



PROFESSIONAL LIABILITY UNDERWRITING SOCIETY

Financial Institutions' E&O: Weathering the Storm

Moderator

Luigi Spadafora, Winget, Spadafora & Schwartzberg, LLP

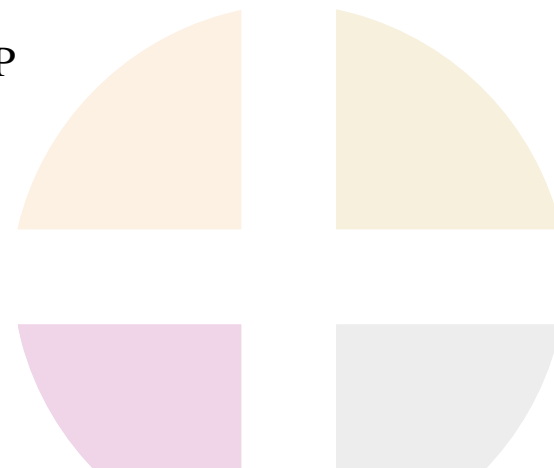
Panelists

Jimmy Kirtland, Voya Financial

Mary McIvor, AIG

John McKenna, ARC Excess & Surplus

Lilian Morvay, Catlin



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OVERVIEW

- FINRA arbitrations up 8% over 2013
- Increased regulatory oversight by more aggressive regulators
- Claims in this environment become more product specific (REITS, DPP'S, etc.)
- We will provide an overview of the exposures, regulatory/litigation environment, claims and other effects on coverage and placements

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TYPES OF EXPOSURES

- Fund Liability
- REITS
- Hedge Funds
- Private Equity
- Investment Banking
- Security Broker Dealer



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- **FUND LIABILITY**

- Investment Advisor Litigation – The `40 Act
- Started with market timing investigations
- Excessive management fees (12-B-1 Fees)
- Inadequate prospectus disclosure



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- **REITS**

- Publicly Traded REITS

- Non-Traded REITS

- a) Liquidity/valuation issues (FINRA Reg. No. 09-09)

- b) Had been priced at par on customer statements

- c) In July 2014 proposal, FINRA proposes mandating as estimated value on customer statements- “sticker shock” to follow



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- **HEDGE FUND LITIGATION**

- Fund Manager Claims

1. Conflict of interest
2. Failure to disclose risk
3. Failure of due diligence on underlying investments

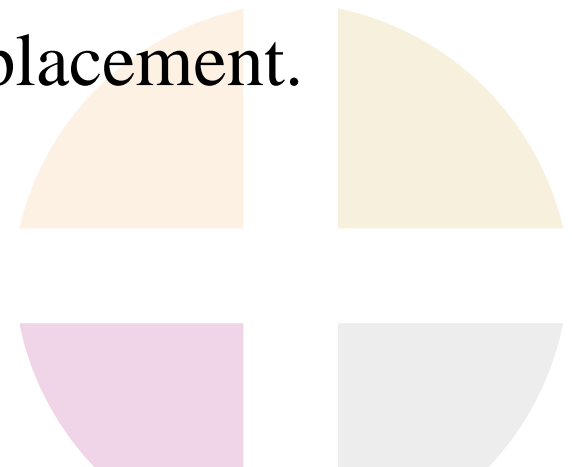
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- **PRIVATE EQUITY**

- A Private Equity fund, usually organized as a limited partnership or limited liability company, raises capital from a limited number of sophisticated investors in a private placement.

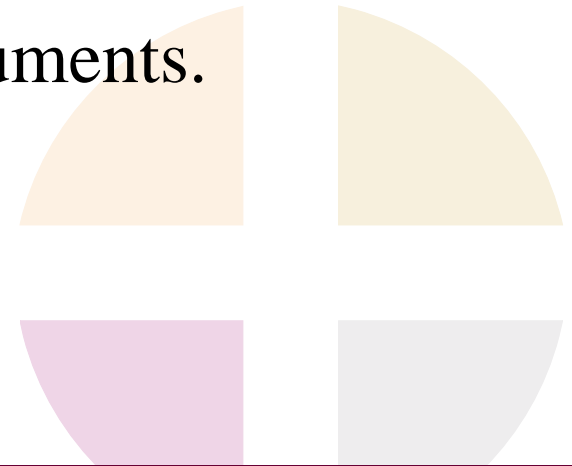


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- Portfolio entity files for bankruptcy. Claims arise by creditors.
- Breach of contract claims if acquisition does not go through. Sometimes target seeks a termination fee if contained in acquisition documents.



