

December 2, 2025

Via Email Only @ russ.mccracken@vermont.gov

Russ McCracken
Assistant General Counsel
Vermont Department of Financial Regulation
89 Main Street
Montpelier, VT 05620

RE: Comment Letter Regarding DFR Regulation Number: S-2016-01 Vermont Securities Regulations

Dear Mr. McCracken:

I write on behalf of the Public Investors Advocate Bar Association ("PIABA"), an international bar association comprised of attorneys who represent investors in disputes with the securities industry. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in rules promulgated by both state and federal securities regulators relating to both investor protection and disclosure. As such, PIABA frequently comments upon proposed rule changes and retrospective rule reviews in order to protect the rights and fair treatment of the investing public.

Background

We understand the Department of Regulation is proposing changes regarding, among other things, the addition of a requirement that Vermont-domiciled investment advisers controlling client funds carry errors and omissions insurance. Specifically, the requirement adds to the protection of customers by increasing the monetary protections above the much lower minimum adjusted net worth requirements currently in the Rule. PIABA supports this amendment.

Discussion/Position

PIABA applauds the Department of Regulation's proposal to require all member firms to maintain appropriate liability insurance. The proposal addresses the long-standing and well-documented problem of unpaid arbitration awards, which continues to plague the financial services industry and harm investors in every state, including Vermont. Justice requires that investors harmed by financial professionals and their firms are not left injured and without practical remedy merely because they were doing business with, what turned out to be, a thinly-capitalized advisor. PIABA believes that the interests of protecting investors could be advanced even more if Vermont required insurance more generally for financial advisors operating within the state. While the DFR's survey of Vermont-registered investment advisers ahead of its rule proposal concluded it is common for

Vermont investment advisers to maintain E&O insurance, many RIA firms across the country operate without any liability insurance, and some even structure themselves with no intention to ever satisfy adverse arbitration awards.

PIABA has written extensively on this problem in the past. Attached to our Comment Letter is a recent article from PIABA's immediate past president, Adam Gana, and Professor Benjamin Edwards, entitled "The Insurance Solution for Financial Advice Failures." We echo our members' voices here. As PIABA has advocated over the years, requiring financial services providers to carry insurance solves several problems simultaneously, including but not limited to:

1. **Insurance ensures recoverability.** It dramatically reduces the number of unpaid awards by providing an external funding source when a firm fails or disappears. *See, e.g.* Vermont's Department of Financial Regulation's *In Re: Thomas Chadwick et. al.*, NO. 22-011-S.
2. **Insurance enforces discipline.** Insurers price risk. They require firms to implement compliance programs, reject known bad actors, and avoid risky behaviors that lead to claims. In effect, insurers act as a private market discipline mechanism.
3. **Insurance is commonplace and feasible.** States like Oregon and Oklahoma already require investment advisers to carry insurance. Major custodians like Schwab and Fidelity have also implemented insurance mandates for firms on their platforms. These requirements have *not* reduced access to financial advice, and the number of advisers in those jurisdictions *increased* post-implementation.¹
4. **The market supports implementation.** Empirical data show that requiring even modest insurance coverage (e.g., \$1 million per firm) does not drive professionals from the industry.² If anything, mandatory insurance can enhance investor trust and attract more business to reputable, well-insured firms.

Vermont's leading effort to add errors & omission requirements pursuant to V.S.R. § 7 aligns with longstanding efforts within Congress, North American Securities Administrators Association (NASAA), and the SEC to address unpaid awards. Furthermore, Vermont's proposal aligns with the broader, national sentiment and positions on this investor protection issue.

In sum, PIABA supports the amendments, and thanks the Commission and FINRA for the opportunity to comment on these proposals.

Sincerely,



Michael C. Bixby, President
Public Investors Advocate Bar Association

Attachment

¹ See Chuan Qin & Craig McCann, *RIA Insurance Mandates Didn't Reduce Access to Advisory Services*, SLCG ECON. CONSULTING, <https://www.slcg.com/resources/blog/713> (last visited Aug. 28, 2024)

² *Id.*

THE INSURANCE SOLUTION FOR FINANCIAL ADVICE FAILURES

ADAM J. GANA AND BENJAMIN P. EDWARDS¹

ABSTRACT

Solving the retirement savings crisis requires widespread access to reliable financial advice. Yet financial advisers now often operate without insurance, collecting fees and commissions from customers and leaving them penniless when substandard advice causes harm. Instituting insurance coverage requirements would provide protection for investors and allow market forces to discipline misconduct. For decades, advocates and regulators have raised awareness about the millions of unpaid arbitration awards each year; an insurance solution would greatly reduce the harm suffered.

This essay aims to create a roadmap to solve the problem. It identifies the problem and maps out the different levers available to policymakers to increase overall insurance coverage across a fragmented regulatory landscape.

¹ Adam J. Gana is the managing partner of Gana Weinstein LLP and the president of the Public Investor Advocate Bar Association. Benjamin P. Edwards is a Professor of Law at the William S. Boyd School of Law at the University of Nevada, Las Vegas. Thanks to Adam Marchant for research assistance and Jennifer Shaw for thoughtful comments on the draft.

