

■ AALU MEETING COVERAGE

E&O Policy Exclusions For Securities Violations On The Rise

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WASHINGTON

CONSIDER THIS TRAIN OF EVENTS: A producer tells a client that he will “shop the market” and “get the best deal” for a guaranteed universal life product. After comparing annual premiums for two policies, one from company ‘A’ priced at \$98,000 and a second from company ‘B’ priced at \$110,000, the producer recommends buying the first.

Weeks after signing the insurance contract, the client alleges the producer engaged in bid-rigging because company B’s policy could have been configured with a \$94,000 annual premium using a term rider. A district court agrees, and then slaps the producer with a \$50,000 fine—all of which has to be paid out of pocket because the producer’s errors and omissions policy excludes coverage for bid-rigging.

Sounds far-fetched? Think again. The chances of producers getting personally hit with stiff financial penalties or other sanctions stemming from securities violations are increasing, according to Larry Rybka, president of Valmark Securities, Akron, Ohio. Rybka detailed the threats facing independent producers and brokers during a session here of the Association for Advanced Life Underwriting’s annual conference.

“The stakes are high,” said Rybka. “Knowing what transactions are governed by securities regulations can mean the difference between earning a livelihood and loss of net worth because of NASD violations not protected by E&O policies.”

The minefield of uninsurable violations, he added, is growing because of a convergence of trends. Chief among these is heightened federal oversight of the insurance industry because of NASD notices and court rulings that now view certain arrangements—non-recourse financing of life insurance policies, life settlements and the sale of equity-indexed annuities—as securities transactions. Ryb-

ka also cited an expanding list of producer and broker actions that E&O policies will no longer cover and a failure among broker-dealers to keep pace with changes in securities laws.

The greatest “mortal sin” that a producer or broker can commit, said Rybka, is

WHAT'S NEW

SOME OF WHAT'S NOW EXCLUDED

In his AALU session, Larry Rybka detailed occurrences that are excluded from E&O policies, including:

- ▶ **“Fines or penalties imposed by law or regulation or self-regulatory agencies,”** such as the NASD and SEC.
- ▶ **“Sums deemed uninsurable under state law”** such as penalties and punitive damages.
- ▶ **Claims “arising from or contributed to** by activities through which the insured gained any profit or advantage” to which he or she wasn’t legally entitled, such as paying or receiving commissions without a license, insurance fraud, bid-rigging, ‘wet ink transactions’ and rebating.
- ▶ **Actual or alleged price-fixing,** price discrimination, unfair trade or anti-competitive conduct.
- ▶ **Claims arising from alleged tax advice,** except where such advice is accompanied by a written disclaimer advising the client to seek counsel from a tax professional.
- ▶ **Claims arising from placement of coverage** with a multiple employer welfare benefit plan, such as a 419 plan.

“selling away,” to wit: selling a product that one’s broker-dealer has not approved. Doing so can result in suspension or revocation of one’s securities license and/or life insurance license, an NASD investigation, public notice of penalty, and the advisor’s personal liability to investors.

The chances of producers running afoul of their broker-dealer have increased in the wake of NASD Notice 05-50, said Rybka. The ruling extends the association’s oversight to equity-indexed annuities as securities. The notice also makes

binding on producers their broker-dealer’s policy with respect to such products.

Rybka added that Notice 05-50 has created a “catch-22.” He described a scenario in which a wholesaler tells a producer that non-NASD-compliant sales materials can be used for promoting a product that the Securities and Exchange Commission hasn’t yet declared a security. Later, the product’s buyer sues when the promised benefits don’t materialize due to poor disclosure on the absence of dividends, disclosure that would otherwise have been mandated by the NASD.

E&O policies aren’t as attractive as they used to be, Rybka said, observing that policies from the four remaining E&O insurers carry lower coverage limits and higher premiums than in years past. Some broker-dealers and producers, he noted, are unable to get coverage. The policies also entail new exclusions.

For example, they won’t pay for “fines or penalties imposed by law or regulation or self-regulatory agencies,” such as the NASD and SEC. Nor will the policies cover “sums that are deemed uninsurable under state law,” such as penalties and punitive damages.

Additionally excluded from policies, Rybka observed, are claims “arising from or contributed to by activities through which the insured gained any profit or advantage” to which he or she wasn’t legally entitled. These activities include paying or receiving commissions without a license, insurance fraud, bid-rigging, ‘wet ink transactions’ and rebating.

The last may encompass non-recourse premium financing, an arrangement through which a bank finances a client’s premium payments for two years, after which the client can retain, transfer or sell the policy. Rybka said the arrangement’s key attractions for the client—the offer of free insurance for two years and the prospect of securing a portion of the cash value upon the sale of the policy to a settlement company—may constitute rebating.

Also now excluded from E&O policies are claims involving the use of confidential information not authorized by the in-

▶ continued on page 33

SMART

continued from page 6

regulator, in, of all places, federal court.”

