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E&O underwriters screen alt products

Private-placement debacles invite more scrutiny

By Bruce Kelly | *October 14, 2012 - 12:01 am EST*

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Insurers that underwrite errors-and-omissions policies for broker-dealers are exercising greater authority in approving the alternative investments that their clients sell.

After the private-placement disasters in 2009 of Medical Capital Holdings Inc. and Provident Royalties LLC, and the recent steep devaluations of some high-profile nontraded real estate investment trusts, insurance companies are more frequently deciding which alternative investments independent broker-dealers can sell and which ones they can't.

Dozens of broker-dealers that sold MedCap notes and Provident Royalties preferred shares have closed in the past few years, unable to withstand the cost of defending complaints by investors.

Insurance companies "have final approval," said Dean Rager, senior vice president at independent broker-dealer Geneos Wealth Management Inc.

"They decide whether they will offer insurance" on a product, he said.

"If they say no, we turn it down," Mr. Rager said.

Geneos' renewal policy from its E&O insurer, Starr Surplus Lines Insurance Co., took effect in July.

So far, the insurance company typically has turned down alternative investment products that don't have audited financial statements, Mr. Rager said.

Although insurers over the past three years have been taking a closer look at the types of alternatives products that broker-dealers sell, the scrutiny has intensified this year, insurance brokers and broker-dealer executives said.

“The biggest issue for most broker-dealers is alternative products,” said John McKenna, an E&O insurance broker with ARC Excess & Surplus LLC. “And the regulators are more present and looking to make a bigger mark on the industry as a whole. They don't want to look stupid, as some people have accused them in the past.”

Scrutiny of alternative investments can affect a broker-dealer's bottom line, executives noted.

For example, insurers are placing tighter limits on claims stemming from alternative investments, Mr. McKenna said.

A broker-dealer with an individual limit of $2 million for a claim stemming from a stock, bond or mutual fund complaint could see that limit drop to between $500,000 and $1 million if a claim is made due to an alterative investment, he said.

As limits tighten, deductibles for claims stemming from alternative investments have skyrocketed, Mr. Rager said.

Most such deductibles are $50,000; in past policies, they were $25,000, he said.

Indeed, deductibles for alternative investments can now be 33% to 50% higher than a standard deductible for a mutual fund, said Brian Kovack, president of Kovack Securities Inc.

“It's become more expensive to deal in this space,” he said.

The Financial Industry Regulatory Authority Inc., the securities industry's self-regulatory organization, is focusing not only on the suitability of alternatives products for clients but whether firms have done independent due diligence on them.

Insurers have placed “an increased emphasis on 'reasonable due diligence' by broker-dealers,” Mr. Kovack said.

Regarding nontraded REITs, insurance companies want a heightened duty of care by broker-dealers to perform a reasonable due-diligence investigation of the products, he said.

Geneos recently hired a due-diligence firm to provide continuing reports on its more than two dozen alternative investments, which include nontraded REITs, business development companies, and oil and gas partnerships, Mr. Rager said.

Major E&O insurance underwriters for independent broker-dealers include Ace USA, Catlin Specialty Insurance Co., Chartis Inc., CNA Financial Corp., Endurance Specialty Underwriters, Everest Re Group Ltd., ProSight Specialty Insurance and XL Group PLC.

E&O insurance protects against unintentional mistakes in serving clients such as human errors in trading and investment products that go bust. Many times, advisers and their reps don't understand the extent or limits of their coverage until it is too late.

CHANGED RELATIONSHIP

The relationship between broker-dealers and insurance underwriters has changed since the market collapse of 2008, industry executives and insurance brokers said.

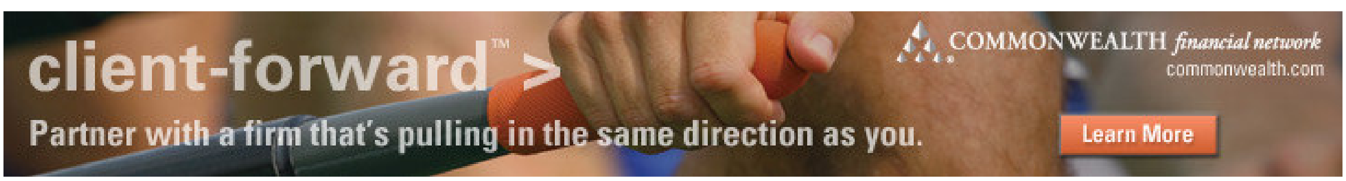
And in some cases from 2010 and 2011, broker-dealers in the middle of investor litigation became embroiled in disputes with their insurance carriers over the amount of coverage they had to satisfy claims.

"Finding out that your policy limits are not nearly what you believed them to be when you have claims is too late," said Conrad Deneault, senior vice president with The Daniel and Henry Co., an insurance brokerage firm.

In the past, product sponsors frequently paid for due-diligence reports that were then handed to broker-dealers and used to determine if a firm would sell the sponsor's product or not. Broker-dealer executives, saying that performing due diligence on their own would be too expensive, were happy to use the reports.

But in this environment, a broker-dealer relying on a product sponsor's due-diligence report has become "a hot-button issue with investor claims," Mr. Deneault said.

"Now broker-dealers must show their own due diligence to garner coverage and defense with claims," he said.



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