

BROKER/DEALER E&O

RISK MANAGEMENT



HYBRID ADVISORS – E&O COVERAGE AND OUTSIDE RIA

By Conrad M. Deneault, Jr., Senior Vice President
The Daniel and Henry Co.

The decision to extend E&O coverage to outside RIA activities is the firm's to make. The firm should do so, however, fully aware of the inherent risks, and possible alternatives. Many independent contractor broker/dealers allow registered representatives to maintain outside, unaffiliated RIAs. Representatives choose the independent channel for a reason, and flexibility with fee-based business is often a primary driver. The firm wishes to retain high caliber representatives, who would undoubtedly move on if this private securities transaction activity were denied.

The regulatory and supervisory risks to the firm are obvious and have been well documented by FINRA, the SEC, and numerous compliance consultants over the years. However, allowing outside RIA activity, and extending coverage under the firm E&O program, are two different issues and two different decision points. Regardless of the final decision, there are important risk management steps the firm may take to protect the E&O program integrity, and thus the firm itself.

The Case for Not Extending.

Preserve the E&O policy coverage. Broker/Dealer E&O is designed to protect the firm and its registered representatives, for claims arising out of professional services rendered on behalf of the firm, to clients of the firm. By extending the coverage to unaffiliated RIAs, the firm is exposing the E&O coverage limits to activity over which the firm has little practical, real-time supervisory control. Expounding on 94-44, NASD Notice To Members 96-33, states, "*Member firms have tremendous flexibility to develop and implement recordkeeping and supervisory systems that meet the unique nature and scope of their own operations...In all circumstances, however, recordkeeping and supervision must be adequate to ensure that full and complete transaction information is captured, and be reasonably designed to detect and/or prevent misconduct...*" [emphasis added]. A more concise way of stating this would be, "We are going to require supervision, we are not going to tell you how, but you best do it properly." Be assured that a FINRA examiner, or arbitration panel chair, will judge with much greater clarity at time of alleged failure.

While firms are required to supervise this activity, actually doing so effectively is very difficult. Why then, would the firm wish to expose its E&O policy? The associated liability has many tentacles. Liability arises not only from the money management activities of the hybrid representative/advisor, but also from the myriad of 3rd party money managers the advisor may have on platform (think Madoff).

Alternative: Allow the outside RIA, but do not extend coverage to the advisor/entity under the E&O program. Rather, require that the RIA carry independent E&O coverage, and show proof of coverage annually to the firm. In tandem, and this is critical, negotiate supervisory coverage for the firm under the firm's E&O program, should the firm be named in a claim for such outside advisory activity. In so doing, the firm has accomplished several objectives:

- Retention of high caliber representatives with outside RIA firms.
- The outside RIA firm's activities, policies and procedures will be analyzed and underwritten by an E&O carrier.
- At time of claim there will be another source of coverage (advisor E&O) minimizing the impact to the firm's E&O program.
- Maintaining Firm-Level E&O coverage for the firm's supervision responsibilities

BROKER/DEALER E&O

RISK MANAGEMENT

Extending the Coverage.

Broker/Dealer E&O is an extremely volatile line of insurance, and a large claim can have serious impact to a firm's ability to obtain quality coverage and pricing terms for several years. As a risk manager and insurance broker representing broker/dealers for 20 years, it is difficult to recommend extending the coverage. In reality, however, many of my clients do so, and the reasons are obvious. Many representatives with independent RIA firms have come to expect the coverage from their broker/dealer. Moreover, representatives instinctively dislike E&O and the associated fees charged them by their broker/dealer. Many firms fear that requiring hybrid representatives to obtain additional independent E&O, at additional cost and fees, will create backlash. If the firm decides to afford coverage, certain steps should be taken to protect the firm, and the long-term integrity of the E&O program, including:

- Match the policy language to the intended coverage grant for outside RIA activity. Regardless of what you have been told, do not take it on faith. As stated above, broker/dealer coverage is written contingent on the existence of a broker dealer/customer relationship, which may not exist with outside RIA clients. Look for key policy phrases that must be amended to afford the coverage, phrases such as *“for or on behalf of the broker/dealer”*, *“professional services rendered to customers or clients of the broker/dealer”*, *“pursuant to a written contract between the broker/dealer and the customer or client”*, and *“products approved by the broker/dealer”*. Such language must be modified, as the services will not be rendered on behalf of the broker/dealer, there will not be a contract with the client, and the broker/dealer approves activities, not products.
- Consider affording coverage for outside RIA only so long as the representative remains registered with the firm. Once the representative terminates, any such outside coverage ceases, regardless of when the professional services are rendered. With such a restriction, a “past representative” is unable to come back at time of claim and tap the broker/dealer policy, diminishing the coverage limits.
- Know your hybrid representatives and their RIA entities. Often, their independent RIA activities are substantially larger than their brokerage activity, increasing the E&O policy exposure dramatically. Rather than a representative with outside RIA activity, the situation is more accurately described as an investment advisor with outside brokerage activity. The broker/dealer has control over the E&O program, and can ultimately decide to extend coverage to some, but not all independent RIAs.

Regardless of which direction the firm takes regarding outside RIA coverage, there are key risk management protections the firm should implement. Failure to take such steps before a claim occurs may well result in unintended and adverse consequences to the firm and its E&O program.
