

Don't Make Insurance Coverage An Afterthought When Entering New Markets

By Robert Y. Chung

When a company seeks to enter new markets in the financial services industry it must not only consider insurance coverage as a prudent part of risk management but also consider insurance coverage requirements under the law. During the course of compliance with the typical myriad of federal and state regulations, financial institutions should make sure insurance coverage is not overlooked, particularly when the organization lacks an experienced risk management division.

To meet their needs, financial institutions will obtain "financial institution bonds" in a form promulgated by the Surety Association of America. These standard forms are commonly known and are similar in format, such as "Form No. 24", also known as a "banker's blanket bond". Form No. 24 has been revised to meet the unique needs of the finance and banking industry and new revisions are promulgated by the SAA in conjunction with the American Bankers Association. Financial institutions eligible to use Form 24, are limited by the SAA to certain types of financial service entities including, for example, national commercial banks, state commercial banks, and American agencies of foreign banks. Other standard form bonds likewise have eligibility limitations based upon the type of financial institution in question.

Commentators have analyzed the various standard forms extensively, but frequently take for granted that obtaining them should be standard practice. Companies obtaining such insurance coverage, however, should not—but why? By way of example, if the company in question is a nationally chartered bank, then the Code of Federal Regulations §7.2013 requires all of its officers and employees to have "adequate" fidelity coverage. Adequate coverage should be determined by the board of directors and include: (1) Internal auditing safeguards employed; (2) Number of employees; (3) Amount of deposit liabilities; and (4) Amount of cash and securities normally held by the bank.

These broad guidelines appear to allow some flexibility beyond the banker's blanket bond to include other policies such as a standard Commercial Crime Policy. The standard Commercial Crime Policy is similar to the banker's blanket bond with much of the same coverage. If a bank is a member of the New York Stock Exchange, however, Rule 319 of the NYSE's Constitution and Rules requires that it carry only the "Stockbrokers Partnership Bond and the Brokers Blanket Bond approved by the Exchange". Thus, Form No. 14 is mandatory for entities regulated by the NYSE. Furthermore, specific rules place further requirements specific to the entity itself.

Similarly, the National Association of Securities Dealers' Conduct Rule 3020 requires members to "[m]aintain a blanket fidelity bond, in a form substantially similar to the standard form of Brokers Blanket Bond promulgated by the Surety Association of America..." with certain minimum protections and coverage limits. The NASD further requires members to annually

ANDERSON KILL & OLICK, P.C.
1251 Avenue of the Americas
New York, NY 10020-1182
(212) 278-1000 Fax: (212) 278-1733

ANDERSON KILL & OLICK, P.C.
1600 Market Street
Philadelphia, PA 19103
(215) 568-4202 Fax: (215) 568-4573

ANDERSON KILL & OLICK, P.C.
One Gateway Center, Suite 901
Newark, NJ 07102
(973) 642-5858 Fax: (973) 621-6361

ANDERSON KILL & OLICK, L.L.P.
1275 K Street, N.W., Suite 1101
Washington, DC 20005
(202) 218-0040 Fax: (202) 218-0055

ANDERSON KILL & OLICK
190 South LaSalle Street, Suite 800
Chicago, IL 60603
(312) 857-2500 Fax: (312) 857-0122

ANDERSON KILL & OLICK, P.C.
Two Sound View Drive, Suite 100
Greenwich, CT 06830
(203) 622-7668 Fax: (203) 622-0321

www.andersonkill.com



who's who

Robert Y. Chung is an attorney in the New York office of Anderson

Kill & Olick and a member of the Financial Services Insurance Coverage Group. Mr. Chung has experience in insurance coverage litigation. He also has litigation experience in a number of other practice areas including commercial and bankruptcy law.

Anderson Kill & Olick, P.C. created the Financial Services Insurance Coverage Group to serve its various clients in the financial industry and to focus its coverage expertise on the insurance issues common to broker/dealers, commercial banks, investment banks, investment advisors, hedge funds and financial institutions including mutual funds.

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In addition to rules and regulations set forth by federal law, regulatory agencies, and national associations, financial institutions also must remain cognizant of the particular laws of the state in which they are incorporated, chartered, or otherwise do business. For example, if a holding company seeks to start a bank incorporated under the laws of New York and seeks to require an individual fidelity bond in its favor from officers and employees, such bond must be sold by "a corporation authorized to issue fidelity bonds and doing business in [New York] under the authority of the department." N.Y. Ins. Law § 4121. Accordingly, although the holding company may believe that the insurance obtained is adequate, New York law further requires that such insurance only be accepted from companies authorized by New York under authority of the Insurance Department.

Some states are more restrictive than New York, in that fidelity bonds for officers and employees are mandatory or that failure to obtain a fidelity bond places strict limitations upon a banks operations. In Tennessee, for example, a bank may only avoid its fidelity bond obligation if it has "a sufficient capital to assets ratio as established by the commission" and establishes "a special reserve fund in such form, amount, and including such assets, as approved by the commissioner." Tn. St. § 45-2403. Likewise, under Mississippi law, in the event banks and financial institutions fail to comply with the fidelity bond requirements "the state comptroller may contract for such protection and indemnity and add the cost thereof to the assessment otherwise payable by such bank for the support of the department of bank supervision." Miss. Code Ann. § 81-5-15.

These federal, state, and regulatory regulations do not apply in all instances. For example, some states' requirements are pre-empted by federal law for nationally chartered banks. Thus, every financial institution should look at each and every one of its business divisions and be cognizant of the potential pitfalls of failing to meet its insurance obligations—not only from a business standpoint, but also to avoid violating any laws or regulations. These guidelines are especially important to keep in mind in light of increasing regulatory burdens in the financial services industry. This similarly is true for companies considering ways to cut back on insurance coverage in the face of rising insurance rates for decreasing coverage. While it obviously is never advisable to "go bare"—in many cases, it is illegal—it further is prudent to monitor your insurance program to maintain compliance with the specific laws and regulations applicable to individual financial markets. ■

Eugene R. Anderson	(212) 278-1751	eanderson@andersonkill.com
Robert Chung	(212) 278-1039	rchung@andersonkill.com
Mark Garbowski	(212) 278-1169	mgarbowski@andersonkill.com
Greg Hansen	(212) 278-1173	ghansen@andersonkill.com
Alex D. Hardiman	(212) 278-1471	ahardiman@andersonkill.com
Robert M. Horkovich	(212) 278-1322	rhorkovich@andersonkill.com
R. Mark Keenan <i>Co-Chair</i>	(212) 278-1888	mkeenan@andersonkill.com
Pablo Quiñones	(212) 278-1034	pquinones@andersonkill.com
David M. Schlecker <i>Co-Chair</i>	(212) 278-1730	dschlecker@andersonkill.com
Mark Silverschotz	(212) 278-1870	msilverschotz@andersonkill.com
Edward J. Stein	(212) 278-1745	estein@andersonkill.com