Errors & Omissions Liability:
Due Diligence & the Risk Management Process

By

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Recent industry wide scandals (i.e. Madoff, Stanford) have sent shockwaves throughout the investment community with financial advisors now scrambling to determine the adequacy of their Errors & Omissions (E&O) Insurance. These events present an opportunity to carefully review and understand all aspects of your insurance protection, and to determine if your interests are properly represented.

I recently attended two compliance industry conferences where the focus was on "due diligence" and the risk management process. The sessions concluded the existence of liability even while attempting proper due diligence in avoiding possible regulatory investigations and potential client litigation. The S.E.C. representatives stated there are currently over 500 ongoing regulatory investigations. In addition, there will be an increased focus on due diligence pertaining to Regulation S-P, safeguarding your client's confidential information including the additional liability from outsourcing to third-party vendors. Since September of 2008, numerous claims are being brought against financial advisors based on lack of due diligence, as well as loss due to "trading errors."

Here are some pertinent questions to consider:

- Have I taken the time to properly review and understand all of the emerging industry exposures?
- Does my present coverage contemplate the broadest possible coverage? At competitive market price?
- Does my insurance advisor have the requisite intellectual capital to fully evaluate and educate on recent industry trends?
- Is our risk management program at a level of "best practices," or is it a work in progress?
- Is our insurance representative independent; unaffiliated with any underwriting companies?

To best address concerns regarding how E&O insurance may respond, one needs to be armed with some basic E&O knowledge. In this article I will address the following key coverage features and their potential affect on coverage:

- ✓ Cost of Corrections Coverage
- ✓ Cost of Investigations Coverage
- ✓ Insured Services
- ✓ Where to find coverage restrictions within the policy
- ✓ Continuity of Coverage
- ✓ Duty to Defend.

The intent of an Errors & Omissions policy is to protect the firm and its directors, officers, partners and employees against loss due to an alleged negligent act, error, omission or breach of duty by the named insured while performing investment advisory or professional services. In the majority of policies, what triggers coverage is a written demand for monetary damages from a client. The first two coverage features, Cost of Corrections and Cost of Investigations, are exceptions to the coverage trigger.

Cost of Corrections coverage is not always available to a financial adviser or mutual fund group, and is typically added by an endorsement to the policy form. It amends the policy by expanding the coverage trigger to be a potential loss situation discovered by the insured, prior to receiving any written demand. An example of this is a trading error, where you discover a mistake, whether buying instead of selling a particular security; purchasing the incorrect amount of a security; or a failure to recognize a stock split within mutual funds. These are typical types of claim scenarios that fall under the Cost of Corrections Endorsement. The intent of this coverage is to take preventive medicine in order to avoid claims by your client(s). This coverage feature typically comes with separate reporting provisions, which may include receiving the insurers approval prior to taking the corrective action. The insurer will want to verify the mistake is legitimate, and not merely an attempt to recoup on a bad investment decision.

The other amendment to the coverage trigger is the Cost of Investigations coverage. This extension triggers coverage with the filing of a **formal** regulatory proceeding against the insured entity. Recently, the U.S. Supreme Court's decision to review a case on mutual fund fees, Jones vs. Harris Associates LP, magnifies the importance of this extension for other mutual fund groups. While fines and penalties are not covered under E&O policies, the defense cost associated with such litigation may apply, and it may also lead to future claims. The intent of the Cost of Investigations coverage is not to reimburse your firm for the cost associated with a routine SEC Exam, but to trigger coverage for those situations that may lead to litigation.

What is considered "insured services" under the firm's insurance policy is paramount to understand since it does intertwine with coverage features such as the Cost of Investigations coverage as well as Directors & Officers Liability Insurance. The E&O policy states that you are covered for investment advisory or professional services. This means coverage extends for losses arising out of financial or economic advice, unless otherwise amended or defined within the policy. If you are the Chief Compliance Officer (CCO) of the firm, are <u>your</u> professional services considered to be providing investment advice? It is important to understand whom is being covered, and for what services. In reference to the CCO, recent policies have been amended to include coverage for their professional services. Older policy forms have extended this additional coverage via an endorsement to the policy. A careful reading of this coverage extension is required to make sure that you are not only covered for those claims brought by the firm's clients, but also for investigations and litigation brought by regulators, including the S.E.C. While investigatory action by the S.E.C. may result in a fine or penalty, (not covered), there still exist attorney fees for defense. A "best practice" solution is to include the CCO as a corporate officer under the bylaws, and to purchase Directors & Officers (D&O) Liability insurance in addition to the E&O Insurance.

