

THE DOW HAS GONE CRAZY: WHAT IS AN INSURER TO DO?

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With the Dow Jones Industrial Average soaring past the 10,000 mark and now surpassing the 11,000 mark, the stock market occupies a large part of daily life. Many people play or dabble in the market, often with little or no formal investment training. People participate in trading on the Internet from their desktop computers at work. Recently, many of these investors are “day traders” who follow the hot tips on the Internet or flip one or two stocks each day by watching the small fluctuations in the market price. Stocks continue to reach dizzying new heights that have no correlation to historical benchmarks or valuations formulas. Despite frequent warnings from economists that this bubble soon will burst, no apparent end is in sight.

With all of this activity in the market, the ability to make vast sums of money exists. Of course, the ability to very quickly lose vast sums of money also exists.

With this in mind, it is appropriate to revisit the issue of when a loss caused by an employee engaging in trading is or is not covered by a fidelity bond. Both insurance claims representatives and businesses must review and become familiar with the trading exclusions contained in the standard forms

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relating to the stock market and securities. Only then can the risks associated with the current stock market conditions be fully appreciated and evaluated.

I. HISTORY OF THE TRADING LOSS EXCLUSION

A. Current Version of the Trading Loss Exclusion

The exclusion's language is not standard. The language differs in different policy forms, such as a financial institution bond or a brokers blanket bond. Regardless of the policy type, the purpose for including the trading loss exclusion is the same: to eliminate risks to a business from involvement in trading.

In 1918, The Surety Association of America¹ added a rider to the Form 14 Brokers Blanket Bond.² The rider, which deleted all trading losses, stated:

This bond does not cover loss directly or indirectly from trading, actual or fictitious, whether in the name of the Insured or otherwise, and whether or not within the knowledge of the Insured and notwithstanding any act or omission on the part of any Employee in connection therewith or any account recording the same.

The bond did not define "trading." That language has evolved over the years into the current version that excludes all trading losses in customer accounts. The current version states that the bond does not cover:

(i) Loss resulting directly or indirectly from transactions in a customer's account, whether authorized or unauthorized, except the unlawful withdrawal and conversion of Money, securities or precious metals, directly from a customer's account by an Employee provided such unlawful withdrawal and conversion is covered under Insuring Agreement (A).³

The exclusion contained in the financial institution bond was adopted from the insurance contracts that were issued to stockbrokers, albeit with slight variations in the language.⁴ This exclusion was first added due to banks' increased involvement in trading.⁵ The trading loss exclusion was placed into the financial institution bond (FIB) to eliminate trading higher than usual risks from the standard coverage.⁶

¹ Hereinafter SAA.

² This rider, of course, later served as the starting point for the trading loss exclusion to be used in a Bankers Blanket Bond.

³ Standard Form No. 14 (rev'd Oct. 1987), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA).

⁴ *Shearson/American Express, Inc. v. First Continental Bank & Trust Co.*, 579 F. Supp. 1305, 1310 (W.D. Mo. 1984).

⁵ *Id.*

⁶ *Home Sav. & Loan v. Aetna Cas. & Sur. Co.*, 817 P.2d 341, 360 (Utah Ct. App. 1991).

The FIB version of the trading loss exclusion is exclusion (i), which states:

This bond does not cover:

(i) loss resulting directly or indirectly from trading with or without the knowledge of the Insured, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance, except when covered under Insuring Agreements (D) and (E).⁷

As with the Brokers Bond, the standard form of this bond does not define the term "trading."

This provision was drafted by the SAA in 1975. An SAA subcommittee recognized the need to consider excluding trading losses under the Form 24 Bankers Blanket Bond because coverage for losses resulting from trading had always been a matter of concern for insurers. The subcommittee pointed out that many trading losses involved "violation of instructions" rather than dishonesty. It was feared that insureds might tolerate such activities when the violation of instructions produced a profit but would present a claim when the violation of instruction produced a loss. Therefore, the subcommittee believed consideration of such an exclusion was justified.⁸ Prior to the mid-1970s, banks were not extensively involved in trading. However, by that point, banks were becoming more involved in trading currencies, stocks, bonds, and commodities, which justified the need for the exclusion.⁹

Since the exclusion does not generally cover trading losses committed by a dishonest employee, the insured can purchase such coverage for trading losses as it applies to Insuring Agreement (A) by purchasing an additional rider. The subcommittee felt that the availability of this rider for an additional premium would be important for both banks and insureds. By purchasing such a rider, a financial institution obtains an exclusion that provides coverage for trading losses caused by conduct covered under Insuring Agreement (A).

As for commercial policies, a form of the trading loss exclusion rider for commercial entities dates back to 1933. The rider was, at that time, restricted to brokers of "Cotton, Coffee, Grain, and other Commodities." A 1969 amend-

⁷ Standard Form No. 24 (rev'd Jan. 1986), *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS'N OF AMERICA) [hereinafter FIB].

⁸ The Surety Association of America, Fidelity & Public Official Advisory Committee Minutes (October 29, 1975).

⁹ *Id.*

ment made a rider available to “Mutual Funds, or to Organizations Acting as Sales Representatives of Mutual Funds.”¹⁰ Since commercial entities did not usually engage in trading, an exclusion for trading losses was not considered necessary at that time. Thus, trading losses were not excluded directly in the commercial policy.

An SAA subcommittee examined the need to revise the commercial forms to add a trading loss exclusion in 1981. That subcommittee ultimately concluded that a revision was still not necessary because the rider was still sufficient to underwrite those commercial entities with a trading loss exposure. The current form of the exclusion rider states as follows: “We will not pay for loss resulting directly or indirectly from trading, whether in our name or in a genuine or fictitious account.”¹¹ This language continues to be sufficient to exclude such losses. As the trading markets continue to evolve, however, it may become necessary to revisit the issue of modifying the exclusion to address new market issues. Some commercial entities that historically did not engage in trading are now extensively involved in trading. Thus, the changing face of business makes this an issue the SAA may want to revisit in the commercial policy context in the next few years.

B. Alternative Coverage Offered by Various Carriers

For an additional premium, carriers are often willing to provide alternative coverage. Because of this variability in language, it is critical to review the exact language used in the exclusion at issue when evaluating a new claim. And a business, when purchasing insurance coverage, should consider whether it will have sufficient protection with standard form language. If not, it should seek alternative coverage.

For example, in 1997, Lloyds of London began offering protection for some types of unauthorized employee trading.¹² The Lloyd’s policy is intended to cover trades for a firm’s own account that were concealed or falsely recorded in excess of permitted limits, outside of permitted product lines, or with an unauthorized counterparty.¹³ The Lloyd’s policy does not offer coverage for trades that are within the trader’s authority.¹⁴

¹⁰ The Surety Association of America, Fidelity & Public Official Advisory Committee Minutes (May 11, 1979). This set of minutes is particularly helpful because it reviews and traces the history of the trading loss exclusion rider in this context.

¹¹ Comprehensive Crime Policy, Exclude Trading Loss Endorsement, Form CR 10040189 (Insurance Services Office, Inc. 1984) *reprinted in* STANDARD FORMS OF THE SURETY ASSOCIATION OF AMERICA (SURETY ASS’N OF AMERICA).

¹² *Lloyd’s of London Creates a Policy for Trading Losses*, Wall St. J., Oct. 6, 1997.

¹³ *Id.*

¹⁴ *Id.*

Calling its unique product the Bankers Professional Indemnity Policy, Lloyd's developed it after identifying problems with unauthorized trading in an institution's own account.¹⁵ The traders causing the losses had various motives, such as covering errors, attempting to recoup prior losses, protecting bonuses, or out-of-control egos. The losses demonstrated that, in certain circumstances, the institution's internal controls were not effective.¹⁶ While fidelity coverage could have covered those institutions' own account loss from theft and other dishonest acts, Lloyd's recognized that a gap in insurance coverage existed for acts committed by traders that did not meet the Insuring Agreement (A) requirements.¹⁷ Thus, Lloyd's drafted a policy that provides coverage for a loss sustained by a bank as the result of trading concealed by the trader or falsely recorded in the institution's records. This includes coverage for commitments in excess of permitted limits, trading in unauthorized instruments, or trading with unapproved counterparties.¹⁸

Lloyd's does not, however, offer this insurance coverage to just anyone. A financial institution must demonstrate that it has sufficient internal controls in place to satisfy an underwriter. Those controls could include written trading policies and procedures, segregation of job duties and account reconciliations, independent oversight, and review of trading activities.¹⁹

If a financial institution or business feels that it is possibly at risk and wants the additional coverage, it should look into these Lloyd's policies or inquire as to what modifications its current insurance carrier will make to the standard language in order to retain the institution's business.

II. CASES INTERPRETING THE TRADING LOSS EXCLUSION

A. *General Types of Trading Exclusion Cases*

There have been several distinct lines of attack on the trading loss exclusion. When the losses result from trading, courts generally enforce the exclusion even if the trading was unauthorized or dishonest.²⁰ In some cases, the loss ultimately results from some cause other than trading; but trading is

¹⁵ Mark H. Wheeler, *New Insurance Products from the London Market and New Channels of Product Distribution: Innovative Insurance Products*, 766 PLI/Comm 131 (1998).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Wall St. J., *supra* note 12.

