Fraudulent-'wire' claims bedevil RIAs and their E&O insurers in 2023 -- and investors also asked for RIAs to compensate them for reliance on bonds as 'safe' asset

Jessica Thayer: "Most of these advisors will make callbacks if they get an email."

Some insurers saw a spike in 2022 claims although experience varied, and impact was mitigated by shared risk.

Author Lisa Shidler March 13, 2024 at 11:38 PM

RIA insurers saw a 231% increase in total errors-and-omissions (E&O) liability claims last year, but the good news is RIAs say premiums have remained stable.

The 2022 bond market crash and the rising threat of cyber scammers triggered the insurance payout spike, according to a new analysis by Golsan Scruggs, a Portland, Ore., corporate insurance brokerage firm.

Brian Hamburger: 'We're seeing a lot of balls being dropped"

The bond market exposure was an anomaly compared to cyber pirates who impersonate clients with clever digital scams and hoodwink RIAs into wiring money to them.

Brian Hamburger, CEO of Hamburger Law Firm and MarketCounsel, says his firm has anecdotally seen an increase in claims against RIAs, but not regarding bonds.

"For bonds, we're not even tracking that as a blip. But we're dealing with an onslaught of claims for fraud against the advisors," Hamburger says.

"Firms have been slow to create rigid business practices, and we're seeing a lot of balls being dropped," he adds.

"You may not have done anything to give rise to the fraud, but did you do everything that you could to prevent it?" Hamburger says.

Sophisticated scams

Each time an RIA crafts a plan to protect clients against one scam, the scammers come up with a new attack, says Jessica Thayer, senior vice president of Starkweather & Shepley Insurance, a Golsan Scruggs competitor.

Brian Francetich: These are claims where the RIA thought they were dealing with the client and were dealing with a bad actor.

“From a cyber standpoint, we’ll get multiple calls in a week and that ebbs and flows.

"We’ll see that trend very quickly, and then it goes away because advisors can patch the problem and it returns. That’s where we see the frequency of claims," she says.

Cybersecurity has gotten sophisticated because scammers can even use voice manipulation with phone calls where it sounds like a client’s actual voice, Thayer says.

“Most of these advisors will make callbacks if they get an email," she says. "It’s almost impossible to know when it’s a scam.

"Advisors put these policies and procedures in place, and these people find another way around it,” Thayer says.

Companies are continuing to struggle with cyberattacks. A 20% increase in data breaches was reported from 2022 to 2023, according to The Harvard Business Review.

A 78% increase in data compromises year-to-year, from 1,801 in 2022 to 3,205 in 2023 was also tracked, according to an Identity Theft Resource Center (ITRC) report released in January.

Golsan Scruggs President Brian Francetich says his firm's social engineering and wire claims rose, as well.

“We continue to see an uptick in social engineering and wire claims. These are claims where the RIA thought they were dealing with the client and were dealing with a bad actor. They were used by a criminal to separate funds.”

Bonds bite

Bonds proved to be anything but safe, and 2022 became the worst year on record for the investment.

The Federal Reserve's decision to impose seven rate hikes in rapid-fire succession over seven months (Mar-Dec) caused The Total Bond Index, which tracks U.S. investment-grade bonds, to lose more than 13%.

The interest rate spike triggered a Treasury bond market crash. That led to the collapse and sell-off of Silicon Valley Bank early last year and put pressure on other banks with large bond holdings. See: The hot take on why a 100-basis-point rate rise from here simply can't be dismissed after the Silicon Valley Bank exhale and may put Charles Schwab Bank on the hot seat

Neither investors nor RIAs were immune. Advisors who sold bonds as a hedge against risk, faced a backlash.

High-net-worth clients tended to have as much as 40% of their portfolio in bonds because of the perception that they were “very safe.”

Popping the data

Needless to say, deep-pocketed clients were prone to sue. The decline in bonds was a “particular shock” that contributed to the uptick in claims.

