a broker or brokerage firm in arbitration. However, because E&O insurance may not necessarily address awards against inactive firms or claims involving fraud or other excluded conduct, it is not a complete solution to the problem of unpaid arbitration awards.

As an alternative to requiring all firms to carry E&O insurance, a requirement could be imposed only upon certain firms, such as those with a lengthy disclosure history, Taping Firms (FINRA rule 3170), or Restricted Firms (under FINRA's proposed rule 4111). In addition, requiring a brokerage firm to disclose whether it has E&O insurance, and whether that insurance covers the business conducted by the brokerage firm and the brokers employed by the firm, may provide a valuable investor protection safeguard. It would incentivize broker-dealers to obtain E&O coverage and would also allow investors to make more informed decisions about which

[6] However, no information was collected on the merit of the claim.

[7] The survey gave firms the option of choosing one to five claims, six to ten claims, eleven to fifteen claims, or over fifteen claims.

brokerage firm with which to do business. Some investors may wish to avoid firms without E&O insurance. Regardless, the survey showed that the small firms included in the survey could obtain E&O insurance at a manageable cost.