²⁰ *See, e.g.,* Glusband v. Fittin Cunningham & Lauzon, 892 F.2d 208, 211-12 (2d Cir. 1989).

somehow involved in the case. In those instances, the exclusion is generally rejected.²¹ As one commentator explained:

If a market loss is sustained by the insured as a result of ill-advised, unauthorized, or unlikely trading decisions made in the purchase, sale or trade of securities, the loss is precluded from coverage under the trading loss exclusion clause. The scope of the exclusion, however, often will depend on whether its language states that it applies (or does not apply) to claims covered under the employee dishonesty insuring agreement.²²

Other courts have interpreted this exclusion to apply to losses occasioned by bad trading, even if the trading was unauthorized, as it was in this case. The trading-loss exclusion also applies to losses occasioned by a fluctuation in market value and ill-advised or unlucky trading decisions. It is only where the loss has no connection to actual trading that the exclusion has no application.²³

When evaluating or reviewing a new claim, the specific language of the exclusion at issue must be reviewed to determine if the language is the standard form language or if it has been modified by rider. As noted, in these competitive insurance markets, non-standard language may be used. Therefore, cases can be easily distinguished because of variations in the policy language.

B. What is "Trading"?

To know if the exclusion applies to a particular claim, it is important to understand how the term "trading" is interpreted by the courts. Courts have often tried to define what constitutes "trading" or a "trading loss" for purposes of this exclusion. Some courts state simply that "trading" is trading in

²¹ See, e.g., *Insurance Co. of North America v. Gibrasco*, 847 F.2d 530 (9th Cir. 1988).

²² Robert B. Budelman & Jeffrey M. Winn, *Recovering for Derivative Trading Losses under Financial Institution and Crime Bonds*, 62 DEF. COUNS. J. 572 (1995).

²³ See *Straz v. Kansas Bankers Sur. Co.*, 986 F. Supp. 563 (E.D. Wis. 1997), *aff'd*, 165 F.3d 33 (7th Cir. 1998) (citations omitted). Interestingly, this is one of the few director and officer insurance policy cases that interprets the D&O version of the trading loss exclusion. In the *Straz* case, the First Trust Bank had improperly invested St. Catherine Hospital's money in volatile derivative securities instead of the conservative investment vehicles that the hospital wanted. First Trust Bank settled with St. Catherine's after the losses were discovered and sued its insurer. The court concluded that, because the directors and officers policy excluded losses relating "directly or indirectly" to trading securities, the insurer had no obligation to defend or indemnify First Trust Bank.

securities.²⁴ Other courts have held that the trading exclusion applies only to an insured's "market losses in securities stemming from market fluctuations."²⁵ Another court ruled that "trading" meant the operation of the usual occupation of buying and selling of stocks.²⁶

The American Bankers Association fully understands the meaning of "trading" and the purpose of the trading loss exclusion. It describes the exclusion to its members as:

Losses arising from the undefined term "trading" are specifically excluded except when covered under the forgery insuring agreements. A rider is available to purchase coverage for employee dishonesty generated trading losses. Trading loss exposures may emanate through the investing of the bank's own funds, from trust operations, or from securities brokerage services.²⁷

The explanation offered by the American Bankers Association shows that "trading" should be considered defined quite broadly since exposure can result from investment of bank funds, trust operations, or securities brokerage services.

Insureds often get creative in trying to define "trading" so that a loss does not constitute trading for purpose of the exclusion. For example, in one case, an insured argued that "trading" had a special connotation in the securities business and that it meant the purchase and sale for a gain by a dealer, for its own profit and in its own name.²⁸ Thus, the insured tried to argue that when a purchase was made for a customer's investment account, such purchase was not "trading."²⁹ The court was not persuaded and ruled that "trading" had the same meaning as in any mercantile business, namely the buying and selling of commodities.³⁰

Another court was not satisfied with simply defining "trading." Instead, the court went on to define "securities."³¹ North Jersey Savings & Loan sought

²⁴ *Home Savings*, 817 P.2d at 360.

²⁵ See *First Fed. Sav. & Loan v. Fidelity & Deposit Co. of Maryland*, 895 F.2d 254, 260-61 (6th Cir. 1990); *Insurance Co. of N. Am. v. Gibrasco, Inc.*, 847 F.2d 530, 533 (9th Cir. 1988).

²⁶ *Sutro Bros. & Co. v. Indem. Ins. Co. of N. Am.*, 264 F. Supp. 273 (S.D.N.Y. 1967), *aff'd*, 386 F.2d 798 (2nd Cir. 1967).

²⁷ DIGEST OF BANK INSURANCE 94 (6th ed. 1992).

²⁸ *Sade v. Nat'l Sur. Corp.*, 203 F. Supp. 680, 685 (D.C. Cir. 1962).

²⁹ *Id.*

³⁰ *Id.* at 686. See also *Research Equity Fund v. Insurance Co. of N. Am.*, 602 F.2d 200, 203 (9th Cir. 1979).

³¹ *North Jersey Sav. & Loan Ass'n v. Fidelity & Deposit Co. of Maryland*, 660 A.2d 1287 (N.J. Super. 1993).

coverage under its Savings and Loan Blanket Bond from Fidelity & Deposit Company³² for losses it suffered in connection with purchases of packages of serviced mortgage loans.

F&D argued, among other things, that the claims were excluded under the trading loss provision.³³ The court noted:

Trading losses are understood to be “market losses sustained by firms as a result of ill-advised, unauthorized, or simply unlucky trading decisions made in the purchasing, selling or trading of securities.” *Insurance Co. of N. Am. v. Gibrasco, Inc.*, 847 F.2d 530, 533 (9th Cir. 1988). A “security” as defined by the bond is an instrument which has the following four characteristics: (1) it is issued in bearer or registered form; (2) it is of the type commonly dealt in upon securities exchanges or market or markets; (3) it is either one of a class or series, or by its terms is divisible into a class or series of instruments; and (4) it evidences a share, participation or other interest in property or in an enterprise or evidences an obligation of the issuer.³⁴

The court found that the pool of mortgages involved in this case was not a “security” under the definition contained in the bond.³⁵ Since the mortgages or mortgage pools did not have the requisite characteristics of a security, North Jersey’s losses normally would not be excluded under the provisions of the trading loss exclusion.³⁶

The North Jersey opinion is unusual in discussing “securities” in such detail for purpose of the trading loss exclusion. Of course, the North Jersey court said that the bond defined “securities.” Most of the standard form bonds do not define “securities.” Given that situation, most courts that have reviewed the issue limited their analysis to defining “trading” for purposes of the exclusion.

³² Hereinafter F&D.

³³ *Id.* at 1298.

³⁴ *Id.* at 1298 (emphasis added). Many bonds do not typically define “security.”

³⁵ *Id.*

³⁶ *Id.* at 1299. Unfortunately for North Jersey, however, the analysis did not end there. North Jersey had previously taken the position in litigation that the mortgage pools *were* securities. North Jersey had been a plaintiff in a declaratory judgment action against Landbank and had designated itself as an “investor and purchaser of mortgage securities.” *Id.* Since North Jersey had argued that these mortgaged-back pools of loans were securities in federal court, the New Jersey state court would not allow North Jersey to take a contrary position under the doctrine of judicial estoppel. Therefore, since North Jersey had previously characterized these mortgage loans as securities, its claims against F&D on the Savings and Loan Blanket Bond were barred by the trading loss exclusion. *Id.*

As shown, courts generally apply a common sense definition to the word “trading.” If an activity appears to be “trading” as it is generally understood, most courts then look to see if the trading loss exclusion applies. Of course, the common understanding of what generally appears to be “trading” can and will change over time. With the advent of “day-trading,” Internet trading, and more complex financial transactions, market activities will continue to evolve.

C. Cases Offering Extensive Analysis of the Exclusion

The trading loss exclusion, although not frequently litigated in comparison to some other exclusions, has been analyzed in detail by some courts. Of the cases discussing the exclusion in detail, some of the greatest discussion is generated by the issues of whether the exclusion is ambiguous and the interplay of the exclusion with other Insuring Agreements.

1. Is the Exclusion Ambiguous?

A threshold issue often faced by courts is whether the trading loss exclusion is ambiguous. Insureds, trying to avoid the impact of the exclusion, frequently argue that it is ambiguous and that general rules of contract construction should then apply to strictly construe the exclusion against the insurer. Two leading trading loss exclusion cases reached different conclusions on that issue.³⁷

In *Shearson/American Express v. First Continental Bank*,³⁸ Shearson sued William Evans and First Continental Bank. Evans, a First Continental employee, used forged guarantee papers to open a securities account at Shearson and made it appear that First Continental’s assets stood behind the account. First Continental never, however, guaranteed the transactions. When Evans could not cover the losses in the account, Shearson sued First Continental for payment. First Continental requested that its two insurers, Kansas Bankers Surety Company and Fidelity & Deposit Company of Maryland, defend it in the litigation. Both refused to provide a defense, and First Continental filed a third-party claim against them.

The two sureties contended that the trading loss exclusion excluded coverage for First Continental’s alleged loss. Since any liability that First Continental owed to Shearson resulted from Evans’ acts of purchasing and selling securities, the trading loss exclusion precluded coverage.

³⁷ See *Shearson/American Express v. First Continental Bank & Trust Co.*, 579 F. Supp. 1305 (W.D. Mo. 1984); *Glusband v. Fittin Cunningham & Lauzon, Inc.*, 892 F.2d 208 (2nd Cir. 1989); *Insurance Co. of N. Am. v. Gibrasco*, 847 F.2d 530 (9th Cir. 1988).

³⁸ 579 F. Supp. 1305 (W.D. Mo. 1984).