Table of Contents

<i>I. Introduction and Background</i>	2
<i>II. Existing Insurance Requirements are Imperfect</i>	5
A. Limited Existing State Insurance Mandates Have Not Reduced Access to Investment Advice	5
B. Industry Insurance Requirements	7
C. Existing Insurance Disclosure Requirements	8
1. Kansas Insurance Disclosure Requirement.....	8
2. Limited Access to Insurance Coverage Information	9
D. Marketplace Impacts from Insurance Requirements	10
<i>III. A Framework to Improve Insurance Coverage</i>	11
A. Elements of A Successful Insurance Program	11
1. Appropriate Coverage Amounts and Terms for Firm Size and Characteristics ...	11
2. Functioning Insurance Markets Price Risk And Reduce Misconduct	13
3. Insurance Disclosure.....	13
B. Possible Implementation Sources	14
1. Uniform State Legislation or Regulation.....	14
2. Securities and Exchange Commission Action.....	15
<i>IV. Conclusion</i>	17

I. INTRODUCTION AND BACKGROUND

Investors wronged by wealth management firms often find themselves unable to recover. For example, Bruce Wilkerson reached the Super Bowl as an offensive tackle for the Green Bay Packers in 1996.² After he left the National Football League, having played for the Packers, Jaguars, and Raiders, he worked as a machinist and trusted Resource Horizons Group, a brokerage firm, to manage the wealth he earned by putting his body on the line.³ After one of the brokerage's registered representatives ran a Ponzi scheme, an arbitration within the Financial Industry Regulatory Authority's ("FINRA") Dispute Resolution Forum found Resource Horizons Group liable for over \$600,000 in compensatory damages and another \$1.4 million in damages under the Tennessee Consumer Protection Act.⁴ Yet Wilkerson would never see any recovery because Resource Horizons Group closed its doors without insurance to cover Wilkerson's claim.⁵

For decades, bottom-tier financial services firms have profited by selling high-commission products only to fold once claims for abusive sales practices arrive.⁶ In 2000, the Government Accountability Office found that nearly two-thirds of arbitration awards against stockbrokers and brokerage firms went unpaid.⁷ Often, the brokers involved scurry from one brokerage to another, continuing to exploit investors. This occurs so often that some use the term "cockroaching" to describe "brokers moving from one problem firm to

² Mason Braswell, *Ex-NFL player left out in the cold after \$2 million award*, INVESTMENT NEWS (Jun. 22, 2015), <https://www.investmentnews.com/industry-news/features/ex-nfl-player-left-out-in-the-cold-after-2-million-award-61449>.

³ Benjamin Edwards & Hugh Berkson, *Fix the flaw in financial self-regulation*, THE HILL (Mar. 19, 2018), <https://thehill.com/opinion/finance/379134-fix-the-flaw-in-financial-self-regulation/>.

⁴ *Wilkerson v. Resource Horizons Group, LLC, FINRA Case Number 14-00904*, (available at https://www.finra.org/sites/default/files/aao_documents/14-00904-Award-All%20Public%20Panel-20150311.pdf).

⁵ Melanie Waddel, *Savings of Ex-NFL Player Left Gutted by Unpaid FINRA Arb Award*, THINKADVISOR (Mar. 7, 2018), <https://www.thinkadvisor.com/2018/03/07/ex-nfl-player-wilkerson-deeply-affected-by-unpaid-finra-arb-award/>.

⁶ United States General Accounting Office, SECURITIES ARBITRATION: ACTIONS NEEDED TO ADDRESS PROBLEM OF UNPAID AWARDS, U.S. GOV'T ACCOUNTABILITY OFFICE 33 (2000), <https://www.gao.gov/assets/ggd-00-115.pdf>.

⁷ *Id.* (finding that "an estimated 61 percent . . . of investors who won arbitration awards in 1998 either were not paid or received only partial payment.").

another.”⁸ Financial advisers will sometimes even shift from selling securities to other financial products simply to evade federal oversight.⁹

Wall Street’s deadbeat firms come in different varieties. Some operate as FINRA-supervised brokerage firms,¹⁰ generally selling securities in exchange for transaction-based compensation.¹¹ Others operate as registered investment advisory firms, generally receiving compensation directly for investment advice about securities.¹² Often, firms and individuals will operate under both regimes simultaneously, with their duties and obligations shifting depending on the hat worn at the time.¹³ Adding to the complexity, many financial advisers also sell insurance products under lax state regulation and supervision.¹⁴

In recent years, business models have shifted, with more brokers and brokerage firms shifting to operate as investment advisers.¹⁵ Private equity firms have accelerated this move by acquiring investment advisory firms for their predictable cash flows and growth.¹⁶

Both brokerage and advisory firms often operate without any insurance and leave investors unable to recover if problems arise.¹⁷ Although the unpaid award problem has been extensively studied and documented in the brokerage

⁸ Jean Eaglesham & Rob Barry, *More Than 5,000 Stockbrokers From Expelled Firms Still Selling Securities*, WALL ST. J. (Oct. 4, 2013), <https://www.wsj.com/articles/more-than-5000-stockbrokers-from-expelled-firms-still-selling-securities-1380843149>.

⁹ Colleen Honigsberg, Edwin Hu & Robert J. Jackson, Jr., *Regulatory Arbitrage and the Persistence of Financial Misconduct*, 74 STAN. L. REV. 737, 742 (2022) (studying “financial advisers who exit federal oversight after committing serious misconduct yet continue to advise investors” in insurance transactions).

¹⁰ FINRA is a trade association of brokerage firms charged with serving as the front-line regulator for brokerage firms. The Securities and Exchange Commission supervises FINRA and a number of other self-regulatory organizations.

¹¹ See SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS iii (Jan. 2011) (describing broker-dealers and investment advisory firms) (*available at* <https://www.sec.gov/files/913studyfinal.pdf>).

¹² *Id.*

¹³ *Id.* at 12-13.

¹⁴ Honigsberg, Hu & Jackson, *supra* note 9, at 740-42.