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INVESTMENT BANKING

- Fee disputes in connection with private placement can mushroom into claims of wrongdoing in connection with PPM.
- Failure to disclose risks in PPM.
- Failure to do proper due diligence.
- Aiding and abetting the company for which capital is being raised.
- Conflicts with the board of directors of the selling company. See *In re Rural Metro Corp.*, C.A. No. 6300-VCL (Del. Ch. March 7, 2014)

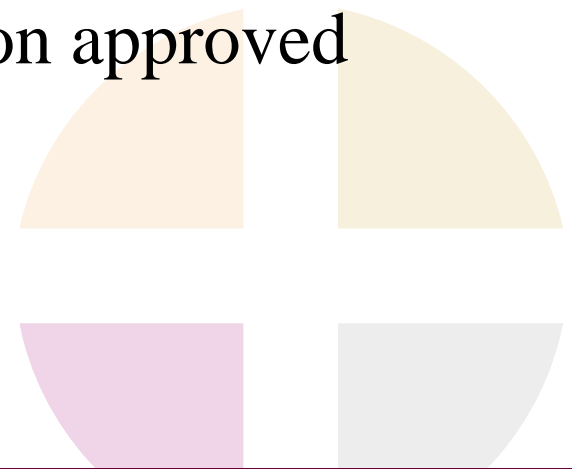
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- **SECURITY BROKER DEALER**

- Independent BD vs. “Wirehouse”
- Failure to Supervise Claims
- Failure to Conduct due diligence on approved products
- Suitability





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REGULATORY ENVIRONMENT

- SEC
- FDIC
- CFPB
- FINRA



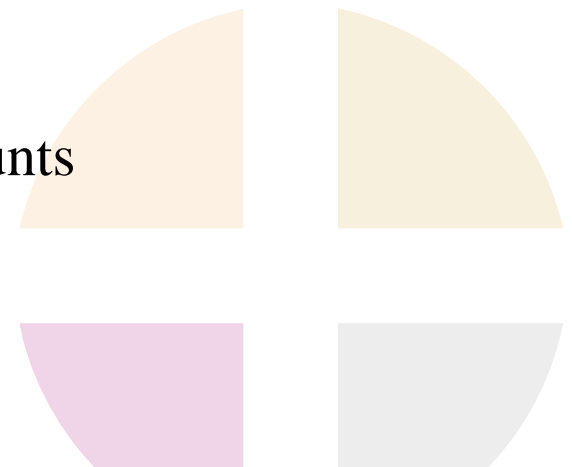
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SEC

- Chair Mary Jo White is a former prosecutor-more aggressive
- SEC Stated priorities for 2014
 1. Conflicts of interest
 2. Regulate alternative investments
 3. Fee based managed accounts/ Wrap accounts
 4. Dual Registration
 5. Retirement Rollovers



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FDIC

1. Like other regulators has become increasingly aggressive, especially in the wake of the Financial Crisis.
2. Lawsuits against former directors and officers of failed banks increased from 2 in 2010 to 40 in 2013 due to increase in such failures and more aggressive enforcement.
3. FDIC seized 24 banks in 2013 which is the lowest number since 2007.
4. FDIC has brought 735 professional liability claims since 2008 with 430 having been resolved and 305 still pending.

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CONSUMER FINANCIAL **PROTECTION BOARD**

1. Created by the Dodd-Frank Act and started in 2011.
2. It covers mortgages, bank accounts and services, private student loans, auto and other personal loans, credit reporting, debt collection, payday loans and other consumer-oriented financial products. In August 2014, it will start regulating pre-paid cards, pawn shops and debt settlement companies.
3. Has won \$4.6 billion in damages in connection with 15 million consumer complaints.
4. Has increased Federal funding and will only become more aggressive.