First Continental argued that “trading” was ambiguous when used in a bank insurance policy, as opposed to a stockbroker’s policy.³⁹ The court found that “trading” was not ambiguous. In making this determination, the court relied heavily on the discussion of the trading loss exclusion contained in the DIGEST OF BANK INSURANCE.⁴⁰ Furthermore, the court found that the banking community had discussed the “trading” exclusion at length and that bankers were well aware that “trading” included the purchase and sale of securities. As the court stated:

[I]t is clear that the purpose of the trading exclusion was to deal with the insurance problem caused by losses resulting from the buying and selling of securities. The historical context, the adoption of the clause from stockbroker’s bonds, and the discussions in the American Bankers Association publication all lead to the conclusion that a reasonable banker would understand the “trading” exclusion to bar recovery for a loss resulting from the purchase or sale of securities.⁴¹

The court refused to find the trading loss exclusion ambiguous, noting that the standard form of the bond resulted from combined efforts of the Surety Association of America and the American Bankers Association.⁴² That the bond resulted from joint efforts of banking and surety industry is a potent argument for defeating ambiguity arguments.

The court also pointed out that, for an additional premium, First Continental could have purchased coverage that would have protected it against the dishonest trading of its employees. Since First Continental failed to purchase the optional coverage, the court found that the loss was excluded under the provisions of the trading exclusion.⁴³ The failure to purchase coverage available also becomes a theme in several trading loss cases. In general, courts have not been very sympathetic to insureds who failed to purchase all potential coverage.

The Ninth Circuit set a very dangerous precedent by finding that the language of the trading loss exclusion was ambiguous four years after the *Shearson* opinion. In *Insurance Co. of North America v. Gibrasco*,⁴⁴ INA

³⁹ *Id.* at 1309.

⁴⁰ *Id.* at 1310.

⁴¹ *Id.* at 1311. *See also* DIGEST OF BANK INSURANCE at p. 94 (6th ed. 1992).

⁴² *Id.*

⁴³ *Id.*

⁴⁴ 847 F.2d 530 (9th Cir. 1988).

issued a Brokers Blanket Bond to Gibrasco, Inc. that excluded coverage for “loss resulting directly or indirectly from trading . . . except when covered under Insuring Clause (A), (D), or (E).”⁴⁵

Steven Grayson, a Gibrasco employee, maintained two trading accounts at the firm without his employer’s knowledge, including one account in the name of a “Michael Scott.” Grayson persuaded several Gibrasco customers to let him exchange municipal bonds for higher-yielding investments. Grayson sold the customers’ bonds through one of his accounts and used the proceeds to gamble. He also ordered \$150,000 of municipal bonds through his “Michael Scott” account. When Gibrasco demanded that “Michael Scott” pay for the bonds, Grayson took the bonds, ostensibly to deliver the bonds to the purchaser. Grayson, however, never returned the bonds or paid Gibrasco for the bonds.

Gibrasco made a claim to INA for losses suffered as a result of Grayson’s fraudulent activity. INA denied the claim, asserted it was excluded by the trading loss exclusion, and then filed a declaratory judgment action against Gibrasco.

The court recognized that trading losses are generally understood to be market losses sustained by firms as a result of ill-advised, unauthorized, or simply unlucky trading decisions made in the purchasing, selling, or trading of securities.⁴⁶

The court made the unfortunate ruling, however, that the bond was ambiguous with respect to losses involving trading.⁴⁷ This holding contravenes several reported decisions.⁴⁸ The court did not cite to or attempt to distinguish its holding from the other reported decisions. This court reached this conclusion, in part, due to what it called the “inclusionary language found in the exception to the trading loss exclusion” and “INA’s failure to provide more precise exclusionary language in the explanatory clause of the exception.”⁴⁹ Footnotes 6 and 7 in the opinion quote the exact language used in the

⁴⁵ *Id.* at 532. The exclusion also contained a second clause that provided: “If any instrument covered under Insuring Clause (D) or (E) is involved in any trading loss, then this Subsection (e) shall not be construed as excluding liability under Insuring Clause (D) or (E) on account of such instrument for the amount applicable under this bond for the payment of such loss.” *Id.* at 532 n.7.

⁴⁶ *Id.* at 533.

⁴⁷ *Id.* at 534.

⁴⁸ *Shearson*, 579 F. Supp. at 1309-10. *See also* *Research Equity Fund v. Insurance Co. of N. Am.*, 602 F.2d 200, 203 (9th Cir. 1979) (holding that trading loss exclusion is not ambiguous and the term “trading” is well understood in the industry and that there is no common understanding in the insurance brokerage industry that the trading loss exclusion applies only to stockbrokers).

⁴⁹ *Id.* at 534.

INA policy.⁵⁰ When dealing with different language, this case should be easy to distinguish.

Although this case has been cited in many other opinions in regard to the Insuring Agreement (A) holding, this ruling concerning ambiguity has received surprisingly little attention or criticism. That could be due to the fact that there are several other reported decisions in which courts expressly ruled that the exclusion was not ambiguous.⁵¹

Before holding that the trading loss exclusion was ambiguous, the court analyzed INA's argument in detail and refused to apply the trading loss exclusion to preclude coverage. The court found that Gibrasco's losses were not caused by Grayson's trades. Instead, the losses were caused by his dishonest conduct.⁵² Grayson stole both the municipal bonds and the proceeds from the sales of the customers' bonds. Thus, the court theorized that "[t]he fact that Grayson disguised the theft of the customers' bonds as a sale does not make it any less a theft."⁵³ Furthermore, the court pointed out that Gibrasco's losses did not occur at the time Grayson traded the bonds. The actual losses did not occur until Grayson wrongfully retained the sales proceeds of the customers' bonds or when he stole the municipal bonds.

Although INA argued that the trading loss exclusion precluded coverage if a trade occurred anywhere in the chain of events leading to a loss to the insured, the court rejected that argument, noting as follows: "The broad applicability of the trading loss exclusion urged by INA would eviscerate the employee dishonesty coverage provisions of the Bond in every case where a trade might occur in the course of an employee's dishonest scheme."⁵⁴ Of course, it is important to note that the particular trading loss exclusion language at issue provided an exception to the exclusion for conduct that fell within the scope of Insuring Agreement (A).

Not all cases contain the exception to the exclusion for conduct that falls within the scope of insuring agreement (A). Because the applicability of a precedent to any given fact situation varies with the exclusion language, the exact policy language should be compared to the case. As previously noted, courts tend to be unsympathetic to a financial institution that chooses not to purchase all coverages available.

⁵⁰ *Id.* at 532.

⁵¹ *See, e.g., Shearson*, 579 F. Supp. 1309.

⁵² *Id.*

⁵³ *Id.* at 533.

⁵⁴ *Id.*

In a previous case, *Research Equity Fund v. Insurance Co. of North America*,⁵⁵ the Ninth Circuit had rejected the argument that the trading loss exclusion was ambiguous. INA issued a fidelity bond to Research Equity Fund f/k/a/ Winfield Growth Fund,⁵⁶ a mutual fund company. A fund employee, Stephen Sanders, managed the portfolio of WGF and determined which securities would be purchased or sold for the WGF portfolio. Sanders was bribed by persons outside the company to purchase securities at prices that Sanders knew were manipulated. Thus, WGF, acting on Sanders' recommendation, purchased several securities at artificially inflated prices. WGF suffered losses after discovering the scheme and selling the securities.⁵⁷

INA argued that WGF's loss was excluded by the trading loss exclusion. WGF tried to argue that the term "trading" used in the exclusion was ambiguous because this type of bond was developed for stockbrokers and was intended to apply only to the kinds of risks normally encountered by stockbrokers. Since it was a mutual fund company, WGF argued that it was not a stockbroker and that the exclusion did not apply to it.

WGF's arguments were unsuccessful. The court found that the term "trading" was well understood in the mutual fund industry in which WGF was a participant and was understood by both WGF and INA. The court also found that there was no understanding in the insurance brokerage industry that the trading loss exclusion applied only to stockbrokers. Significantly, the court pointed out that INA offered to waive the exclusion for WGF for an additional premium. However, WGF declined the coverage.⁵⁸ Thus, the court held that the trading loss exclusion applied and excluded WGF's claim from coverage.⁵⁹

⁵⁵ 602 F.2d 200, 203 (9th Cir. 1979).

⁵⁶ Hereinafter WGF.

⁵⁷ *Id.* at 201-02. Although the factual scenario is quite similar to *Index Fund, Inc. v. Insurance Co. of N. Am.*, 580 F.2d 1158 (2d Cir. 1978), this court reached a different result.

⁵⁸ This court and the court in *Shearson/American Express*, 579 F. Supp. 1305, both remarked on the fact that the insured's desired coverage had been available to it for an additional premium, but that the insured chose not to purchase it. This proves the old adage "penny wise, pound foolish" true. These cases indicate that courts are not likely to be sympathetic to financial institutions who do not purchase the option coverage available.

⁵⁹ *Id.* at 203.

The difference between the two Ninth Circuit rulings might be explained by the different focus on the ambiguity arguments. In *Gibralco*, the court examined the entire language contained in the exclusion.⁶⁰ In *Research Equity Fund*, however, the focus was less on the language contained in the entire exclusion. Instead, the focus was more on the word “trading”.⁶¹ Whatever the explanation for the conflicting holdings, it is not helpful to insurance companies that at least one court found the language of the trading loss exclusion ambiguous. Fortunately, few other courts have reached such conclusions.

2. Interplay Between the Insuring Agreements and the Trading Loss Exclusion

Often, the exceptions to the trading loss exclusions (Insuring Agreements D, E, and sometimes A) operate to provide coverage for a claim that would be otherwise excluded. Many cases demonstrate this interplay.