¹⁵ Justin Mack, *Independent and hybrid RIA channels are adding advisors the fastest, Cerulli report says*, FINANCIAL PLANNING (Nov. 1, 2023), <https://www.financial-planning.com/list/independent-and-hybrid-ria-channels-are-adding-advisors-the-fastest-cerulli-report-says>.

¹⁶ Ian Salisbury, *Your ‘Independent’ Advisor Now Works for Private Equity. What It Could Mean for Your Portfolio.*, BARRON’S (Jun. 14, 2024), <https://www.barrons.com/articles/financial-advisors-private-equity-clients-portfolio-de076c68>.

¹⁷ North American Securities Administrators Association (NASAA), E&O INSURANCE SURVEY REPORT, NASAA 2 (Dec. 2019), <https://www.nasaa.org/wp-content/uploads/2019/12/2019-BD-EO-Survey-Report-Formatted-FINAL.pdf>.

context,¹⁸ the problem extends beyond brokerages. NASAA enforcement reports show that both investment advisors and brokers regularly misbehave.¹⁹

After decades of harm, federal policymakers have taken notice and demanded action. The U.S. Securities and Exchange Commission (SEC or the “Commission”) Investor Advocate recently called for investment advisers to disclose more information to better understand the scope of the problem in the advisory context.²⁰ Congress has also begun applying pressure for FINRA to take action to address the problem in the broker-dealer space. The Senate Committee on Appropriations recently found that “FINRA has failed to undertake steps to address unpaid arbitration awards by its members.”²¹ It directed that the “SEC shall continue to engage with FINRA to identify ways to reduce and eliminate the occurrence of unpaid awards.”²²

Despite this problem persisting for decades and leaving investors with enormous losses, a solution to dramatically mitigate the problem exists—insurance. In this context, insurance requirements offer two major benefits. First, insurance companies may force brokerages and advisory firms to adopt better practices to maintain coverage at favorable rates. Second, a reasonable degree of insurance will allow more investors to recover in instances when and if harm arrives. Notably, this insurance solution does not guarantee that all investors will recover every dime in every instance of misconduct. Yet, an industry carrying insurance offers investors substantially better protection than an industry without it.

The states have taken some action to improve insurance coverage. Notably, two states—Oregon and Oklahoma—have already moved to require some wealth management firms to carry insurance.²³ Their requirements offer some lessons for a broader insurance mandate. At a minimum, the existing numbers in the aftermath of this natural experiment indicate that creating modest insurance requirements does not lead to any material reduction in the

¹⁸ See Hugh Berkson & David P. Meyer, *Finra Arbitration’s Persistent Unpaid Award Problem*, PUBLIC INVESTOR ADVOCATE BAR ASSOCIATION (Sept. 2021), <https://piaba.org/piaba-newsroom/piaba-report-finra-arbitrations-persistent-unpaid-award-problem-september-29-2021> (documenting the unpaid arbitration award problem in the brokerage context).

¹⁹ NASAA, 2020 ENFORCEMENT REPORT 13 (2020), <https://www.nasaa.org/wp-content/uploads/2020/09/2020-Enforcement-Report-Based-on-2019-Data-FINAL.pdf>.

²⁰ SEC OFFICE OF THE INVESTOR ADVOCATE, FISCAL YEAR 2023: REPORT ON ACTIVITIES 43 (Dec. 5, 2023), <https://www.sec.gov/files/2023-oiad-annual-report.pdf> (explaining that “[a]n absence of information prevented Staff from generating reliable statistics about the frequency of SEC-registered adviser arbitration or the number of unpaid arbitration awards”).

²¹ S. REP. NO. 118-206, at 103 (2024).

²² *Id.*

²³ Or. Rev. Stat. Ann. § 59.175; Okla. Admin. Code 660:11-7-11.

availability of financial advice for main street investors.²⁴ However, the existing insurance requirements only reach a portion of the wealth management firms operating within those jurisdictions.²⁵

This essay aims to explore the critical need for insurance and provide guidance for how to require insurance across a fragmented financial advice industry.²⁶ Part II discusses the imperfect existing insurance requirements and errors and omissions insurance marketplace available today. Part III frames the elements of a successful insurance program and overviews the regulatory mechanisms for instituting insurance requirements.

II. EXISTING INSURANCE REQUIREMENTS ARE IMPERFECT

At present, state and federal law says little about insurance requirements for wealth management firms.²⁷ As financial advisers may be supervised by FINRA, state securities regulators, state insurance regulators, the SEC, or some combination of the foregoing, requiring coverage across the industry will require coordinated action from an array of regulators.

Fragmented and overlapping regulation may partially explain the inaction when it comes to mandatory insurance. For example, if FINRA moved first and mandated that brokerage firms carry insurance, it might place brokerage firms at a competitive disadvantage to state and SEC-registered investment advisory firms. The same may be true if the states or SEC acted first.

Despite the pressure toward inaction, some insurance requirements have emerged and merit consideration at the state level and from clearing firms.²⁸ Critically, current evidence indicates that insurance requirements, as currently implemented, do not appear to meaningfully alter the public's ability to access investment advice.²⁹

A. Limited Existing State Insurance Mandates Have Not Reduced Access to Investment Advice

Many financial advisers now practice without insurance or enough insurance to cover liability.³⁰ Currently, only two states—Oregon and

²⁴ See Qin & McCann, *infra* note 65.

²⁵ OR. REV. STAT. § 59.175 (2018); OKLA. ADMIN. CODE § 660:11-7-11 (2024).

