CLIENT ADVISORY

ENHANCING SECURITIES MARKET INVESTORS' PROTECTION IN NORTH AMERICA

There can be little doubt that the financial markets' crisis has changed investors' understanding of and appetite for risks. But it is not merely the volatility and reversal in stock market performance which has driven these perceptions. The failure of major banks, securities broker/dealers and insurers, together with an upswing in cases of fraud, has meant that investors are profoundly concerned with the protection of assets they have entrusted to others. It is difficult enough these days to make any gains from stock market investments, but assessing and managing risks associated with investors' choice of broker is an almost impossible task, given the apparent randomness of insolvencies and failures.

INVESTOR COMPENSATION SCHEMES IN THE US/CANADA

Fortunately, there are statutory bodies in both the US and Canada which have been created to address these concerns. Indeed, the Securities Investors Protection Corporation ("SIPC") and the Canadian Investors Protection Fund ("CIPF") have the sole responsibility of compensating investors in the event that securities broker/dealers fail (i.e., become bankrupt) and are unable to return customers' segregated securities or cash balances.

There can also be little doubt that both the SIPC and the CIPF undertake this task very generously; compensation is paid irrespective of the circumstances which may have led to the broker/dealer's inability to fully restore or return customer assets on a very inclusive, as opposed to exclusive, basis. Apart from a few exceptions (mainly directors, officers and those with controlling interests in the brokerages themselves and those customers whose assets are not segregated, such as prime brokerage customers) every investor – whether individual, corporation, financial institution, charity, trust or other legal entity – is entitled to primary compensation cover.

In addition, the SIPC pays a maximum of $500,000 in compensation with respect to lost securities, with a sub-limit of $250,000 for cash, which is equal to the sum that the FDIC currently offers. The CIPF meanwhile offers compensation up to a maximum of $1M per customer and is arguably the most generous scheme of its type in the world.

EXCESS COVER

The level of primary cover provided by both the SIPC and the CIPF, together with the pro-rata distribution of surviving customer assets, means that very high percentages of securities market investors in both the US and Canada would expect to be fully compensated in the event that their broker/dealers failed.

However, for high net worth individuals and other "corporate" investors, even these sums could represent only a small percentage of losses suffered. For this reason, the arrangement of excess SIPC/CIPF insurance policies has long been available to broker/dealers to assuage the concerns of their clients and to provide valuable additional protection over and above the amount of statutory primary protection they are afforded by the SIPC/CIPF.

But in this day and age, what investor is not concerned with the failure of their broker or the theft, fraud or other act of wrongful abstraction at this entity? Thus, there has been an ever-increasing number of broker/dealers in both the US and Canada which arrange excess SIPC/CIPF cover as a staple element of the protection mechanisms created for customers' assets.

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CONTACT

For more information, contact your professional lines broker at AmWINS. If you do not currently work with one, please visit amwins.com for a list of AmWINS locations.

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Indeed, any broker who acts as a custodian for clients, from small broker/dealers with $100M in client assets to enormous brokerages with over $1TR of customer assets, should contemplate arranging this type of cover. With policy limits available from just $20M to $1BN, more capacity available, and the ability to include the existence of this additional coverage in marketing materials, there is real opportunity to differentiate between broker/dealers.

At least 50 brokerages in the US and six in Canada annually return to the London insurance market to arrange such cover. Those that do not arrange such cover are potentially at a very great competitive disadvantage given the actions of their peers.

LIMITATIONS OF COVER

Excess SIPC/CIPF policies generally follow the form of the underlying schemes, in that anyone who is eligible for primary cover is automatically entitled to excess cover. However, London insurance policies respond solely to named perils (such as theft, fraud, embezzlement and other acts of wrongful abstraction of customer assets). Thus, there are potential instances in which customer assets are subject to primary SIPC/CIPF protection, but may not be returned in full because they cannot be traced back to one of the named perils mentioned above. The loss of excess customer cash balances held externally at a bank which subsequently fails is a good example of an exceptional event. In such cases, excess SIPC/CIPF policies cannot and would not respond, as this would in effect translate into a form of a contingent financial guarantee.

Other than scenarios like that described above, the excess SIPC/CIPF policies are designed to offer inclusive and defined protection which sits very comfortably above the statutory compensation vehicles which have been established in both the US and Canada.

STATE OF THE MARKET

Recent events in the financial markets have changed underwriters' perceptions on this type and class of business. It is no longer seen as a benign, almost risk-free policy. But while premiums have risen to reflect the perceived increase in generic risks, they remain competitive and affordable. However, underwriters are now more risk-aware and assess risks on a case-by-case basis rather than applying a broad rate-on-line, meaning that depending on the risk characteristics, some broker/dealers fare better than others.

In addition, there has been a noticeable trend in the size of cover requested, per customer sub-limits and even the "carving out" of certain clients in additional policies to cover the specific interests of a few major investors.

Overall, a very flexible and accommodating market exists in London for excess SIPC/CIPF cover and insurable sums remain substantial and meaningful.

As such, the market for excess SIPC/CIPF insurance is not only apparently here to stay, but it is developing, expanding and is in higher demand than ever. Just ask any securities market investor why.

AmWINS Professional Lines and THB Professional Risks
The AmWINS Professional Lines Practice is a team of more than 100 individuals focusing exclusively on executive and professional liability. Annually, the team handles more than $700M in premium placements, $200M of which is placed in the London market. As a company, we have built specialized solutions for unique problems, and our practice uses the expertise of our London-based colleagues at THB Professional & Financial Risks to market on behalf of our U.S. retail clients. This gives our retail partners the assurance that we are using the full resources within the AmWINS organization to solve their clients' problems.