In one frequently cited opinion, the Second Circuit analyzed the trading loss exclusion in detail in *Glusband v. Fittin Cunningham & Lauzon, Inc.*⁶² Glusband, as receiver for MSIA, sued to recover losses MSIA suffered under a bond insuring against the dishonest or fraudulent conduct of employees. Michael Starbuck was the sole owner, officer, and director of MSI. Starbuck later created MSIA as a limited partnership with MSI as the general partner to invest in securities.

Starbuck induced investors to invest with him by promising to follow a conservative investment strategy. Starbuck’s strategy was anything but conservative. Starbuck engaged in high-risk options and concealed this from his clients by sending them misleading statements. While Starbuck’s trading was risky and his statements to his customers were highly misleading, Starbuck did not convert any of the customer’s funds to his own gain. Starbuck’s sole gain was entirely in the form of salary or commission.

MSI was insured under a Brokers Blanket Bond. When Glusband was appointed receiver of MSI and MSIA, Glusband filed suit against INA under the Brokers Blanket Bond.

The court analyzed whether Starbuck had the manifest intent to cause losses under Insuring Agreement (A) and whether the losses were excluded by the trading loss exclusion. On the issue of manifest intent, the court noted that the evidence indicated that Starbuck intended to benefit MSIA, no matter how reckless and improvident his conduct might have been. There was no

⁶⁰ *Gibralco*, 847 F.2d at 534.

⁶¹ *Research Equity*, 602 F.2d at 203.

⁶² 892 F.2d 208 (2d Cir. 1989).

evidence that Starbuck ever misappropriated any of the funds for his own benefit except for those funds he received as salary or commission.⁶³ Thus, the court found that the evidence did not support a finding of manifest intent. Therefore, the loss was not covered by Insuring Agreement A.

As for the trading loss exclusion, the court recognized that the obvious purpose of the trading loss exclusion was to exempt from coverage losses caused by market forces, misjudgments of market forces by buyers and sellers of securities, or various errors and omissions.⁶⁴ In this case, the losses were caused solely by Starbuck's bad trades. The losses were not covered because the bond did not insure against losses caused by reckless or improvident trading, even if the investors had been led to believe that a more conservative strategy would be followed.⁶⁵

In reaching its decision, the *Glusband* court distinguished the case of *Index Fund, Inc. v. Insurance Co. of North America*.⁶⁶ In the *Index Fund* case, the Second Circuit reached a different result while construing identical language because the loss was caused by dishonest trading that was induced by a bribe. In that instance, the court found that, no matter how high the stock might have gone, the loss incurred by paying an artificially inflated price for the stock was a permanent loss. Because of the bribe, the transaction was not one governed by a good faith judgment as to market movement.⁶⁷

In *Glusband*, however, Starbuck did not purchase stocks at artificially inflated prices induced by a bribe. Instead, he simply exercised poor judgment in his trades. The court thus found that the losses caused by Starbuck's actions were excluded by the trading loss exclusion.

Interestingly, the Second Circuit in *Glusband* (a 1989 case) distinguished the case of *Index Fund, Inc. v. Insurance Co. of North America* (a 1978 Second Circuit case), but it did not cite the case of *Research Equity Fund v. Insurance Co. of North America* (a 1980 Ninth Circuit case). Of course, the *Glusband* case was pending in the Second Circuit, which may account for why the Ninth Circuit *Research Equity* opinion is not cited. It is interesting to compare the two cases, however, because those two cases have extremely similar fact patterns; yet the Second Circuit and the Ninth Circuit reached different conclusions.

⁶³ *Id.* at 210.

⁶⁴ *Id.* at 211.

⁶⁵ *Id.* at 212.

⁶⁶ 580 F.2d 1158 (2nd Cir. 1978).

⁶⁷ *Glusband*, 892 F. at 211.

In *Index Fund, Inc. v. Insurance Co. of North America*, Robert Hagopian was the president of Index Fund. Hagopian was bribed by and entered into conspiracies to purchase certain securities at prices which Hagopian knew were manipulated. After this was discovered, Index Fund sued INA on its fidelity bond. Index Fund was organized pursuant to the Investment Company Act of 1940.

Securities and Exchange Commission Rule 17g-1 required Index Fund to obtain a fidelity bond against “larceny and embezzlement” that covered its officers who had access to its funds or securities or the authority to draw such funds or to dispose of such securities.⁶⁸ When Index Fund sued, INA argued that the claims regarding Hagopian’s conducts were excluded pursuant to the trading loss exclusion. Index Fund first attempted to argue that the losses it suffered were not “trading” within the meaning of the exclusion. Although the court did not completely accept this argument, the court noted: “Where, as here, the obligee is a regulated investment company, rather than a broker, fraudulent purchase of securities for the company by the covered employee at a manipulated price may well be considered outside the contemplated meaning of ‘trading.’”⁶⁹ The court declined to state specifically whether Hagopian’s conduct was “trading” for purposes of the exclusion. Instead, the court analyzed the argument as if trading did include Hagopian’s activities.

Since the bond was a “statutory” bond, it was not necessary to resolve the issue of whether Hagopian’s conduct did or did not constitute trading. This bond was a statutory bond under the provisions of the Investment Company Act of 1940. Therefore, the court held that the bond must be interpreted in light of the principles and objectives of the Investment Company Act.⁷⁰ The court stated:

We have no doubt that in requiring a bond to provide coverage against losses from “larceny and embezzlement” by an officer of a registered investment company Congress intended such bonds to cover the kind of dishonest and fraudulent activity in which Hagopian engaged. ... Consequently, we conclude that I.N.A. is liable on the bond to Index Fund for those losses it suffered from the dishonest and fraudulent activities of Hagopian.⁷¹

The Second Circuit essentially disregarded the clear language of the trading loss exclusion to rule that Hagopian’s conduct was not excluded by the

⁶⁸ *Index Fund*, 580 F.2d at 1159.

⁶⁹ *Id.* at 1162.

⁷⁰ *Id.*

⁷¹ *Id.* at 1163 (citation omitted).

trading loss exclusion. Justice Meskill dissented and vigorously argued that the loss suffered by Index Fund was clearly within the provisions of the “trading exclusion.”⁷² Justice Meskill’s dissent also pointed out that Index Fund could have purchased the more expensive bond which would have protected it from the type of loss but chose not to do so. That coverage had been available for an additional premium did not, however, persuade the majority court; therefore, the loss was not excluded.

The Ninth Circuit in the previously discussed *Research Equity Fund, Inc. v. Insurance Co. of North America* specifically rejected the statutory bond argument that was so successful in *Index Fund, Inc. v. Insurance Co. of North America*.⁷³ In that case, WGF was a Maryland corporation registered as a management investment company under the Investment Company Act of 1940. WGF was also subject to SEC Rule 17g-1. Winfield & Co. was employed under a management contract with WGF to act as its investment advisor. Winfield & Co. purchased fidelity bonds from INA on behalf of various corporate entities known as the Winfield Complex. Both Winfield & Co. and WGF were named insureds under the bond. As noted, Steven Sanders, an employee of Winfield & Co., managed various portfolios, including WGF’s portfolio. It was his responsibility to arrive at decisions with respect to security to be purchased or sold for WGF’s portfolio. Sanders received bribes for recommending the purchase of certain securities at prices which Sanders knew were manipulated.⁷⁴ After discovering this activity, WGF sought to recover these losses from INA, but INA asserted that the loss was excluded by the trading loss exclusion.⁷⁵ As previously discussed, WGF’s argument that “trading” was ambiguous was rejected.⁷⁶

Since the ambiguity argument was not successful, WGF then argued that, even if the trading loss exclusion precluded recovery for Sanders’ activities, the bond should be read to provide such coverage because it was issued as a “statutory” bond.⁷⁷ To prevail on that theory, the court pointed out that WGF first had to establish that its loss was encompassed by the terms “larceny” or “embezzlement” as used in Securities Exchange Commission Rule 17g-1.⁷⁸ The court did express its opinion that Sanders, who knowingly paid more for an item than it was worth with the intention of enriching the person from whom the purchase was made, committed theft.⁷⁹ As the court pointed out:

⁷² *Id.* (Meskill, J., dissenting).

⁷³ *Research Equity Fund, Inc. v. Insurance Co. of N. Am.*, 602 F.2d 200 (9th Cir. 1979).

⁷⁴ *Id.* at 202.

⁷⁵ *Id.* at 203.

⁷⁶ *Id.*

⁷⁷ *Id.* at 204.

⁷⁸ *Id.* at 201.

Arguably then, the trading loss exclusion here could, under the statute, be interpreted so as not to exclude losses occasioned by Sanders' activities. However, interpretation of a bond to provide coverage beyond its literal terms is permissible only to the extent that such coverage is required by statute. Rule 17g-1 requires that management investment companies obtain coverage against larceny or embezzlement committed by its officers or employees. Thus, in order to limit the scope of the trading loss exclusion and thereby imply coverage beyond the express terms of the bonds, appellant must not only show that Sanders' activities constituted larceny or embezzlement, but also that Sanders was an officer or employee of the management company, WGF.⁸⁰

Since Sanders was not an employee of WGF, the management investment company, the statutory bond analysis should not have applied. WGF attempted to circumvent that technicality by arguing that the term "officer and employee of the investment company" in SEC Rule 17g-1 should include individuals such as Sanders because WGF had no employees of its own. The Winfield & Co. employees functioned as if they were WGF employees. The court rejected this argument due to the evidence that both Congress and the SEC were well aware of the practice of having a special relationship between investment advisors and mutual funds. The court recognized that practice was the norm in the industry when Rule 17g-1 was passed. Furthermore, the court pointed out that separate legislation existed concerning the conduct of investment advisors and that the legislation did not require that investment advisors be bonded.⁸¹ Because Sanders was an investment advisor, even though he was empowered to determine what securities or other property could be sold or purchased by the mutual fund, the Investment Advisors Act of 1940 did not require that Sanders be bonded.⁸² Therefore, the Ninth Circuit rejected the statutory bond argument made by WGF.