²⁶ See Christine Lazaro & Benjamin P. Edwards, *The Fragmented Regulation of Investment Advice: A Call for Harmonization*, 4 MICH. BUS. & ENTREPRENEURIAL L. REV. 47 (2014) (explaining how fragmented regulatory structures complicate overseeing financial advice).

²⁷ § 59.175; 660:11-7-11.

²⁸ *Id.*

²⁹ See Qin & McCann, *infra* note 64.

³⁰ See NASAA, *supra* note 17.

Oklahoma—require some financial advisers to carry some professional liability insurance for errors and omissions. Yet both have exemptions for broker-dealers, relying on FINRA to fill the regulatory gap—an invitation FINRA has yet to accept.³¹

In 2018, Oregon began requiring all state-registered investment advisers to carry at least \$1 million in errors and omissions insurance.³² The \$1 million requirement applies to all firms regardless of size, capturing intra-state brokerage operations and state-registered investment advisers.³³

Oregon's requirement does not capture all investment advisers operating in the state because Oregon only oversees a portion of the market. Investment advisers may register with the SEC when their regulatory assets under management reach \$100 million or more.³⁴ At that point, the SEC oversees their operations instead of the state.³⁵

Oregon's flat \$1 million coverage requirement may generate a degree of inequity among financial firms. For example, under Oregon's statute, a firm with \$6 million in assets under management has the same insurance requirements as a firm with \$96 million in assets under management.³⁶ To the extent that policies cost approximately the same, firms with smaller assets under management will pay a higher relative cost than firms with more assets. The requirement may also create an incentive for smaller advisory firms to merge with larger firms to reduce costs or entirely avoid Oregon's insurance requirement by transitioning to SEC oversight.

When Oklahoma followed Oregon's lead in 2020 with an administrative rule requiring state investment advisers to carry \$1 million in errors and omissions insurance, it too missed the opportunity to provide a tailored coverage requirement.³⁷ Notwithstanding the gaps in coverage, the laws increase investor protection in both states to this day.³⁸

Although the insurance mandate itself is simple, both states worked to facilitate compliance. To make sure that all licensees can access the coverage they need, Oregon and Oklahoma both admitted surplus line insurers and risk

³¹ § 59.175; § 660:11-7-11.

³² § 59.175.

³³ *Id.*

³⁴ 17 C.F.R. § 275.203A-1(a)(1) (2011) (“You may, but are not required to register with the Commission if you have assets under management of at least \$100,000,000 but less than \$110,000,000, and you need not withdraw your registration unless you have less than \$90,000,000 of assets under management”).

³⁵ *Id.*

³⁶ § 59.175.

³⁷ § 660:11-7-11.

³⁸ § 59.175; § 660:11-7-11.

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retention and purchasing groups into the state.³⁹ In Oregon, licensees simply submit annual proof of insurance.⁴⁰ Firms that fail to submit proof of insurance risk having their licenses canceled.⁴¹

B. Industry Insurance Requirements

Some financial advisers carry insurance because some custodial platforms insist on insurance for advisers using their platforms.⁴² For example, in 2021, Charles Schwab & Co. (“Schwab”) launched a program to eventually require all Registered Investment Advisers (“RIA”) using its custodial services to carry at least \$1 million in insurance, including errors and omissions coverage.⁴³ Like Oregon and Oklahoma, Schwab undertook measures to ensure that the insurance market could accommodate the new rule, which included working with insurance companies to obtain preferred pricing for Schwab’s clients.⁴⁴

RIA firms voluntarily elected to comply with Schwab’s insurance requirement instead of seeking a different custodial platform. Unlike the states, where in-state advisers had to comply or lose their licenses, Schwab’s users could have readily chosen to shift to a different custodial platform because none of Schwab’s competitors imposed similar requirements.⁴⁵

Instituting the insurance requirement did not reduce Schwab’s market share. Despite 2022 being one of the worst-performing years for stocks and bonds in history, Schwab’s net income still increased after mandating insurance, and Schwab saw rapid RIA growth in 2023.⁴⁶

³⁹ OR. ADMIN. R. 441-175-0185(3) (2018); OKLA. ADMIN. CODE § 660:11-7-21 (2024).

⁴⁰ OR. REV. STAT. § 59.225 (2018).

⁴¹ § 59.225.

⁴² When a person buys securities, a brokerage firm ordinarily keeps custody of the securities for the benefit of the individual. Investment advisers managing client portfolios generally use select brokerage platforms to custody and transact business.

⁴³ *What Insurance Is Required for RIA Firms?*, SCHWAB, <https://advisorservices.schwab.com/navigating-risk-regulation/advisor-insurance> (last visited July 27, 2024).

⁴⁴ See Sam Del Rowe, *Schwab Requiring RIA Firm Clients to Purchase Errors and Omissions, Other Insurance*, FINANCIAL ADVISOR IQ (Dec. 20, 2021), https://www.financialadvisoriq.com/c/3441634/437184/schwab_requiring_firm_clients_purchase_errors_omissions_other_insurance.

⁴⁵ *Id.*

⁴⁶ *2022 Annual Report*, SCHWAB 6 (2022), https://content.schwab.com/web/retail/public/about-schwab/schwab_annual_report_2022.pdf; Diana Britton, *Schwab Benchmarking: RIA Growth Rebounds in 2023*, WEALTH MANAGEMENT (July 18, 2024), <https://www.wealthmanagement.com/ria-news/schwab-benchmarking-ria-growth-rebounds-2023>.

Schwab's insurance requirement may provide it with a range of benefits. In instances where a claimant names Schwab as a defendant alongside an advisor using its platform, Schwab may now be readily assured that the RIA firm will have coverage and counsel—potentially mitigating Schwab's costs.