For clarification purposes, E&O insurance is designed to protect your firm for claims arising out of your professional investment advisory services. D&O Liability is designed to protect your

firm from claims arising out of business decisions. The most typical D&O claim is a shareholder suit which is not the case for privately held firms. As a privately held investment advisory firm, potential exposures can come from litigation brought by regulators as well as service providers. In addition, there may be coverage for employment practices allegations. In most cases, D&O Liability may be added to an E&O policy for a 10 to 20% additional premium charge but results in sharing of limits. A stand-alone D&O policy, while not cost effective, will provide separate limits for these exposures.

The exclusions section of your policy will list restrictions in coverage for certain types of services and/or specific types of investments. This may include exclusions for investment in or the use of CBO's, CMO's, commodities, derivatives, exchange traded notes, foreign securities, futures, hedge funds, below investment grade bonds, limited partnerships, options, warrants and perhaps other areas that the insurance carrier determines to be "specialty" areas. Not all policies have these exclusions, and negotiations may lead to less restrictive wording. This list of excluded activities tends to fluctuate year to year, so "best practices" suggests that at a minimum, an annual review be undertaken.

Another area to review within the policy form for coverage restrictions is within the definition section. Important definitions include "claim," investment advisory services, professional services, wrongful acts, and many other definitions. For example, does investment management consulting, financial planning, or wealth management services fall under the definition of investment advisory services? Does the definition extend out to cover bill paying services offered by a wealth manager? What about the sale of life insurance products including annuities and long-term care insurance?

You may also find restrictions in coverage based upon information contained within the completed application, including a completed "warranty" question or letter. By responding to any question pertaining to your knowledge on behalf of the firm and their employees surrounding "known" losses or potential claims, you are thus providing the insurance carrier with representations to rely on during a disputed claim. If the insurance carrier believes an individual or someone at your firm had specific knowledge of an action that may arise to a claim, and that action took place prior to purchasing the insurance policy, they may deny coverage based upon these representations. Make sure that you are familiar with your policy's continuity and retroactive date to facilitate "continuity of coverage." You should also be aware that most insurers do not require a "warranty statement" when renewing coverage, and may waive the requirement on new business as well. However, there are other insurers who require a warranty statement from you on an annual basis. Your insurance broker should make you aware how they may affect your coverage.

It is practical not to assume coverage automatically applies to all services and entities listed in your application. Numerous potential clients believe they have coverage for broker/dealer activities, or services as trustee, simply by acknowledging their existence on the application. If these areas of exposures are not specifically addressed by name, definition or description within the policy itself, coverage may not apply. Once again, your insurance broker is critical in assisting to identify who is covered and for what services.

I am frequently asked to review policies for "duty to defend" wording. The findings are often inconsistent. With policies that offer "duty to defend" wording, there is a requirement that the

insurer appoints the attorney to represent you in the event of a claim. However, if the policy states that the insurer has "the right but not the duty to defend," then you are afforded the right to select your own attorney. There are advantages and disadvantages to having either wording, and there are ways to modify either set of language as it applies to the duty to defend. The key is to ensure the selected attorney will fight to protect your reputation in the event of a frivolous claim, versus trying to reach a settlement simply to mitigate the insurers ultimate expense.

This article is a brief summary of points to consider in purchasing an E&O insurance policy. The key is consulting an experienced insurance professional whom understands the intricate nuances of the investment industry. Most investment firms have either their Chief Compliance Officer or Chief Operating Officer handling their insurance requirements; however, the current regulatory environment demands outsourcing to an insurance professional to handle the complicated coverage issues and to carefully explain what is purchased prior to securing coverage. At a minimum be sure to have an insurance professional whom is familiar with the obstacles and requirements that you face on a daily basis. The professionals can be readily found at investment industry conferences, learning more about your industry so to provide unparalleled quality of service.

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