Although the *Research Equity Fund and the Index Fund v. Insurance Co. of North America* appeared to reach different results, the *Research Equity Fund* case is obviously distinguishable on the fact that the Ninth Circuit found that the accused dishonest employee was not a person covered by the terms of the statutory bond requirement.

⁷⁹ *Id.* at 204 (citing *Index Fund, Inc. v. Insurance Co. of N. Am.*, 580 F.2d 1158 (2d Cir. 1978)).

⁸⁰ *Id.*

⁸¹ *Id.* at 205 (citing Investment Advisors Act of 1940, 15 U.S.C. §§ 80b(1)-80b(21)).

⁸² *Id.* (citing 15 U.S.C. § 80a(2)(a)(20)).

There are few recent trading loss cases where insureds have made the statutory bond argument. However, in the event an insured wished to make such an argument at this time, the insured does have the authority under *Index Fund, Inc. v. Insurance Co. of North America* to make that argument. The effect or impact of the statutory bond argument is that it circumvents the purpose of the trading loss coverage by allowing conduct which should clearly be excluded under the trading loss exclusion to actually ended up being covered by the bond.

In other cases, losses arguably caused by trading are not excluded due to exceptions contained within the trading loss exclusion. The standard form language generally does not exclude trading losses when those losses are otherwise covered by Insuring Agreements (D), (E), and sometimes (A).

In one such case, *Continental Bank v. Aetna Casualty & Surety Co.*,⁸³ Moore & Schley, Cameron & Co., a securities brokerage company, purchased fidelity insurance coverage from Aetna and National Union. Two Moore & Schley employees tried to corner the market in Chase Medical Corporation stock. The two employees made unauthorized trades in customers' accounts and sold the Chase Medical stock from one customer to another without either customers' knowledge or consent. When the scheme fell apart, Moore & Schley and its clearing broker held a large number of shares of Chase Medical stock purchased on margin. Since the customers had not authorized the trades, the customers refused to meet the margin calls. The total loss was over \$11 million.⁸⁴

Moore & Schley sought coverage under its fidelity bond. The court found that the bonds excluded "loss resulting directly or indirectly from transactions in a customer's account, whether authorized or unauthorized."⁸⁵ Because the loss resulted from transactions in a customer's account, there was no coverage for these transactions.⁸⁶

Although the bond contained an exception to the exclusion for conduct covered by Insuring Agreement (A), the court found that exception to the exclusion, *i.e.*, "except the unlawful withdrawal and conversion of ... securities ... directly from a customer's account by an employee provided such unlawful withdrawal and conversion is covered under Insuring Agreement

⁸³ 626 N.Y.S.2d 385, 387 (N.Y. Sup. Ct. 1995).

⁸⁴ *Id.* at 386.

⁸⁵ 626 N.Y.S.2d at 387.

⁸⁶ *Id.*

A,” was not applicable because the two employees had not acted with the manifest intent to cause a loss.⁸⁷

In another case that concerned both trading and Insuring Agreement (A), a Chapter 7 trustee filed an adversary proceeding claim to recover on a securities dealer blanket bond issued by National Union to a brokerage firm.⁸⁸ The debtor brokerage firm claimed a loss resulted when one of its stockbroker employees violated its established policy prohibiting registered representatives from trading for their own accounts in options without having sufficient liquid assets in their accounts to cover potential losses.⁸⁹ National Union contended that the loss was not covered because the employee’s conduct did not fall within the “dishonest or fraudulent acts” clause of the bond.⁹⁰

The court examined the facts intensively to determine if the employee’s conduct fell within Insuring Agreement (A). The court noted that fidelity bonds are not issued to cover reckless or improvident trading losses caused by employees of insured securities firms but only to limit protection under the bond to losses due to embezzlement or embezzlement-like acts.⁹¹ The court observed as follows:

That a trader may have violated the insured’s established policy or standing orders or committed a grave breach of the broker’s fiduciary duty does not mean that such conduct falls within the operative language of the fidelity bond, where the faithless employee simply wanted to make money rather than cause the employer to lose money.... To invoke the operative language of the fidelity bond in question, the plaintiff trustee must plead and prove that the employee had a “manifest intent” to “cause the insured to sustain such loss.”⁹²

The court found that the employee did not act with the manifest intent to cause the securities firm to suffer a loss. Thus, no Insuring Agreement (A) violation could be established. The court recognized that the alleged dishonest act was simply a violation of an established policy and found that the employee had the intent to make money if the securities rose in value – not to hurt the debtor because the employee expected to be able to cover the open account.⁹³

The court did not identify the bond by standard form number but noted that it was a security dealer blanket bond. The trading loss exclusion was not

⁸⁷ *Id.*

⁸⁸ *In re J. T. Moran Fin. Corp.*, 147 B.R. 335 (Bkrcty. S.D.N.Y. 1992).

⁸⁹ *Id.* at 336.

⁹⁰ *Id.*

⁹¹ *Id.* at 339-40 (citing *Glusband v. Fittin Cunningham & Lauzon*, 892 F.2d 208 (2d Cir. 1989)).

⁹² *Id.* at 340 (citations omitted).

⁹³ *Id.*

discussed in any greater detail since the thrust of the analysis involved whether the insured had an employee dishonesty claim.

In *Columbia Equities Ltd. v. Underwriters at Lloyd's, London*,⁹⁴ the court had to determine coverage under a Mortgage Brokers Blanket Bond Indemnity Insurance Policy issued by Lloyd's that specifically excluded coverage for "any loss resulting directly or indirectly from actual or fictitious trading."⁹⁵ The court found that coverage for losses resulting from the allegedly unauthorized trading in U.S. government securities by the company president were excluded under this provision. Furthermore, the plaintiff failed to introduce any evidence that the loss would have been covered under the employee dishonesty provision. Thus, the loss was excluded.⁹⁶

In one case that is largely of historical interest now, *Roth v. Maryland Casualty Co.*, the court held that the trading loss exclusion precluded coverage of a claim arising from an employee's misuse of a legitimate account for a fraudulent purpose.⁹⁷ In this case, Roth's employee, Fletcher, had the authority to buy and sell securities for customers on written orders from the customers.⁹⁸ However, Fletcher also used the account to trade in his own name. His actions caused a loss in the account. Since Roth was a securities broker, it had an indemnity bond. The bond contained an exclusion that provided it did not cover:

(f) Any loss resulting directly or indirectly from trading with or without the knowledge of the Insured, in the name of the Insured or otherwise, whether or not represented by an indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness or balance.

It was clear to the court that Fletcher's dishonest acts constituted trading and that the losses were explicitly excluded under the bond.⁹⁹ The court noted

⁹⁴ 589 N.Y.S.2d 411 (N.Y. 1992).

⁹⁵ *Id.* at 412.

⁹⁶ *See also* *Flushing Nat'l Bank v. Transamerica Ins. Co.*, 491 N.Y.S.2d 793 (1985) (holding language of the trading loss rider to the blanket employee fidelity bond unambiguously indicates that trading losses were excluded from coverage; thus, a claim for recovery of losses arising from a "short-sale" of U.S. treasury notes should be dismissed).

⁹⁷ *Roth v. Maryland Cas. Co.*, 113 F. Supp. 770, 773 (E.D. Pa. 1953), *aff'd*, 209 F.2d 371 (3d Cir. 1954).

⁹⁸ *Id.* at 771.

⁹⁹ *Id.* at 772.

that all trading loss was excluded, whether it resulted from honest or dishonest acts.¹⁰⁰ Given the revisions to the exclusion since 1954 and variety of optional coverages, the significance of this opinion has faded over time.

3. The Interplay of the Trading Loss Exclusion in Repurchase Transactions

Since the financial markets constantly evolve and new forms of transactions come into existence, the limits of the trading loss exclusion will be tested. Repurchase transactions are examples of a newer transaction that cause the financial markets to evolve. Twenty years ago, repurchase transactions were rare. That is not the case today. This increased involvement in repurchase transactions leads to new risks. Several courts have addressed repurchase transactions in the context of losses alleged to be covered under a financial institution bond. In the first, an insured bank filed a declaratory judgment action asserting that the trading loss exclusion violated federal law.¹⁰¹ Lincoln-Way entered into repurchase and reverse-repurchase transactions with an investment firm, Bevill, Bresler and Schulman ("BBS"). Lincoln-Way executed documents that indicated a "sale" of a mortgage participation certificate with a market value of almost \$4 million to BBS with a corresponding agreement by BBS to "resell" the certificate to Lincoln-Way at the end of ninety days at a lower price plus interest. Lincoln-Way also entered into a repurchase transactions with BBS such that it agreed to "buy" four mortgaged-backed securities from BBS at the end of the ninety days at the same price plus interest. BBS subsequently filed for bankruptcy protection and advised Lincoln-Way that both its mortgage participation certificate and the securities were "gone." Lincoln-Way made a claim under its financial institution bond. Employers denied the claim and asserted that claim was precluded due to the trading loss exclusion.¹⁰²

Lincoln-Way argued that both the trading loss exclusion and loan loss exclusion violated federal law. The bond at issue was the Standard Form No. 22 bond which had been expressly approved by the Federal Home Loan Bank Board¹⁰³ under 12 C.F.R. 563.19 for use with savings and loans institutions.¹⁰⁴ Because the standard form had been statutorily approved, the court ruled that the trading loss exclusion contained in the standard form bond did not run

¹⁰⁰ *Id.*

¹⁰¹ *Lincoln-Way Fed. Sav. Bank v. Employers Ins. of Wausau*, 717 F. Supp. 617 (N.D. Ill. 1989).

