PLI Exposures for Financial Services Intermediaries
PLI EXPOSURES FOR FINANCIAL SERVICES INTERMEDIARIES

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Challenges Financial Institutions Face in the wake of the financial crisis and increased regulation on the State and Federal Level

- This panel will explore the challenges underwriters have to overcome in assessing the risks associated with insuring financial service providers: Broker/Dealers, Registered Investment Advisors, Insurance Agents.
- We shall also explore the issues our claims and legal defense teams face in this highly regulated industry and the impact these issues have on underwriters.
Exposures Financial Professionals Face

• Claims Alleging:
  – Unsuitability – Age Related, Complexity/Risk of Investment, Unsophisticated Investor, Risk Averse Investor, Dementia
  – Failure to Train the Brokers/Advisors
  – Failure to Supervise the Brokers/Advisors
  – Misrepresentation
  – Guarantees of Future Earnings
  – Failure to Advise of Fees/Commissions Earned
Summary of Basic Concepts

• Financial Intermediary – Defined
• Alternative Investments – Defined
• Distinction between the fiduciary standards applied to Brokers and Advisors
• Dodd-Frank Act Proposes Uniform Fiduciary Duty
Financial Intermediary

• An entity that acts as the middleman between two parties in a financial transaction
  – Commercial banks
  – Investment banks
  – Insurance companies
  – Broker-dealers
  – Mutual funds
  – Pension funds

• Source: Investopedia
Alternative Investments

• An investment that is not one of the three traditional investment types (stocks, bonds and cash). Includes:
  – Hedge funds
  – Managed futures
  – Real Estate
  – Annuities
  – Commodities
  – Derivatives Contracts

• Source: Investopedia
ELEMENTS OF A CLAIM AGAINST A FINANCIAL SERVICES INTERMEDIARY

“Torts 101”

• DUTY OF CARE – What does an intermediary need to do for a client?

• BREACH OF DUTY – Did an intermediary not discharge her duty?

• CAUSATION – Did an intermediary’s failure to discharge her duty result in a loss?

• DAMAGES – What harm was caused by the above?
BASIC DUTY

“ORDER TAKER”

Diligently carry out a client’s instructions and immediately advise her of any reasons why instructions cannot be fulfilled.

No obligation to provide services, advice or recommendations beyond what is asked for by the client.

_Frost v. Mayville Tremaine, Inc., 750 N.Y.S.2d 398 (4th Dep’t 2002)._

_Desai v. Farmers Insurance Exchange, 55 Ca. Rptr.2d 676 (1996)._
ELEVATED DUTY

Special standard of care to go above and beyond fulfilling a client’s instructions. Includes providing advice as to insurance or financial needs regardless of what is requested.


More often, applied when there is a “Special Relationship.”

Not just a long time relationship. Depends on whether the intermediary held herself out as a consultant or expert, which induced reliance on special services by the client. *Fitzpatrick v. Hayes*, 67 Cal. Rptr.2d 445 (Ct. App. 1997); *Murphy v. Kuhn*, 90 N.Y.S.2d 371 (1997).
DUTY OF SECURITIES BROKERS

Includes all common law duties plus those imposed by SEC and FINRA.

Brokers must insure that securities are “Suitable” for a client, meaning appropriate for her financial needs and objectives.

Need to “know your client.” Basically have to get full information about worth, income, liabilities, needs and goals before recommending an investment.

Particularly with alternative investments, broker must determine that securities are suitable for any customer (i.e. due diligence) and appropriate for the particular client.

FINRA Regulatory Notice 10-22.
FIDUCIARY DUTY

Fiduciary –
“A broad term for someone who has a duty to act for the benefit of someone else. He must subordinate his personal interests to that duty in the event that there is a conflict. The duty requires fulfillment of trust and confidence, e.g., trustee, executor, administrator, guardian, committee, assignee of the benefit of creditors and public official.” The Law Dictionary, Anderson Publishing Co. (2002).

“Although we have long held that there is no general fiduciary duty inherent in an ordinary broker/customer relationship, we have also recognized that a relationship of trust and confidence does exist between a broker and a customer with respect to those matters that have been entrusted to the broker.” United States v. Wolfson, 642 F.3d 293 (2d Cir. 2011); See also United States v. Laurienti, 611 F.3d 530 (9th Cir. 2010).
FINRA Suitability Rules
(“Know Your Customer”)

• FINRA Rule 2111 (Suitability, eff. May 1, 2014)
  – RR must “have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer . . . .”

• FINRA Rule 2090 (Know Your Customer, eff. July 9, 2012)
  – RR must “use reasonable diligence . . . to know (and retain) the essential facts concerning every customer . . . .”