Schwab's insurance requirement may also provide a filtering mechanism for uninsurable firms. To the extent that any RIA firm cannot obtain insurance because of risks unique to that RIA firm, Schwab likely benefits by excluding the firm from its platform. Thus, the insurance requirement may allow Schwab to use insurance companies to exclude firms that would draw the most litigation and attendant problems for Schwab from its platform.

Despite Schwab's influence in the marketplace, private insurance requirements have not yet proliferated and changed broader industry practice.⁴⁷ Financial advisers often operate without insurance, and other custodial platforms do not require firms to maintain insurance.

C. Existing Insurance Disclosure Requirements

Insurance disclosure requirements might also play a role in investor protection. Knowledge of insurance coverage can influence an investor's behavior, such as whether to work with an adviser and whether and how to pursue a claim if the adviser causes harm. Yet, as it stands, investors are generally poorly situated to evaluate insurance information and often lack access to basic information about a financial adviser's insurance.⁴⁸

1. Kansas Insurance Disclosure Requirement

In 2012, Kansas began requiring investment advisers to disclose their professional liability insurance status to all current and prospective clients.⁴⁹ In theory, requiring investment advisers to disclose their professional liability insurance information allows clients to take this information into account when deciding between firms.⁵⁰ A disclosure requirement may even drive some financial advisers to obtain insurance to avoid disclosing that they operate without insurance.

Securities law often defaults to a disclosure-oriented model because disclosure plays such a critical role in both the market and the SEC's regulation

⁴⁷ See Sam Del Rowe, *supra* note 43.

⁴⁸ *Does My Investment Advisor Have Insurance?*, SAMUELS YOELIN KANTOR LLP (Oct. 30, 2018), <https://www.investordefenders.com/blog/does-my-investment-advisor-have-insurance/>.

⁴⁹ In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By K.A.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856 at *2 (Nov. 7, 2012).

⁵⁰ An Oregon legislator recently proposed a bill that would similarly allow the state to require investment advisers to disclose their policy and coverage information. H.B. 2274, 82nd Or. Leg. Assemb., Reg. Sess. (Or. 2023).

of public company disclosures.⁵¹ Yet disclosure-oriented rules may not achieve investor protection goals in this context because many people work with financial advisers because they desire informed guidance. Unlike public company disclosures, no market price transmits information about a financial adviser in real-time to other persons seeking information about the financial adviser.⁵² No market mechanism makes uninformed investors aware that sophisticated investors have shunned advisers without insurance.⁵³

In this context, disclosure requirements may even expose the least sophisticated investors to greater risks. If some relatively sophisticated clients alert to risks and leave the adviser, the remaining clients likely face greater peril because the advisor still needs to pay bills and must now generate the same income from a shrinking client base. Unscrupulous advisers may opt to make up the difference by exploiting investors.

Kansas's disclosure requirements may be most useful for investors after harm occurs. Because Kansas firms must disclose their insurance status, investors who have suffered harm can take insurance information into account when deciding whether to pursue relief.⁵⁴

2. Limited Access to Insurance Coverage Information

Despite Kansas's requirement, insurance coverage information often remains a closely guarded secret. In contrast to ordinary litigation, FINRA arbitration does not require its members to produce information about insurance coverage in arbitration.⁵⁵ FINRA's current discovery guide does not require brokers to provide information about any insurance coverage they may have.⁵⁶ As a result, investors may pursue actions against uninsured brokers who cannot afford to pay claims.⁵⁷ In contrast, the Federal Rules of Civil Procedure mandate parties to disclose insurance coverage.⁵⁸

⁵¹ See Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. L.Q. 417, 418 (2003) ("Securities regulation is motivated, in large part, by the assumption that more information is better than less. Perhaps this is no surprise since the SEC's chief regulatory tool is to require companies to disclose more.").

⁵² See David Harper, *Forces That Move Stock Prices*, INVESTOPEDIA (May 20, 2024), <https://www.investopedia.com/articles/basics/04/100804.asp>.

⁵³ *Id.*

⁵⁴ In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By K.A.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856 at 2 (Nov. 7, 2012).

⁵⁵ See *Discovery Guide*, FINRA (2013), <https://www.finra.org/sites/default/files/ArbMed/p394527.pdf>.

⁵⁶ *Id.*

⁵⁷ See NASAA, *supra* note 17, at 2.

⁵⁸ See FED. R. CIV. P. 26(a)(1)(A)(iv) (requiring disclosure of "any insurance agreement under which an insurance business may be liable to satisfy all or part of a possible judgment in the action").

Realizing the inequity in its process, in 2018, FINRA requested comments about a potential rule that would require brokers to disclose their insurance information in arbitration proceedings.⁵⁹ Making insurance information presumptively discoverable could prevent wronged investors from digging a hole for themselves by pursuing claims against uninsured brokers that might never be able to satisfy an award.⁶⁰

Requiring parties to exchange information about insurance coverage does not come without risks. The contemplated rule aimed to ensure that insurance coverage information would not overly shift outcomes in arbitrations.⁶¹ FINRA aimed to address concerns that knowledge about insurance coverage might prejudice arbitration panels by designating insurance information as inadmissible absent extraordinary circumstances.⁶²

For reasons that remain unclear, FINRA chose not to move forward with the rule.⁶³ As a result, many investors now proceed with claims against uninsured brokerages incapable of paying damages.⁶⁴

D. Marketplace Impacts from Insurance Requirements

To forestall any regulation, the financial advice industry will sometimes argue that raising standards would hurt the public because it would reduce their access to financial advice. Opponents of mandatory insurance contend that insurance requirements would do more harm than good by reducing the public's ability to find financial advice. Yet the best available evidence indicates that this simply is not true.