¹⁰² *Id.* at 618.

¹⁰³ Hereinafter FHLBB.

¹⁰⁴ *Id.* at 619. The court did not discuss the applicability of the loan loss exclusion in regard to this repurchase transaction. *Cf. North Jersey Sav. & Loan Ass'n v. Fidelity & Deposit Co. of Md.*, 660 A.2d 1287 (N.J. Super. Ct. 1993).

afoul of the FHLBB regulations. The court did not include any further analysis of the trading loss exclusion.

Shortly after the *Lincoln-Way* case was resolved, repurchase transactions appeared in the case of *First Federal Savings & Loan v. Fidelity & Deposit Co.*¹⁰⁵ In this case, Sandusky, the predecessor to First Federal Savings & Loan, entered into a series of repurchase agreements with AMC that involved the purchase and sale of government securities. Many of the transactions were done via telephone with little or no written confirmation and deplorable record-keeping. While reconciling statements, Sandusky discovered that three securities underlying repurchase agreements that should have been placed in the safekeeping account were not included. It also discovered over one million dollars in treasury bonds for which it had already paid that were not in the safekeeping account.

Sandusky made a claim to Fidelity & Deposit Company. In considering whether the trading loss exclusion applied to exclude this claim from coverage, the court tried to determine whether Sandusky's losses resulted from fluctuations in market value of the securities purchased.¹⁰⁶ The court looked to the interpretation of "trading loss" made by the court in *Lopez v. Dean Witter Reynolds, Inc.*¹⁰⁷ and *Insurance Co. of North America v. Gibrasco.*¹⁰⁸ Those two courts had previously ruled that "trading" losses were those resulting from fluctuations in market value of securities purchased or resulting from ill-advised, unauthorized, or simply unlucky trading decisions made in the purchasing, selling, or trading of securities.¹⁰⁹

The Sixth Circuit found that the losses claimed by Sandusky were not market losses. Instead, the loss resulted from the mysterious disappearance of the securities. Thus, the trading loss exclusion did not preclude coverage for the losses. Had the losses not been caused by the fact that securities had not been placed in the safekeeping account as required by the parties' agreement, the court could have easily reached a different result. The almost complete lack of documentation that existed between the parties may have contributed to the court's ruling.

In the *Resolution Trust Corp. v. Aetna Casualty & Surety Co. of Illinois*¹¹⁰ case, the RTC, as conservator for a failed savings and loan, filed suit

¹⁰⁵ 895 F.2d 254 (6th Cir. 1990).

¹⁰⁶ *First Federal*, 895 F.2d at 260.

¹⁰⁷ 591 F. Supp. 581 (N.D. Cal. 1984), *aff'd*, 805 F.2d 880 (9th Cir. 1984)

¹⁰⁸ 847 F.2d 530 (9th Cir. 1988).

¹⁰⁹ *First Federal*, 895 F.2d at 260-61.

¹¹⁰ 25 F.3d 570 (7th Cir. 1994).

against Aetna on its savings and loan blanket bond to recover losses sustained in repurchase transactions. The key issue in this case was whether the repurchase transactions were characterized as the purchase and sale of securities or whether the transactions were transactions “in the nature of a loan.”¹¹¹ If the repurchase transactions were considered loans, then the claims would be barred by the loan exclusion. If the transactions were considered the purchase and sale of securities, then the claims were possibly barred by the trading loss exclusion.

The Seventh Circuit did not address whether the trading loss exclusion applied to this claim. Instead, the court found that the repurchase transactions were in the nature of loans. Since the loan exclusion precluded coverage, it was not necessary to determine whether the trading loss exclusion provided an independent ground for Aetna to deny coverage.¹¹² It is surprising that neither the *First Federal Savings and Loan* nor *Lincoln-Way* court looked at the issue of whether repurchase transactions were loans. It is not clear from those opinions whether that argument was not raised by the parties or the argument simply was not addressed by the courts.

Given the complexity and potential problems created by the repurchase transactions, two commentators prepared a very thorough analysis of repurchase transactions and exposure for liability under fidelity bonds.¹¹³ Any business or financial institution contemplating participating in a repurchase transaction should review that article. The Seventh Circuit opinion in *RTC v. Aetna* will provide some comfort to insurers that these transactions will not be covered under the bond since they are sometimes considered the equivalent of loans. However, an insured faced with a claim that involves a repurchase transaction should not overlook its ability to assert that both the trading loss and loan loss exclusions could apply.

4. The Trading Loss Exclusion in Commercial Policies

There are very few reported decisions interpreting the trading loss exclusion in the commercial context. In the *Lincoln Grain v. Aetna Casualty & Surety Co.*¹¹⁴ case, the court addressed as trading loss entity is a commercial policy. This case is unique in that respect. Most reported decisions stem from financial institution bonds or brokers blanket bonds.

¹¹¹ *Id.* at 572.

¹¹² *Id.* at 577.

¹¹³ John T. Harris and David R. Glissman, *Fidelity Exposure for Repo Losses: A Billion Dollar Time Bomb?* (unpublished paper presented at the Surety Claims Institute in Lake of the Ozarks, MO. June 27, 1986) (on file with authors).

¹¹⁴ 756 F.2d 75 (8 th Cir. 1984)

In this case, Lincoln Grain had an Iowa Division that bought and sold grain delivery contracts on its own behalf. Lincoln Grain also had a Commodities Division which did not buy or sell grain on its own behalf but executed the orders of its trading customers. William Oler was the general manager of the Iowa Division. Oler's actions caused the Iowa Division to suffer losses of \$2.6 million resulting from poor trades and hedges. Lincoln Grain argued that the trading loss endorsement on its fidelity bond did not exclude its loss. The endorsement contained the following words: "When issued to any Cotton, Coffee, Grain or Other Commodity Brokerage House, to exclude trading losses whether in the name of the insured or in a genuine or fictitious account."

The court had no trouble finding that Oler's conduct resulted in trading losses and that the losses resulted from poor judgment in the buying and selling of grain delivery contracts.¹¹⁵ Lincoln Grain argued, however, that the trading loss exclusion should apply only to its Commodities Division – not to the Iowa Division. The court rejected that argument by noting that the endorsement excluded trading "whether in the name of the insured or in a genuine or fictitious account."¹¹⁶ The court ruled that the trading loss exclusion applied to all of the company's divisions and was not limited to the Commodities Division. Thus, Lincoln Grain's claim were not covered under the terms of its commercial bond.

Whether the *Lincoln Grain* case will provide much guidance in future commercial business trading loss exclusion cases is doubtful. The narrow holding can be limited to addressing which company division should be covered by the trading loss endorsement and nothing more.

As more commercial entities increase their involvement in trading activities, there will be more cases that test the trading loss endorsement of the commercial policy.

5. Is the Trading Loss "Indirect"?

In the *Home Savings & Loan v. Aetna Casualty & Surety Co.*¹¹⁷ case, Aetna issued a savings and loan blanket bond to Home Savings. Home Savings made forty-two second mortgage loans to individuals who invested in a company called AFCO and who had been referred to Home Savings by AFCO. After AFCO failed, the AFCO investors sued Home Savings because of its involvement with AFCO. Home Savings lost that lawsuit and lost the ability to collect on these mortgage loans. Home Savings then sought coverage of

¹¹⁵ *Id.* at 77.

¹¹⁶ *Id.* at 78.

¹¹⁷ 817 P.2d 341 (Utah Ct. App. 1991).

this loss from Aetna on its fidelity bond. After Aetna denied coverage, Home Savings filed suit.

Aetna asserted that Home Savings' loss resulted from trading in securities and that the loss was excluded under Rider 6030, which provided as follows:

The Underwriter shall not be liable under the attached bond for any loss resulting directly or indirectly from trading, with or without the knowledge of the Insured, in the name of the Insured or otherwise, whether or not represented by any indebtedness or balance shown to be due the Insured on any customer's account, actual or fictitious, and notwithstanding any act or omission on the part of any Employee in connection with any account relating to such trading, indebtedness, or balance.¹¹⁸

The parties agreed that "trading" meant trading in securities. Thus, the dispute was whether Home Savings' losses on the AFCO investor loans resulted from trading in securities or from some other cause.

Aetna argued that Home Savings was "indirectly" involved in securities trading by virtue of its loans to the AFCO investors. Aetna argued that the rider excluded coverage of losses resulting "directly or indirectly" from trading in securities.¹¹⁹ Thus, Aetna argued that the exclusion applied. The court analyzed the types of occasions when the exclusion applies. The court, in discussing the *Shearson/American Express* opinion, analyzed above, noted:

The losses suffered by the insureds were indirect, in that they did not result from the insured's own securities speculation, but from unauthorized speculation by an insured's employee and from the receipt of improper payment for securities, rather than from market losses suffered by the insureds. The history of the trading exclusion, related in *Shearson/American Express*, indicates that it is intended to exclude losses resulting from the insured's, or the insured's employee's, actual investment in securities. It does not indicate that losses resulting from an insured's customers' investments are to be excluded.

Other courts have held that the trading exclusion applies only to an insured's market losses in securities transactions stemming from market fluctuations.¹²⁰

¹¹⁸ *Id.* at 360.