• FINRA Rule 2310 (Direct Participation Programs, eff. Aug. 17, 2009)
  – Standards of Suitability must be established for programs
  – Must have “reasonable grounds to believe . . . that . . . the program is otherwise suitable for the participant.”
Suitability & “Knowing Your Customer”

• **Suitability Mismatches**
  – Growth investments for customers who seek income (works in bull market, not in bear market).
  – High-risk and/or non-diversified investments for customers who lack either the objective or subjective ability to take risk.
  – Illiquid investments (e.g. limited partnerships) for customers who lack the ability or self-discipline to hold for the long term.

• **DeKwickowski v. Bear, Stearns Forex Inc., 306 F.3d 1293 (2d Cir. 2002)**
  – No breach of fiduciary duty if broker is commission only and is not an investment advisor
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

• Mandated SEC study to examine:
  – effectiveness of the existing legal and regulatory standards of care for brokers, investment advisers, and associated persons
  – whether differing standards of care causes confusion for retail customers
  – should SEC conduct rulemaking to address the current legal and regulatory standards in place
Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010

• SEC Report Released January 2011
  – recommended that SEC implement “a uniform fiduciary standard of conduct that is no less stringent than currently applied to investment advisers.”

• Debate over extending fiduciary standards
  – consumer advocates complain that the suitability rule fails to police conflicts in which brokers' financial interest drives their recommendations
  – Securities Industry and Financial Markets Association (SIFMA), endorses the adoption of a fiduciary standard for brokers
  – B/Ds concerned that fiduciary standard could hamper the promotion and sale of the firm's own products

• As of Oct. 2014, no final word yet on SEC Fiduciary Duty for Brokers, but could be announced soon.
Punitive Damages

  - $300K in punitive damages requested
  - $250K awarded by panel for breach of fiduciary duty, where Respondent engaged in “egregious behavior.”
Elder Abuse

• Statutory Law, not Common Law

• Imposes a higher standard on registered representatives

• Harder to comply with fiduciary duty standard
Claims Handling

• Likely Increase in Claimant Awards with fiduciary standard
• Increase in Discovery (Court) or Increase in Issuance of Subpoenas (Arbitration)
• Increase in Claims
  – Increasing standard will lead Plaintiff/Claimant and Attorneys to believe they have a stronger case than they actually do
FINRA Claims & Market Volatility

• Customer claims against B/Ds and RRs rise following financial market downturn

• Customer claims decrease during bull markets

• Other factors effecting the number of claims
  – increasing foreclosures
  – layoffs
  – bankruptcies
  – failing pension funds
The Bizarre Case of The People of California vs Glenn Neasham
RECAP: Neasham Case Timeline

**FEBRUARY 2008** – Neasham meets with Fran Schuber, then 83, and her boyfriend, Louis Jochim – wanting to buy an annuity “like Louis’.”

**MARCH** – County’s Elder Abuse unit gets case on report from Bank regarding boyfriend and “undue influence”

**APRIL** – Elder Abuse investigator interviews Schuber and Jochim; case closed “unsubstantiated due to victim’s uncooperativeness”

**MAY** – District Attorney refers “case” to Department of Insurance

**DECEMBER** – Department of Insurance investigator interviews Schuber and Jochim
RECAP: Neasham Case Timeline

SEPTEMBER 2009 – Neasham has annual review with Schuber. Neasham nor his assistant notice any signs of dementia

DECEMBER 2010 – Criminal complaint filed against Neasham; he is arrested and charged with felony theft from an elder; the “theft” is measured by the contingent surrender charge. E&O carrier refuses to defend. Insurer cancels his appointment.

OCTOBER 2011 – Jury finds Neasham guilty of theft based in large part on a video of a clearly incoherent Fran Schuber – taped 3 years AFTER the annuity was purchased.
FEBRUARY 2012 – Judge rejects Neasham’s request for new trial; sentences him to 300 days in jail, then reduced to 60 days. Jail sentence suspended pending appeal.
Legal & Ethical Issues of the case

Should insurance agents and other professionals (regardless of how they are paid) be legally expected to determine a client’s competence? If so …

- What training should they get?
- Will there be a Safe Harbor?
- What’s a “senior” – 60? 65?
- Other disadvantaged citizens?
Legal & Ethical Issues of the case

Should the surrender charge of an insurance policy (always used in annuities and life insurance) be the basis for *theft*?

- Jury heard no testimony on why surrender charges actually protect policy holders
- Jury equated surrender charges with commissions
The Appeal

**JULY 2012** – Society of FSP’s Board votes to retain counsel – Horvitz & Levy – to file an Amicus Brief on behalf of FSP’s 13,000 members.

**JUNE 2013** – Horvitz & Levy files on behalf of FSP an Amicus Brief with the California Appellate Court - with the financial assistance of AALU, NAFA, NAILBA, LIDMA, NAHU and a number of individual contributors.

**APRIL 2013** – Jones Day accepts Neasham’s appeals case Pro Bono on the recommendation of Horvitz & Levy.
The Appeal

**AUGUST 2013** – Oral arguments heard by the Appellate Court

**OCTOBER 2013** – California Court of Appeals over-turns jury verdict; Attorney General files immediate appeal to California Supreme Court.