"A lot of people lost money in 2022, and then they sued their advisors in 2023,” says Golsan Scruggs President Brian Francetich, whose firm insures about 2,000 RIAs nationally.

“The bond thing in our experience was actually probably worse than the claims that we saw coming out of [the 2008-09 financial collapse],” Francetich says.

The data can be “noisy” due to large settlements, he adds.

“You could end up with a settlement that is $3 million and another that is a couple hundred thousand dollars, and that larger settlement will pop the data,” he says.

Insurance push

From her vantage point, Thayer says, “we’re not seeing anything trending upwards that concerns us or insurers.”

"We've got 3,000 advisory firms across the country. You'd think if there was a trend or an issue, we'd have seen it, and we haven't.”

For the most part, insurers also agree that RIAs are protected by a no-harm, no-foul aspect to the claim spike.

Unlike prior years, the vast majority of advisors are well-insured – in large part because RIA custodians began demanding it in 2021. See: Schwab Advisor Services informs its 13,000 RIAs -- including legacy TD Ameritrade practices -- they must buy E&O insurance, but rival Fidelity is taking a different tack-- voluntary compliance

RIAs must attest that they carry a minimum of $1 million in E&O insurance.

“This requirement aims to help firms mitigate the potential risks associated with market volatility and related operational complexity. Previously, we strongly encouraged our clients to obtain this coverage,” a Fidelity spokesperson says.

Insurance firms said Pershing also requires RIAs to carry E&O insurance.

Variable rates

The cost of E&O insurance is about 75-basis-points on gross revenues, but it varies. See: [Why RIA demand for E&O insurance is booming, and premium prices are [thankfully] plummeting]

Thayer says a firm with less than $150 million in AUM can get policies that are as low as $2,000 to $2,500 a year.

However, if an RIA has a large percentage of alternatives, then coverage can cost closer to $10,000 per million of coverage, she says.

Francetich hopes claims will fall this year.

“Depending on what goes in the market, I'd expect a great year in 2023, if we have stable markets. I think that number will go down.”

Going after risk

Better yet, the impact of claims is still being absorbed effectively by the pooling of liability by the underwriters – which has helped to stabilize rates.

Thayer says the cost of E&O insurance premiums has stayed the same for years, mostly because there hasn’t been an excess number of claims filed for her financial clients.

She also points out that “one-off” cases involving RIAs who failed to disclose information to clients can be problematic.

But as a whole, she says some RIAs are even getting discounts with renewed policies.

“There is underwriting to the specific risk. When a market likes the risk, they go after it, and it’s very competitive.”

Lisa Shidler has been a journalist for more than 20 years. She has reported on the financial services industry for the past 17 years and has written for RIABiz since 2010. She is based in the Midwest where she reads, writes, edits content and produces a podcast about books. @lisshidler

Brooke Southall and Keith Girard contributed to the editing of this article.

Contact Jessica Thayer to learn more:
Jessica Thayer SVP & Financial Institutions Leader
(774) 241-3121
jthayer@starshep.com

About S&S Financial Institutions Practice Group
The FI Group at Starkweather & Shepley Insurance Brokerage, Inc. is committed to providing hands-on service, collaborating closely to identify competitively priced coverage tailored to your firm's liability needs. Our Financial Institutions Practice serves over 3,000 investment advisors and fund complexes nationwide. We offer knowledgeable advice on insurance, including Directors & Officers Liability, Errors & Omissions, Cyber Liability, ERISA Bonds, Fidelity Bonds, and Property & Casualty coverage. We also provide consultation on limit adequacy, claims handling, captive structures, manuscript policy language, and creative policy structures, ensuring your peace of mind in the dynamic financial landscape.

[i] *RIABiz Article: "Fraudulent-'wire' claims bedevil RIAs and their E&O insurers in 2023 – and investors also asked for RIAs to compensate them for reliance on bonds as 'safe' asset"*

[i] Fraudulent-'wire' claims bedevil RIAs and their E&O insurers in 2023 -- and investors also asked for RIAs to compensate them for reliance on bonds as 'safe' asset | RIABiz