Re: Insurance Industry Summary Regarding Crowdfunding (12/15/12)

Summary:

There are over 25 insurance markets on both an admitted basis and a non-admitted basis that underwrite Directors and Officers (D&O) Liability insurance for public companies, private companies and nonprofit organizations. Many of these companies also underwrite Professional Liability Insurance.

We have contacted nearly all major markets regarding crowdfunding and the review is as follows

- Most insurers are not familiar with crowdfunding.
- Many insurers have not even heard of crowdfunding.
- Most insurers expressed little interest of offering D&O Liability Insurance or Professional Liability insurance to crowdfunded companies or funding portals.
- Several insurers expressed possible interest in offering of D&O Liability Insurance or Professional Liability insurance to crowdfunded companies or funding portals.
- Insurance underwriting guidelines and premium rates have not been developed.
- Education and cooperation must involve insurance industry, crowdfunding community and government/regulatory agencies.
- To advance crowdfunding, D&O Liability Insurance will be very important to crowdfunding companies and Professional Liability, D&O Liability and Cyber Liability Insurance will be very important to crowdfunding portals.

Typical comments from insurance industry:

- Insurance Brokerage Firm, Small Business Division – No interest in crowdfunding.
- Insurance Company - Not interested in this class of business.
- Insurance Company - We do not want to be first.
- Insurance Company - We are waiting for SEC to issue final rules.
- Insurance Company - Sounds like the Wild West.
- Etc.

Reasons:

- The insurance industry has a very small commitment to research and development or corporate planning.
- Budget and time constraints are restricting product development.
- Insurers have a “knee –jerk” reaction of “No” to new products. For example, Cyber Liability insurance is taking a long time to develop.
- Insurers are have absorb large losses on D&O Liability insurance, especially in the financial services segment.
- Insurers need actuarial data to price coverage.
- Insurers are very reluctant to insure start up companies. This applies to funding portals and crowdfunded companies seeking initial capitalization.
- Few insurance companies underwrite financial service companies. Companies like commercial banks, investment bankers, mortgage bankers, financial advisors, broker/dealers, mutual funds, have been sued for major losses and risks are hard to predict. Crowdfunding is being classified as “financial services” or “financial institutions”.
- Misrepresentation of risk factors in the placement memorandum is a large concern to insurers.
- Unsophisticated investors (non-accredited) investors is another concern.
Developing Crowdfunding and Insurance Problems:

- FINRA will probably require funding portals to have Professional Liability insurance and Cyber Liability insurance.
- Crowdfunding companies will have outside shareholders. Companies will also have a board of directors and management. These companies will need D&O Liability insurance and possibly Professional liability and Cyber Liability Insurance.
- Reinsurance may not be available to primary insurance companies because of treaty reinsurance exclusions.
  - It appears a few admitted insurers may be able to consider underwriting crowdfunding companies or funding portals.
- The insurance industry has admitted and non-admitted (excess and surplus) insurance companies.
  - Admitted insurers are licensed by individual states to underwrite coverage provided they file policy forms and rates.
  - Crowdfunded companies will be classified as Private Company Directors and Officers Liability Insurance. Currently, it appears the policy will cover such entities. However, submissions can also still be declined. Both policy and rate amendments may be necessary if insurers want to go forward. The reason may be outside investors who are non-accredited investors. This is a new risk factor and was not previously contemplated in developing rates and policy forms. It can also take several months or up to a year to obtain state regulatory approval.
  - Non-admitted companies do not have to file forms and rates in different states. However, state guarantee funds are not available in the event of insurer insolvency. Lloyds of London is an example of a non-admitted insurer. Before a transaction can be unwritten in the E&S market it must be declined by a least three admitted insurers. We are currently making a presentation to Lloyd’s syndicates in London for crowdfunding and funding portal approval.
- Non-audited crowdfunding company financial statements may be a positive or a negative dependent on views of the insurance underwriters.
- Insurance companies have minimum premium requirements. These rates may be higher than the amount crowdfunding companies can reasonably afford. We would have to structure “in the box” underwriting evaluation and online quotation and application/policy processing software.
- We initiated a quick survey of the insurance industry to review SEC proposals for changes in “general solicitation and advertising” for private placements. See previous results of survey.

Solutions:

- We are forming the Insurance and Regulatory Council of the American Crowdfunding Investment Association to review insurance coverage issues with government agencies, regulatory agencies, crowdfunding community and insurance industry. Both law firms and senior insurance executive are planning to participate.
- We have already been recognized by astute insurance professionals as the leading organization addressing insurance and crowdfunding.
- We are preparing two comprehensive insurance surveys for 2013 first quarter. 1. Crowdfunding Insurance Survey, and 2. Funding Portal Insurance Survey (for both domestic and international funding portals including donation/contribution/reward, accredited investor funding intermediaries, proposed non-accredited investor funding portals, international funding portals and intermediaries involved in crowdfunding. See [www.acfia.org](http://www.acfia.org). On Menu go to Directory > Surveys. These surveys will be sent in January.
- Class action lawsuits are the major problem in D&O Liability insurance. However, we believe class action lawsuits are unlikely with non-accredited investor’s due limitation on an investment amount and the total aggregate amount for capital raised. Many non-accredited investors will also be family, friends, relatives, customers, suppliers, and vendors. Professional investors are probably less likely for many issuers. These considerations may also reduce insurance risk.
• Proposed FINRA and SEC rules for due diligence appear strict.
• Insurer education regarding crowdfunding will be necessary.
• Insurance industry professional organizations involvement will be important.
• We are working to develop loss control/administrative procedures and insurance underwriting guidelines, risk factors or underwriting evaluation.
• Local and national political support will also be helpful.
• We are working with insurers. However, they are not required to issue an insurance policy.
• It is hopeful that non-admitted insurers will be able to consider crowdfunding companies and funding portals, until admitted insurers are available.
• We are offering independent client satisfaction surveys to document customer satisfaction of product/services of existing companies seeking crowdfunding.
• Our objective is to provide Directors and Officers Liability, Professional Liability and Cyber Liability to crowdfunding companies and funding portals.

Crowdfunding Outcome:

• If D&O Liability Insurance is not available to crowdfunding companies it is very unlikely they will receive financing or attract board members or management.
• If D&O Liability Insurance and Professional Liability insurance is not available to funding portals it very unlikely they will be able to process crowdfunding transactions.

Contact:

I look forward to your comments and further discussion.

Please call

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