Consider how advice markets reacted to the introduction of existing insurance requirements. After implementing errors & omissions insurance mandates, Oregon and Oklahoma did not experience a reduction in financial advisory services.⁶⁵ In fact, after the mandates became effective in each state, the number of investment advisers increased and did not fall relative to other states without a mandate.⁶⁶ An in-depth study of the number of investment advisers in Oregon and Oklahoma before and after the mandates introduction shows

⁵⁹ FINRA, REGULATORY NOTICE 18-22 (2018), <https://www.finra.org/rules-guidance/notices/18-22>.

⁶⁰ See NASAA, *supra* note 17, at 2.

⁶¹ See FINRA, *Discovery Guide*, *supra* note 54.

⁶² *Id.*

⁶³ See FINRA, REGULATORY NOTICE 18-22, *supra* note 58.

⁶⁴ See NASAA, *supra* note 17, at 2.

⁶⁵ Chuan Qin & Craig McCann, *RIA Insurance Mandates Didn't Reduce Access to Advisory Services*, SLCG ECONOMIC CONSULTING (Aug. 2024), <https://www.slcg.com/resources/blog/713> (last visited Aug. 28, 2024).

⁶⁶ *Id.*

that the insurance requirements had no material effect on the number of financial advisers in either state.⁶⁷

Although the benefit to the public will be significant, industry insurance costs appear low relative to the profitability of financial advice firms. After Schwab's insurance requirement for investment advisors, the number of advisors using Schwab's custodial services also increased despite a severe economic downturn.⁶⁸

Despite the marginal cost, insurance requirements may increase the volume of financial advice business. More widespread insurance requirements could drive demand by making the industry easier to trust. With insurance behind the industry, more members of the public may work with advisers.

III. A FRAMEWORK TO IMPROVE INSURANCE COVERAGE

Widespread insurance coverage would likely benefit both investors and financial professionals. Investors would more often recover damages in instances of misconduct and benefit from any risk reductions generated by insurance company requirements. Responsible financial firms already carrying insurance would no longer operate against competitors without insurance.

A. Elements of A Successful Insurance Program

Successful insurance reforms should aim to achieve some core objectives. We propose three here: (1) ensuring appropriate coverage amounts and terms for firm size; (2) generating functioning markets that price risk and reduce misconduct; and (3) providing information about coverage.

1. Appropriate Coverage Amounts and Terms for Firm Size and Characteristics

Although one-size-fits-all insurance coverage requirements do some good by mandating coverage, they also generate problems. A per claim two-million-dollar coverage requirement will be too small for some firms and too large and expensive for others. Rather, insurance requirements must consider the size of the firm and provide coverage requirements proportional to the amount of risk that a firm imposes on the public. Appropriately tailored insurance requirements would ensure adequate coverage without imposing undue costs on financial services firms.

Insurance coverage requirements should increase with a firm's assets under management. Tying a firm's insurance level to its asset level ensures that it will be able to afford appropriate coverage. One simple solution would be to

⁶⁷ *Id.*

⁶⁸ SCHWAB, *supra* note 46, at 6.

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require firms to maintain the greater of either (1) a million dollars in coverage or (2) insurance coverage equivalent to 2% of assets under management. This would mean that a firm with \$99 million in client assets would need just under \$2 million in coverage. In contrast, a firm with only \$15 million in assets would only need to carry a million in coverage.⁶⁹

Regulators crafting insurance requirements should also ensure that policy terms do not render protective benefits illusory. For example, a firm might acquire coverage with a high per-incident deductible. Functionally, these policies mean that insurance funds will only become available for a claim after the deductible has been met and each claim must meet its own deductible before tapping into coverage. If the insurance policy only applied after the firm spent more than \$250,000 in costs for defense, a firm facing five or six claims arising out of selling a toxic financial product to investors might face up-front costs greater than the insurance policy's coverage amount and simply opt to go out of business.

This does not mean that no firms should be able to use higher-deductible coverage. A regulatory response here should aim to preserve flexibility while ensuring that insurance coverage improves outcomes. One solution to this problem would be to require firms using high-deductible policies to hold cash or other high-quality assets equivalent to their insurance deductibles.

Here, risk does not always scale uniformly between firms. Some firms pose heightened risks to the public and might benefit from additional coverage. For example, FINRA internally designates certain firms as “restricted” and selects them for a higher degree of oversight because of the risks their operations pose to the public.⁷⁰ Although FINRA does not currently require these firms to carry *any* insurance, a uniform insurance requirement would do enormous good simply by ensuring that these toxic firms carried insurance as well.

⁶⁹ Tying the insurance requirement to a firm's asset level avoids the need to index for inflation or make other changes. As the firms grow, their insurance should grow with them.

⁷⁰ See *Rule 4111 Frequently Asked Questions*, FINRA, <https://www.finra.org/rules-guidance/key-topics/protecting-investors-from-misconduct#:~:text=Firms%20with%20a%20Significant%20History%20of%20Misconduct,-FINRA%20Rule%204111&text=Rule%204111%20allows%20FINRA%20to,numeric%2C%20threshold%2Dbased%20criteria> (last visited Aug. 29, 2024) (explaining that the “rule allows FINRA to impose new obligations on broker-dealers with significantly higher levels of risk-related disclosures than other similarly sized peers, based on numeric, threshold-based criteria”).