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FINRA – RECENT CHANGES AND REQUIREMENTS

FINRA rule changes, Regulatory Actions and Regulatory Notices have created new challenges for Broker-Dealers and the insurance companies who insure them:

- Regulatory Notice 12-03: Heightened Supervision of Complex Products
- Regulatory Notices 11-25 and 12-25: New Suitability Rule

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Regulatory Notice 12-03: “Heightened Supervision of Complex Products”

- Provides guidance to firms about the supervision of “complex products”
 - Does not define what constitutes a “complex product”
 - Characteristics of a complex product: “Any product with multiple features that affect its investment returns differently under various scenarios is potentially complex”



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Regulatory Notice 12-03: “Heightened Supervision of Complex Products”

- Types of products specifically mentioned:
 - Asset-backed securities (e.g. CMOs)
 - Unlisted REITs
 - Reverse convertibles
 - Inverse and leveraged ETFs
 - Structured notes
- List is not exhaustive



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Regulatory Notice 12-03: “Heightened Supervision of Complex Products” (Continued)

Guidelines Regarding Heightened Supervision

- Reasonable basis suitability determination—is the product suitable to sell to at least some of the firm’s customers?
(as opposed to customer-specific determination done on an investor by investor basis)
- Firm must perform reasonable diligence to understand the risks.
 - Testing under extreme market conditions
 - List of questions to be answered



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Regulatory Notice 12-03: “Heightened Supervision of Complex Products” (Continued)

- Post-approval review—continued assessment of suitability even after the product has been approved for sale and sold to customers.
 - Monitor how the products performed after the firm approved them (periodically reassess the product)
 - Insure that only RR’s who are authorized to recommend are doing so



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Regulatory Notice 12-03: “Heightened Supervision of Complex Products” (Continued)

- Customer-specific suitability assessment (akin to options trading account):
 - Consideration of customer’s financial sophistication
 - Discussions with customer regarding their financial sophistication, investment objectives, and the product’s features
 - Limitations/Conditions
 - Pre-qualification of retail investors through specialized investor qualification agreements
- Formal written procedures regarding the suitability assessment
- Training of registered representatives: RR’s need to understand Features and Risks
- “Payoff Diagram”
- Features/Risks of Reference Asset
- Consider whether a less complex or costly product would achieve the same objective

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Regulatory Notices 11-25 and 12-25: Clarifying and Interpreting Rule 2011, the “New Suitability Rule”

- FINRA Rule 2111, the new Suitability Rule, went into effect **July 9, 2012**.
- New guidelines/guidance for assessing suitability.
- Two-tiered suitability analysis:
 - Reasonable basis suitability analysis: is the recommendation suitable for any of the firm’s customers?
 - Customer-specific suitability analysis: is the recommendation suitable in light of the specific customer’s investment objectives and financial wherewithal?

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**Regulatory Notices 11-25 and 12-25:
Clarifying and Interpreting Rule 2011, the “New Suitability Rule”
(Continued)**

- FINRA Regulatory Notice 12-25 (May 18, 2012): Additional Guidance on FINRA’s New Suitability Rule:
- What constitutes a customer’s “best interests”?
- Clarification re: definitions of certain terms
 - “Recommendation”
 - “Customer”
 - “Investment strategy”
- Clarification re: when advising a client to hold a security constitutes a “recommendation”.
- Analysis of the risk-based approach to documenting compliance with suitability obligations.

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CLAIMS

- Insider Trading investigations
- Overdraft fee litigation
- Whistleblower
- LIBOR Claims
- Investor Claims
- Suitability/Churning



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INSIDER TRADING **INVESTGATIONS**

1. Starts out on the regulatory side (US Attorneys/SEC/State Attorney Generals/Department of Financial Services).
2. US Attorney can bring criminal action against inside traders
3. SEC can bring enforcement action or a civil lawsuit
4. SEC has tightened its rules against insider trading in response to different Court interpretations

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OVERDRAFT FEE LITIGATION

1. Series of lawsuits started by the CFPB
2. Plaintiffs' attorneys brought numerous class actions
3. Argument between lenders and insurers as to whether liability policies covered such claims or whether they were considered disgorgement of profits
4. 9th Circuit held such losses might be covered by insurance while Northern District of Georgia stated they are not.