¹¹⁹ *Id.*

¹²⁰ *Id.* at 361 (citations omitted).

In this particular case, the securities market loss was suffered by the Home Savings' customers, the AFCO investors. Home only had a loss when the disappointed AFCO investors avoided their obligation to repay the borrowed funds as a result of the investors' lawsuit against Home Savings. Noting that Aetna pointed to no case holding that the trading loss exclusion applied when the insured did not acquire an ownership interest in securities, the court ruled that Home Savings acquired its interest in real estate only via the second liens on AFCO investors' property. As such, Home Savings did not engage in securities speculation to which the trading exclusion applied.¹²¹ The unique facts of this case will make it easy to distinguish.

The distinction of a "direct" trading loss versus an "indirect" trading loss was also recently examined in *Straz v. Kansas Bankers Surety Co.*¹²² The case involved the construction of a directors & officers policy that excluded "loss resulting directly or indirectly from trading"¹²³ In this case, First Trust Bank had improperly invested a client's money in volatile derivatives – not the conservative investments desired. After the client suffered a loss, First Trust Bank settled with its client and sued its D&O insurer. The insurer argued that the claim was not covered by the D&O policy because the claim resulted from a loss in dealing with securities.¹²⁴ The court agreed. First Trust Bank tried to argue it was entitled to coverage because it had been sued for negligence and breach of fiduciary duty. The court stated:

In this case, the trading loss exclusion should apply irrespective of St. Catherine's original theory of recovery. Moreover, the policy exclusion language is clear; losses arising directly or indirectly from securities trades are excluded from coverage. Even though some of the breaches of fiduciary duty alleged by St. Catherine's took place prior to any securities trade, the ultimate loss was a result of the trading. It was the market that caused the loss, and, therefore, the loss falls within the trading loss exclusion in the insurance policy.¹²⁵

Although the *Straz* case involves a D&O policy – not a financial institution bond – the court's analysis is instructive. The same analysis should apply to a financial institution bond case. It is important to determine the ultimate

¹²¹ *Id.* at 361.

¹²² 986 F. Supp. 563 (E.D. Wis. 1997), *aff'd*, 165 F.3d 33 (7th Cir. 1998).

¹²³ *Id.* at 566.

¹²⁴ *Id.*

¹²⁵ *Id.* at 568 (emphasis added).

cause of the loss. When trading causes the loss (even accompanied by other bad acts), the exclusion should preclude coverage.

III. ADDITIONAL SECURITIES-RELATED EXCLUSIONS

There are several other exclusions that should be considered in any case that involves losses that appear to be caused by trading or somehow relate to securities. Insureds need to remain aware of these additional exclusions in order to fully evaluate potential exposures.

A. *Financial Institution Bond*

In the standard form Financial Institution Bond claim, the following exclusions could be pertinent to a claim that involves trading or securities:

This Bond does not cover:

(s) potential income, including but not limited to, interest and dividends, not realized by the Insured;

....

(w) loss resulting from any violation by the Insured or by an Employee (1) of law regulating (i) the issuance, purchase, or sale of securities, (ii) securities transactions upon security exchanges or over the counter market, (iii) investment companies, or (iv) investment advisers, or

(2) of any rule or regulation made pursuant to any such law, unless it is established by the Insured that the act or acts which caused the said loss involved fraudulent or dishonest conduct which would have caused a loss to the Insured in a similar amount in the absence of such laws, rules or regulations;

....

(y) loss involving any Uncertificated Security except an Uncertificated Security of any Federal Reserve Bank of the United States or when covered under Insuring Agreement (A).

With the exception of the potential income exclusion, these additional exclusions were added in the 1986 revision to the Financial Institution Bond. Few of these exclusions have yet faced any serious judicial scrutiny. Thus, there are no opinions providing any extensive analysis of these newer exclusions.

B. *Brokers Blanket Bond*

Under the provisions of a Brokers Blanket Bond, the following additional exclusions should be considered whenever securities are involved in a claim:

This Bond does not cover:

(f) loss resulting from any violation by the Insured or by any Employee (1) of law regulating (i) the issuance, purchase or sale of securities, (ii) securities transactions upon security exchanges or over the counter market, (iii) investment companies, or (iv) investment advisers, or

(2) of any rule or regulation made pursuant to any such law unless it is established by the Insured that the act or acts which caused the said loss involved fraudulent or dishonest conduct which would have caused a loss to the Insured in a similar amount in the absence of such laws, rules or regulations;

....

(s) potential income, including but not limited to interest and dividends, not realized by the Insured or by any customer of the Insured;

....

(w) loss involving any Uncertificated Security except an Uncertificated Security of any Federal Reserve Bank of the United States or when covered under Insuring Agreement (A);

...

(aa) loss due to liability imposed upon the Insured as a result of the unlawful disclosure of non-public material information by the Insured or any Employee, or as a result of any employee acting upon such information, whether authorized or unauthorized.

Again, with the exception of the potential income exclusion, these exclusions are a fairly recent addition. As with the financial institution bond, few of the new exclusions have been tested in court.

C. Discussion of Additional Exclusions

While neither the financial institution bond or brokers blanket bond defines the terms “trading” or “security,” both contain the same definition of “Uncertificated Security” in regard to the pertinent exclusion contained in each bond. It is defined as follows:

Uncertificated Security means a share, participation, or other interest in property of an enterprise of or the issuer or an obligation of the issuer, which is:

- (1) not represented by an instrument and the transfer of which is registered upon books maintained for that purpose by or on behalf of the issuer;
- (2) of a type commonly dealt in on securities exchanges or markets; and
- (3) either one of a class or series or by its terms divisible into a class or series of shares, participations, interests or obligations.¹²⁶

Exclusion (y) to the financial institution bond was also added in 1986. It was included at the request of the American Bankers Association and uses the Uniform Commercial Code definitions of Uncertificated Securities.¹²⁷

¹²⁶ FIB, Definition (t).

¹²⁷ FDIC v. Insurance Co. of N. Am., 105 F.3d 778, 786 (1st Cir. 1997).

One other recent exclusion, exclusion (w), was added to the financial institution bond standard form in 1986.¹²⁸ The exclusion had been in the brokers blanket bond for years. Exclusion (w) was added to the FIB in response to the increased involvement of banks and other financial institutions in the securities markets.

One astute commentator, David Kerr, pointed out that exclusion (w) contains a potential ambiguity by exempting losses that would have occurred absent the securities laws.¹²⁹ Kerr points out that instead of specifically restricting this exception to acts covered by Insuring Agreement (A), the exception to the exclusion encompasses “fraudulent or dishonest conduct.”¹³⁰ Kerr argues that such language can be interpreted as inconsistent with the “manifest intent” definition of dishonest but ultimately concludes that the manifest intent definition of dishonest should apply to clause (1) of exclusion (w).¹³¹ To date, it does not appear that any insureds have made the argument concerning the exclusion (w) potential ambiguity.

At this point in time, there are no reported decisions addressing the applicability of exclusions (w) and (y) to the financial institution bond in any detail. While a New York court mentions the existence of these two exclusions in regard to a claim seeking to recover amounts paid to settle claims arising from insider trading, it does not discuss these exclusions in any detail.¹³²

As for the Brokers Blanket Bond, one case does discuss these exclusions, but only in the most general terms.¹³³ In this case, Drexel Burnham sought coverage of losses it claimed it sustained by reason of employee fraud and dishonesty, including criminal actions of Dennis Levine and Michael Milken.¹³⁴ The court recognized that the fifty-one bonds at issue specifically excluded coverage, albeit with varying language, for:

- losses resulting from the purchase or sale of securities;
- sale of securities;
- losses resulting from the violation by the Insured or any employee of the Securities and Exchange Act and other federal, state and municipal statutes or regulations; and

¹²⁸ This is Exclusion (f) in the Brokers Blanket Bond.

¹²⁹ David K. Kerr, *The Potential Income and Principal Other Exclusions*, in FINANCIAL INSTITUTION BONDS (Duncan L. Clore ed., 2d ed. 1998).

¹³⁰ *Id.* at 325.

¹³¹ *Id.* at 326.

¹³² *Aetna Cas. & Sur. Co. v. Kidder, Peabody & Co., Inc.*, 676 N.Y.S.2d 559, 564 (N.Y. 1998).

¹³³ *Drexel, Burnham, Lambert Group, Inc. v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999 (N.Y. 1993).

¹³⁴ 595 N.Y.S.2d at 1003.

¹³⁵ *Id.* at 1005.

•exemplary, punitive or consequential damages for which the Insured is legally liable.¹³⁵

This court ruled that Drexel Burnham's claim clearly was not covered by any provision of the bond. This case's unique facts included that Milken's and Levine's dishonest acts were not committed against Drexel. Instead the dishonest acts were committed against the investing public, the companies whose stock prices were manipulated and federal regulatory agencies.¹³⁶

As the court summarized, the dishonest Drexel employees did not steal *from* Drexel; instead, they stole *for* Drexel.¹³⁷ The court continued:

Further excluded are losses resulting from trading and the purchase and sale of securities and from violations of security laws and regulations. That is the very heart of Plaintiff's claim. The acts of dishonesty include stock manipulation, stock parking, insider trading and other trading and securities violations, both garden variety and exotic. There is no coverage provided for lost profits or for "loss of potential income," though Drexel persists in alleging it was deprived of "opportunities."¹³⁸

Thus, the court concluded that Drexel Burnham's claims were either not covered or were expressly excluded under the terms of the bonds.¹³⁹

Although many of these exclusions were added in 1986, most have not been tested by the courts in the past fifteen years. Whether these more recent exclusions will be addressed in any detail during the next fifteen years remains to be seen.