2. Functioning Insurance Markets Price Risk And Reduce Misconduct

Insurance coverage requirements may generate a range of benefits. At the outset, coverage requirements may reduce prices for insured firms by mandating participation. By requiring all firms to procure insurance, risk pools expand—allowing insurance companies to offer coverage at lower prices through economies of scale.

Well-functioning insurance markets also spread risk across firms. Firms hiring financial advisers may not always be able to determine which advisers will generate liability and which ones will not.⁷¹ By requiring the entire industry to maintain insurance, the cost of financial adviser misconduct gets spread across many different firms.

Yet insurance requirements offer another benefit—the ability to price and limit known risks. To the extent that certain firms or individuals pose greater risks to the public—insurance companies now use that information to price their coverage.⁷² Since insurance companies charge more for hiring these high-risk individuals, an insurance requirement may disincentivize firms from hiring them or, at minimum, spread the risk of their bad behavior. These coverage requirements also force riskier firms to internalize the risk their operations create.

For insurance to provide the most benefit, it must cover every financial adviser working with the public. At present, some insurance companies write policies for financial services firms that exclude specific financial advisers from coverage because of identified risks associated with the individual.⁷³ This creates a gap in coverage for those most likely to create harm.⁷⁴

Requiring firms to procure coverage for these higher-risk advisers would generate real benefits. To the extent that a particular financial adviser is too costly to insure, the insurance market may protect the public more swiftly than a regulatory bar by excluding the individual from the industry.

3. Insurance Disclosure

Insurance disclosure requirements may also ensure that investors benefit from coverage. A good disclosure rule would require all investment advisors and

⁷¹ Pricing financial adviser risk may be challenging because of how much complaint data has been expunged from public records. See Benjamin P. Edwards, *Adversarial Failure*, 77 WASH. & LEE L. REV. 1053 (2020) (detailing how a flawed expungement process led to the deletion of public records about complaints against financial advisers).

⁷² See NASAA, *supra* note 17, at 6 (“[I]n general, a firm may reduce the cost of its policy by excluding a high risk representative from coverage”).

⁷³ *Id.*

⁷⁴ *Id.*

broker-dealers to disclose to current and prospective clients information about insurance coverage and provide their current and prospective clients with a copy of their policy upon request.⁷⁵ Although this will not ensure that every meritorious claim will be paid, it could keep many harmed investors from going deeper into the hole by pursuing claims against firms unable to pay an award.⁷⁶

Disclosure requirements would also allow more sophisticated investors to select financial advisers with greater coverage. This would allow the market to reward financial advisers for carrying additional insurance. Although this solution would not do much to help unsophisticated clients *ex-ante*, they would be better able to assess their options *ex-post* should a claim arise.

B. Possible Implementation Sources

Although the need for widespread insurance for financial services firms appears clear, no single regulator now possesses the power to mandate insurance across the market. Rather, a range of different overlapping state, federal, and self-regulatory organizations must take steps to introduce insurance requirements.

1. Uniform State Legislation or Regulation

At the outset, states retain substantial influence over financial regulation and directly regulate a subset of investment advisers and brokerage firms.⁷⁷ Although states sometimes chart their own course on securities law issues, they often adopt model legislation and regulations promulgated by the North American Securities Administrator's Association. ("NASAA").⁷⁸ Nevada, for example, even explicitly statutorily directs its state securities regulator to consult NASAA's model regulations when crafting rules.⁷⁹

By acting through NASAA and generating uniform insurance legislation and regulations, state securities regulators can increase the odds states will enact

⁷⁵ In Re: Waiver of Certain Requirements Under K.A.R. 81-14-9 and New Requirement Authorized By K.A.R. 81-14-10 For Disclosure Regarding Insurance Coverage, 2012 WL 5473856, at 2 (Nov. 7, 2012).

⁷⁶ See SAMUELS YOELIN KANTOR LLP, *supra* note 48.

⁷⁷ *Guide to Broker-Dealer Registration*, SEC (Apr. 2008), <https://www.sec.gov/about/reports-publications/divisionsmarketregbdguidehtm#III> (Broker-dealers must "apply for broker-dealer registration with each state [they conduct] business"); Advisers Act Rule, 17 C.F.R. § 275.203A-1(a)(1) (providing that advisers with less than \$90 million in AUM must withdraw their SEC registration and switch to state registration, advisers with between \$100 million and \$110 million in AUM may elect to register with the SEC, and advisers with over \$110 million in AUM must register with the SEC).

⁷⁸ *NASAA Model Act to Protect Vulnerable Adults from Financial Exploitation*, NASAA, <https://www.nasaa.org/industry-resources/senior-issues/model-act-to-protect-vulnerable-adults-from-financial-exploitation/> (last visited Aug. 23, 2024).

⁷⁹ See NEV. REV. STAT. § 90.785(2)(a) (2023).

insurance requirements covering a significant portion of the industry. Uniform regulation also offers an additional benefit—when states take the same approach, it minimizes the burden for firms operating across multiple state jurisdictions.

NASAA has succeeded in generating widespread investor protection reforms in the past. For example, its model legislation to protect vulnerable adults from exploitation has been adopted in most states.⁸⁰ NASAA adopted the model legislation in 2016, and most states have enacted it in one form or another, providing substantially greater protection to vulnerable adults in adopting states.