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WHISTLEBLOWER LITIGATION

1. Section 1057 of Dodd-Frank enacted additional whistleblower protection and incentives for employees. Employees cannot be retaliated against and can recover 10 to 30% of any SEC recovery.
2. FINRA opened an Office of Whistleblowing.
3. Since Section 1057 became effective in 2011 there have been a number of district varying court opinions about the scope of the statute and what constitutes whistleblowing. A roundup of the cases can be found in *Bussing v. COR Clearing*, 2014 U.S. Dist. LEXIS 98616 (D. Ne. July 17, 2014)(stating that courts have rendered different opinions on scope of Dodd-Frank and cited to District Courts in Massachusetts, New York, Colorado, Connecticut, Tennessee, Florida and California.

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LIBOR CLAIMS

LIBOR (the London Inter-Bank Offered Rate) is the rate at which banks would lend to one another. It is based on the interest rates of 16 banks and is calculated on a daily basis with the top 4 and bottom 4 submitted interest rates being discarded and taking an average of the middle 8. In 2007, suspicion arose that there was rate rigging among the banks and throughout the Financial Crisis, that suspicion grew with UBS and RBS paying major fines for alleged bid rigging.

This has resulted in investor suits relating to LIBOR based derivatives as well as investors who claim they did not receive interest that was due them because of artificially low LIBOR rates. The case is consolidated before Judge Naomi Buchwald in the United States District Court for the Southern District of New York.

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INVESTOR CLAIMS

FINRA has noticed a slight uptick in claims in 2014 vs. 2013 (an 8% increase). This is still down substantially from the highs of 2009-2011. The types of products are still common stock, mutual funds and variable annuities. There were still 31 auction rate securities claims filed in 2013 and after seeing 228 claims relating to derivatives filed in 2010, none were filed in 2013 or the first half of 2014. Given the issues of liquidity and being relatively new, claims involving DPPs (which typically fall under limited partnerships) remain relatively high.

No matter the product, suitability remains one of the most prominent claims after misrepresentation/omission. Churning and unauthorized trading remain relatively small, but constant (245 churning claims in 2012, 238 churning claims in 2013 and 105 as of June 2014).

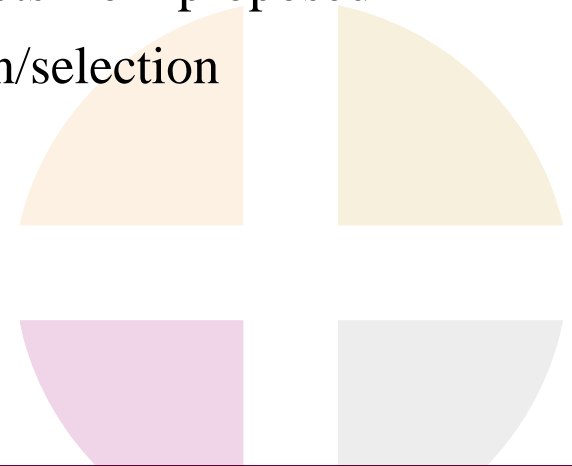
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CHANGES IN SECURITIES BROKER E&O COVERAGE

- Alternative Products: sublimits, interrelation, and other coverage issues
- Selling Away
- Increasing Retentions and potential further effects from proposed change to the FINRA public arbitrator definition/selection
- Other Problem Products



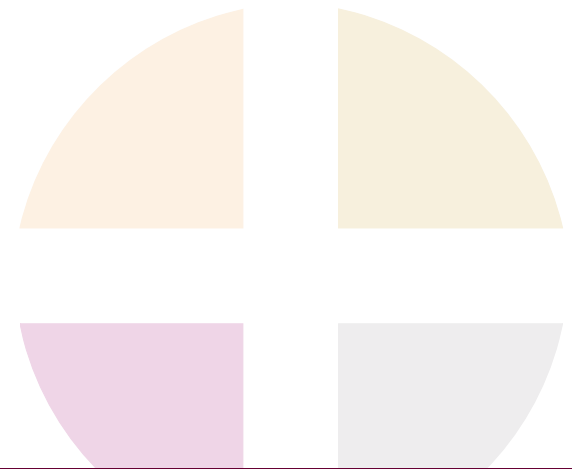
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EFFECTS ON PLACEMENTS

- Markets
- Risk analysis
- Rates



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Q&A