**JANUARY 2014** – California Supreme Court declines to hear the case, letting the Appellate Court’s decision stand. HOWEVER – the decision was decertified – meaning it cannot be used as a precedent defense.

**FEBRUARY 2014** – Local prosecutor declines to retry. 3 years after indictment, Neasham attempts to re-build his life, career, and family.
Oral Arguments

Hypothetical #1

“If a son, knowing his mother is not competent, takes a $100 bill from her and gives her 5 $20's in return, in your opinion that is theft, correct?”

The Assistant AG was at first tentative, but soon conceded: "Yes, that is theft."
Oral Arguments

Hypothetical #2

“The son, knowing his mother is not competent, takes her on a trip to Europe. If he takes a $100 bill from her and goes to a currency exchange service and then gives her back $100 dollars worth of Euro's, that would be theft, too, correct?”

The Assistant AG replied "Yes, but we would probably choose not to prosecute."
Oral Arguments

Hypothetical #3

“The Prosecutor in the trial mentioned in her closing argument how bad a deal this annuity was for Fran Schuber. I want you to assume that the money went into a financial product that all the financial experts agree is an improvement over leaving the funds in the CD - and which has a market value at least as great as the investment. That is theft, too, correct?”

Again, the Assistant AG replied, "Yes."
The 3-Judge Panel of the Appeals Court REVERSED the jury’s judgment of felony theft.

The full opinion is available at:
http://www.courts.ca.gov/opinions/documents/A134873.PDF
“It is doubtful whether one who gives equal value in exchange for property received can ever be found to have intended to steal the property received. Defendant’s conviction must be reversed.”

California Court of Appeals
Have we “dodged a bullet?”

Are there still implications for the relationship between elderly clients and their

Attorneys
Accountants
Insurance Professionals
Investment Professionals
Planning Professionals
And it’s recently been discovered

The California Department of Insurance levies $1 per new policy sold in the state for a special fund. The purpose is to provide grants to local prosecutors to pursue criminal charges against insurance agents for the alleged sales practice violations. No consumer complaint is necessary.

In the past, these violations – almost always requiring a customer complaint – have in the past been processed through administrative hearings. As appropriate, agents found guilty of bad sales practices were fined and/or had their licenses suspended.
Let’s talk about SUITABILITY

Too little / too late for Neasham: as required in the Dodd-Frank Financial Reform Act of 2010, most states have already adopted some form of annuity and/or life SUITABILITY regulations

2010 Suitability in Annuity Transactions Model Regulation “… establish a regulatory framework that …

1) holds insurers responsible for ensuring that annuity transactions are suitable …

2) requires that producers be trained on the provisions of annuities in general, and the specific products they are selling, and

3) where feasible and rational, to make these suitability standards consistent with the suitability standards imposed by the Financial Industry Regulatory Authority (FINRA).”
Let’s talk about SUITABILITY

Cruel irony: Allianz claimed it had no obligation to “…determine the suitability of that policy on behalf of that client.”
Let’s talk about SUITABILITY

Elements of suitability that are prescribed by the Model Act and which an agent should consider in product or plan recommendations include:

(1) Age;

(2) Annual income;

(3) Financial situation and needs, including the financial resources used for the funding of the annuity;
Let’s talk about SUITABILITY

Elements of suitability that are prescribed by the Model Act and which an agent should consider in product or plan recommendations include:

(4) Financial experience;

(5) Financial objectives;

(6) Intended use of the annuity;

(7) Financial time horizon;
Let’s talk about SUITABILITY

Elements of suitability that are prescribed by the Model Act and which an agent should consider in product or plan recommendations include:

(8) Existing assets, including investment and life insurance holdings;

(9) Liquidity needs;

(10) Liquid net worth;
Let’s talk about SUITABILITY

Elements of suitability that are prescribed by the Model Act and which an agent should consider in product or plan recommendations include:

(11) Risk tolerance; and

(12) Tax status
Sample Questions to Establish Competence

1. What is your full name?
2. Where do you live?
3. Are you married?
4. What is the name of your spouse/significant other?
5. What are the names of your children and where do they live?
6. Who is the current President of the United States?
7. What is today's date?
Ask for clarification

We have discussed the following needs/interests as important to you. Are they still important and in the right order? Why?

We have discussed the following as a solution to your needs/interests. Can you explain to me how that solution works and how it solves your needs?
Memorialize

Take careful notes and keep the originals in the client’s file.

Record all client sessions.
Summary
What Agents Can Do Right Away

• Focus on suitability and the Golden Rule

• Maintain your expertise and knowledge; be an expert

• Discuss your process with BGA / Carrier / Broker-Dealer

• Work with your partners / associates / staff to develop a PROCESS for working with older clients

• Keep good records!
Glenn and Tonya Neasham – prior to his indictment