2. Securities and Exchange Commission Action

The SEC may act to impose insurance requirements directly on registered investment advisers and indirectly for brokerage firms.⁸¹ The Commission has direct regulatory authority over registered investment advisers with over \$100 million in assets under management.⁸² It also enjoys a degree of direct authority over brokerage firms and substantial flexibility through its oversight of the Financial Industry Regulatory Authority.⁸³

In an ideal world, all investment advisers and broker-dealers should be required to maintain an errors and omissions insurance policy or policies in the aggregate amount of at least two percent of assets under management as a condition of SEC registration. Yet the road to this goal may be complicated because the Supreme Court recently weakened administrative agencies power to regulate.⁸⁴ Under new precedent, courts no longer defer as much to administrative agencies interpreting and applying somewhat ambiguous statutes.⁸⁵ This does not mean that the SEC should stand idle for fear of some possible challenge.

a. Investment Advisers

The SEC enjoys substantial authority to increase insurance coverage and might opt to do so in different ways. To simply impose an insurance requirement, the Commission could make insurance a condition of

⁸⁰ See NASAA, *supra* note 78.

⁸¹ See 15 U.S.C. § 78s(c) (stating that the SEC may by rule “add to, and delete from ... the rules of a self-regulatory organization ... to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter ... or otherwise in furtherance of the purposes of this chapter”).

⁸² Advisers Act Rule, 17 C.F.R. § 275.203A-1(a)(1).

⁸³ See Benjamin P. Edwards, *Supreme Risk*, 74 FLA. L. REV. 543, 556-60 (2022) (describing the SEC’s power to oversee SRO regulation).

⁸⁴ See *Loper Bright Enters. v. Raimondo*, 144 S. Ct. 2244, 2265 (2024) (eliminating *Chevron* deference).

⁸⁵ *Id.*

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registration.⁸⁶ Although the law does not explicitly grant the Commission the power to impose an insurance requirement, the Commission would be within its authority to deem carrying insurance “necessary or appropriate in the public interest or for the protection of investors.”⁸⁷

In the alternative, the Commission might use its power to regulate arbitration agreements to impose a coverage requirement. Dodd-Frank gave the SEC the power to impose conditions on arbitration agreements.⁸⁸ Congress explicitly authorized it to “impose conditions or limitations” on arbitration agreements “if it finds that such prohibition, imposition of conditions, or limitations are in the public interest and for the protection of investors.”⁸⁹ As these arbitration agreements often impose significant costs on investors, the SEC may require firms to maintain an insurance backstop ensuring some ability to pay before forcing investors into a costly dispute resolution forum.

At the same time, the Commission might also require investment advisers to make disclosures about their insurance coverage.⁹⁰ Although this power would not allow it to impose a mandate to purchase insurance, it would force firms to notify their clients about their insurance coverage.

The Commission might simultaneously adopt a severable coverage and disclosure requirement to address the risk that a federal court would deem the insurance requirement beyond the scope of the Commission’s authority.

b. Brokerage Oversight

Brokerage regulation may be more flexible because FINRA, an ostensibly private entity, serves as the primary regulator for brokerages under SEC supervision.⁹¹ At present, FINRA does not need congressional authorization to make investor protection rules.⁹² Rather, the self-regulatory

⁸⁶ See § 15 U.S.C.A. 80b-3(c)(1) (West) (“An investment adviser . . . may be registered by filing with the Commission an application . . . containing such of the following information and documents as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors”).

⁸⁷ *Id.*

⁸⁸ 15 U.S.C.A. § 78o (West). The Act also grants the SEC authority to impose requirements through self-regulatory organizations, such as FINRA. *Id.*

⁸⁹ 15 U.S.C.A. § 80b-5(f) (West).

⁹⁰ *Id.*

⁹¹ See Edwards, *supra* note 83 at 556-60 (2022) (describing SRO model).

⁹² See *FINRA Rulemaking Process*, FINRA, <https://www.finra.org/rules-guidance/rulemaking-process#:~:text=Following%20SEC%20approval%2C%20FINRA%20issues,and%20announcements%20the%20effective%20date>. (last visited Aug. 23, 2024).

organization could simply impose an insurance requirement as a condition of membership.⁹³

FINRA also enjoys the power to solve disclosure problems. It maintains a “discovery guide” to facilitate disclosures in securities arbitration.⁹⁴ FINRA could ensure insurance disclosure as well by simply finalizing the disclosure rule it considered in 2018.⁹⁵

As the federal regulator overseeing FINRA, the SEC enjoys power to cause FINRA to amend its rules. It could do so informally through moral suasion or explicitly through its power to amend FINRA’s rules.⁹⁶

Although the primary regulator for brokerage firms, FINRA could also use its authority to improve investment adviser conduct. Investment advisers generally custody assets through FINRA brokerage firms. FINRA could require that brokerage firms only allow third parties such as investment advisers to manage securities accounts for others if they maintain appropriate insurance. Indeed, as explained above, Schwab has already taken this approach on its own initiative.

IV. CONCLUSION

Ultimately, the need for widespread insurance remains clear. Until now, financial services firms have largely succeeded at externalizing the cost of bad financial advice while keeping the profits for themselves. Insurance solves for some of this problem by causing the industry to internalize some of the costs created by misconduct.

This essay charts a path for improving insurance coverage across a financial advice market governed by a broad coalition of regulators. Although the available tools to impose insurance requirements will differ depending on the regulatory actor, the need remains urgent across the market.

⁹³ To its credit, FINRA has taken some measures to cause brokerage firms known to pose heightened risks to keep more cash on hand to protect future creditors. *See* FINRA Rule 4111, Restricted Firm Obligations. These requirements would be more effective alongside insurance.

⁹⁴ *See* FINRA, *supra* note 55.

⁹⁵ *Id.*

⁹⁶ *See* 15 U.S.C.A. § 78s(c) (West).