On the positive side, the lawyer said, the “prescriptive standards” are seen as having a greater chance of meeting constitutional muster than did the language in the old bill, which merely mandated state compliance with federal standards. “Industry believes that approach raises constitutional issues,” the lawyer said.

The new draft is being prepared for presentation to Reps. Mike Oxley, R-Ohio, chairman of the committee, and Richard Baker, R-La., chair of the panel’s Capital Markets Subcommittee.

A panel spokesperson confirmed “that there has been some redrafting” but cautioned that no final decision has been made about introducing it this year.

However, an industry lobbyist familiar with the deliberations said the intent is to have it introduced this year.

In a nutshell, under standards set by Congress, the proposal would give the home-state regulator of agents pre-emptive national licensing authority, the regulator of the domicile state for a carrier the same authority, and the regulator of the state of the policyholder pre-emptive authority in the case of surplus lines.

Under the current version, a carrier would have to be examined every three years, with the home-state regulator serving as lead examiner. But the home-state regulator would be required to allow regulators in other states where the carrier does business to participate.

Several lobbyists familiar with the redraft said they believed the current draft of the streamlined bill is likely to undergo extensive changes before being introduced.

The American Council of Life Insurers was not available for comment. But, a lobbyist for a life insurance carrier who declined to be named but whose company has supported SMART since its inception several years ago, said, “It is going to be much more difficult to get us to support this bill today, even though it is being advertised as a more streamlined approach.”

The lobbyist added, “We’re questioning whether it is in our best interest to have Rep. Baker introduce this bill in the hope that we can convince him to support the OFC next year, when Rep. Oxley is no longer in the picture.” ■

AALU

continued from page 7

entire industry in jeopardy.

“The greatest lesson I learned is that we must play offense and defense in the face of the unprecedented threats faced by our industry, and the real vulnerability of the ‘three thin threads,’” Sutton said. “This phrase, coined by former AALU President Lawton M. Nease, is one that I think aptly describes the major focus of our efforts—the ‘three thin threads’ are the fundamental tax preferences afforded to life insurance.”

Rigby called SOLI sales “a significant threat,” adding that the threat is expanding and growing rapidly.

He also commented on efforts by insurance lobbyists to restrain state efforts to rewrite insurable interest laws to support SOLI and investor-owned life insurance. A provision in tax reconciliation legislation passed by the Senate, and now being dealt with by a reconciliation committee, also contains a provision tightening insurable interest laws—too tightly in the view of the industry.

Agreement was reached May 2 by Republicans on a final bill that does not include the provision, according to AALU officials.

That could be the rub, another industry official, who asked not to be named, said.

“The concern about IOLI does not end with the tax reconciliation deal, how-

ever,” the tax lobbyist said. “A number of provisions originally in tax reconciliation have been moved into a second bill, possibly the pension conference bill or a separate bill, which will not be reconciliation-protected in the Senate and for which revenue will be a key consideration.”

IOLI raised \$267 million over five years, the lobbyist said, and is supported by the Bush administration and Sen. Charles Grassley, chairman of the Senate Finance Committee. “So, we need to assume that while it appears to be out of tax reconciliation, it may not be gone for good,” the lobbyist said.

In its statement released at the meeting, the AALU said it “believes that IOLI and SOLI arrangements are not consistent with the intended purposes of insurable interest statutes within the various states.

“These practices erode principles designed to ensure that life insurance is used to protect the long-term interest of parties associated with the insured: families, businesses, business associates, and/or charities,” the statement continued.

“Where it is a common practice to take out a life insurance policy with resources provided or guaranteed by those who have no insurable interest in the insured and who expect to control the beneficial ownership of the policy in the future, we believe it puts our product in jeopardy of being taxed under rules more consistent with those applied to investment products,” the statement added. ■

SECURITIES VIOLATIONS

continued from page 10

sured. Rybka cited the example of a producer who learned about a client’s income through an accountant who failed to first get the client’s approval for the disclosure.

Likewise, producers may be without coverage if they fail to disclose to the client how they’re compensated or if they don’t make clear in what capacity they’re serving the client, be it as agent, broker or registered investment advisor.

Also in the fine print, exclusions: for actual or alleged price-fixing, price discrimination, unfair trade or anti-competitive conduct; claims arising from alleged tax advice, except where such advice is accompanied by a written disclaimer advising the client to seek

counsel from a tax professional; and claims arising from placement of coverage with a multiple employer welfare benefit plan, such as a 419 plan.

How can advisors best deal with all the new pitfalls? The first course of action, said Rybka, should be obvious, if not altogether exciting.

“It’s boring, but it’s important that advisors carefully read through their E&O policy exclusions—all 10 or 15 pages worth. Their livelihood may depend on it. Also, they’ve got to review with clients their expectations, particularly as they relate to brochures, websites and letters.

“I also advise drafting an engagement agreement for every client,” he added. “Producers and brokers also need to carefully coordinate—in writing—with their broker-dealer on offerings.” ■