D. Potential Income Exclusion

An entire line of cases addresses the potential income exclusion. The cases will not be reviewed here in any detail. A recent and excellent article summarizes the recent potential income exclusion cases in great detail.¹⁴⁰ The analysis will not be repeated here. However, in evaluating a claim with trading issues, general familiarity with the potential income exclusion is necessary.

The majority of the potential income exclusion cases relate to interest collected or accrued on fraudulent or fictitious loans. These issues generally

¹³⁶ *Id.* at 1006.

¹³⁷ *Id.*

¹³⁸ *Id.*

¹³⁹ *Id.*

¹⁴⁰ Kerr, *supra* note 129.

arise when a series of fraudulent loans exist and some loan proceeds have been used to pay off prior fraudulent loans or to make interest payments on those earlier fraudulent loans.¹⁴¹

Although the opinions are not all models of clarity, some courts have concluded that the repayment of interest on old notes is not subject to the potential income exclusion. Instead, the courts treat those payments as part of the financial institution's loss.¹⁴²

An Iowa court, however, although considering a substantially similar factual situation, disregarded the *Branch Bank* and *Smothers* decisions and reached a contrary holding.¹⁴³ That court ruled that the term "loss" referred to actual depletion of funds and did not include that portion of outstanding notes representing interest payments made to cover prior embezzlement.¹⁴⁴

Another area in which the potential income exclusion comes into play is the applicability of the exclusion to prejudgment interest. Courts have rejected allowing the potential income exclusion to exclude coverage for prejudgment interest.¹⁴⁵

There do not appear to be any cases specifically addressing the potential income exclusion in the context of a case involving trading losses other than the allegations made in the *Drexel Burnham* case.¹⁴⁶ It is conceivable, though not likely, that an insured would seek to recover the income it lost on the ability to invest had unauthorized trades not been made. Such an argument would so clearly be excluded by exclusion (s) that it is not surprising to see no cases on this point.¹⁴⁷

IV. CURRENT ISSUES PERTAINING TO THE TRADING LOSS EXCLUSION

¹⁴¹ See, e.g., *Bank of Huntingdon v. Smothers*, 626 S.W.2d 267 (Tenn. App. 1981); *St. Paul Fire & Marine Ins. Co. v. Branch Bank & Trust*, 834 F.2d 416 (4th Cir. 1987).

¹⁴² See *Smothers*, 626 S.W.2d at 267; *Branch Bank & Trust*, 834 F.2d at 418.

¹⁴³ *American Trust & Sav. Bank v. United States Fid. & Guar. Co.*, 418 N.W.2d 853, 855-56 (Iowa 1988)

¹⁴⁴ *Id.*

¹⁴⁵ See *Oritani Sav. & Loan Ass'n. v. Fidelity & Deposit Co. of Md.*, 744 F. Supp. 1311 (D.N.J. 1990), *rev'd on other grounds*, 989 F.2d 635 (3rd Cir. 1992); *Cambridge Trust Co. v. Commercial Union Ins. Co.*, 591 N.E.2d 1117 (Mass. Ct. App. 1992).

¹⁴⁶ The court in *Drexel Burnham Lambert Group v. Vigilant Ins. Co.*, 595 N.Y.S.2d 999 (N.Y. 1993) alludes to such an allegation being made by Drexel Burnham. The court considered such an allegation so ridiculous that it did not even bother to dignify such a claim with any meaningful analysis. Instead, the court pointedly noted that there is no coverage provided for loss of potential income despite Drexel's insistence on alleging that it was "deprived of opportunities." *Id.* at 1006.

¹⁴⁷ *Id.*

A. Areas of Risk for Financial Institutions

All companies and financial institutions face some risk for trading losses. Any employee can divert legitimate corporate funds and invest in the stock market. In such an instance, that trading loss is not likely to be excluded since the loss would likely be covered under the employee dishonesty provisions of the bond (if the manifest intent requirement is met).

Companies or financial institutions that do a great deal of stock trading or participate in unique financial transactions face some risk for being at a loss from trading losses. This is particularly the case for companies that have employees whose job duties include investing either company and customer funds. Those companies obviously face increased risks for trading losses.

As previously noted, a recurring theme in several reported decisions involved the use of “repo” transactions, i.e., repurchase and reverse repurchase agreements.¹⁴⁸ Given the fact that repurchase transactions are frequently involved in these claims, financial institutions should think long and hard before entering into these repo transactions.¹⁴⁹ At a minimum, the court opinions involving repurchase transactions should be studied to determine how the losses occurred. Then, preventive measures should be implemented to avoid similar losses.

Of course, repurchase transactions are not the only area of risk. As new forms of transactions come into existence, each type of transaction should be reviewed to see if it could give rise to trading losses. It is incumbent on each financial institution and company to do a thorough self-analysis to determine areas in which it is possibly at risk for trading losses.

B. Steps to Protect from Risk

There are many steps that can reduce the risk for trading losses. The easiest step for a financial institution or business is to purchase all of the possible insurance coverage available to it. As previously discussed, courts have been less sympathetic to plaintiffs in cases when the plaintiff had optional insurance coverage available to it that would have covered the claim, but the plaintiff simply chose not to purchase it.

In addition, companies and financial institutions must establish stringent control and review procedures. While this solution may seem self-evident, many companies stay with outdated policies long since outgrown but that

¹⁴⁸ See, e.g., *First Federal Sav. & Loan v. Fidelity & Deposit Co. of Maryland*, 895 F.2d 254 (6th Cir. 1990); *Lincoln-Way Fed. Sav. Bank v. Employers Ins. of Wausau*, 717 F. Supp. 617 (N.D. Ill. 1989); *Resolution Trust Co. v. Aetna Cas. & Sur. Co. of Illinois*, 25 F.3d 570 (7th Cir. 1994).

¹⁴⁹ Harris and Glissman, *supra* note 113.

have not been reviewed or reevaluated. Often, companies do not realize how loose their control procedures really are until a loss occurs. While it is definitely appropriate to change procedures following a loss caused by employee dishonesty, whether in regard to trading or not, companies and financial institutions should not wait for a loss to review their policies and procedures. Some good control procedures to implement in any business include:

- reviews of operating performance;
- setting up strict limits on authority and tasks for both the company and individual;
- segregating job duties to reduce opportunities to commit or conceal fraud or errors;
- requiring all key employees to take regular vacations;
- safeguarding access to and use of both assets and records;
- controlling access to computer programs and data files; and
- dividing responsibilities between employees.

One area of particular concern in designing control procedures relates to increased reliance on technology, information systems, and electronic transactions. These items create a new set of security issues. One difficulty is the lack of a paper audit trail for transactions. A well-designed control procedure must take the issue of electronic audit trails into account and design programs that allow for the review of such electronic transactions. Furthermore, auditors must have a fundamental understanding of how the information systems and technology operate so that the auditors cannot be easily fooled and know the appropriate questions to ask.

The final element of a well-designed internal control system includes the use of a program that evaluates both the use and effectiveness of the stated internal controls. As new products are introduced, the control procedures should be reevaluated on a regular basis to insure that they are still effective.

C. The Advent of Internet Trading

At this point in time, it is not easy to evaluate the impact that the Internet will have on financial institutions and companies in regard to potential losses arising from trades. The biggest area of risk, of course, is the ease with which employees can now make trades from computer desktops. An employee may check personal stocks and make personal trades from his or her desk at work. It is not inconceivable to believe that, if the employee has access to financial information of the institution or company, the employee can fraudulently transfer money via the Internet into accounts and then begin making trades on those accounts. The risk is real, and the activity can be done with very

little in the way of a paper trail. Thus, the ability to detect this activity is diminished. One concern is that employees may password-protect computers or software programs so that activity cannot be reviewed in their absence. Of course, there may always be a digital trail on the employee's hard drive; but those trails are not always easy to detect or follow.

Companies should evaluate whether their employees have daily access to the Internet. If they do, the companies and financial institutions should evaluate ways to eliminate the ability to make trades from a desk. Most employers would probably be reluctant to put such a policy in place as it really restricts the ability of an employee to manage his or her own personal financial affairs. However, there should be some middle ground that could be acceptable to both employers and employees.

At a minimum, stringent control procedures that prevent unauthorized access to accounts and that allow a financial institution to trace trades made by employees will be the key to protecting against unauthorized trades in this era of easy trading access via the Internet. Furthermore, review of account activity by a different employee will minimize the opportunity for concealment of improper activity. As the Internet continues to evolve, both companies and financial institutions control procedures will have to evolve to provide the maximum protection.

V. CONCLUSION

As discussed, the growth in the stock market over the past few years, the ease with which trades can be made via the Internet, and new forms of financial transactions increase the risk that more financial institutions and companies will suffer trading losses. Without an adequate understanding of what really is excluded by the trading loss exclusion, those entities cannot make appropriate decisions as to whether they have the appropriate insurance coverage.

Thus, financial institutions and companies *and* their insurers need to revisit the exclusions in the policies that address trading losses or other activities related to securities. Only then can decisions regarding adequacy of coverage or the impact of trading activity on a claim be fully evaluated. The exclusions, as stated, currently are probably sufficient to accomplish the intended purpose of excluding trading losses from claims on these policies. If financial institutions or companies desire to purchase coverage for trading losses, it is available to them via rider for an additional premium. Thus, both insurers and insureds, by carefully reviewing the coverages purchased, should be able to achieve the optimum risk management desired.