

INVESTMENT ADVISOR Errors & Omissions

Exposure and Coverage Trends



Asset management firms require a special expertise in insurance product design and placement.

Investment Advisors need to be concerned when it comes to their exposure and how insurance can protect them. Since 1957, Liftman Insurance has focused on providing insurance for the investment industry. This guide aims to educate you about the risks that you face and help you understand your coverage options.

- Insurance Coverage for Investment Advisors
- Insurance Marketplace Trends
- Why Investment Advisors Purchase D&O/E&O Insurance
- Peer Benchmark Analysis of D&O/E&O Limits
- Private Plaintiff Claim Examples
- Regulatory Claim Examples
- Pricing Considerations for Investment
- Advisors Coverage



Insurance Coverage for Investment Advisors

These are the primary coverages that every Investment Advisor should consider:

- Errors & Omissions Liability
- Directors & Officers Liability
- Cyber Security
- Employment Practices Liability
- Fidelity and ERISA Bonds
- State Surety Bonds
- STAMP Bonds



Insurance Market Pricing and Coverage Trends

Pricing for investment adviser E&O coverage depends on various factors. Premiums are based upon assets under management, investment strategy (including portfolio construction, position concentration, leverage, liquidity, risk controls to mitigate loss), management team experience, compliance, trading errors, investor profile, transparency (communication with investors), and claims history.

The investment adviser professional lines environment has benefited from the equity bull market, and stable economic conditions have resulted in a lack of systematic investor losses. The favorable loss environment has allowed insurers to broaden coverage, with most investment adviser policies now providing cost of corrections and trade error coverage with full limits of liability, broad coverage for regulatory investigations and inquiries, and endorsements that contribute to the cost of a compliance audit.

While the rate and loss environment for investment adviser space has been stable, attritional losses limit insurers' ability to grant rate reductions. Investment adviser investiga-

tions and private plaintiff litigation or arbitration demands require niche defense counsel, and hourly rate increases have greatly exceeded traditional inflation metrics. Defense counsel rates and broad investigation coverage grants have significantly increased insurer losses. Loss activity has also increased for private credit and private equity advisers, and class actions by plan participants in 401(k) plans related to mutual fund options occasionally name investment advisers in their capacity as a plan adviser. To the extent that some investment adviser package products include employment practices coverage, the higher-than-average compensation levels in the investment adviser space has triggered large employment practices settlements.

Why Investment Advisors Purchase D&O/E&O Insurance



- To protect the entity and individuals against claims alleging a wrongful act, error, omission, misstatement, misleading statement, neglect or breach of duty in providing or failing to provide professional services as an advisor.
- To provide defense costs and indemnity coverage for client disputes. In addition to covering defense counsel fees, most policies cover the cost of hiring third-party experts to assist in the defense of the claim, and the highly specialized nature of adequate defense counsel can result in substantial defense costs.
- To assist with legal fees associated with regulatory enforcement activity. Policies now provide broadened coverage for investigations.
- The investment advisory regulatory environment is constantly evolving with newly implemented regulations and enforcement priorities based on emerging risk factors. Recent examples of regulatory and enforcement activities include marketing regulations, cybersecurity exposures and security requirements, and artificial intelligence's

potential impact on adviser disclosure obligations or fiduciary duties. Regardless of the political environment, SEC examination priorities consistently focus on protecting retail investors from issues such as misleading or inaccurate disclosures, or advisers recommending products not suitable for an investor's risk appetite or investment needs.

- Partnering with an established insurer with investment adviser product and claims expertise can prove invaluable in assisting the adviser with regulatory or litigation issues.
- Many firms have moved beyond traditional passive investments and have board representation. Managers face additional liabilities when they serve on outside boards. A D&O policy can be extended to cover these outside directorship exposures.
- A D&O/E&O policy can also be extended to cover Employment Practices Liability. This important coverage protects the firm and its principals from employee claims for wrongful termination, discrimination and sexual harassment.
- Advisors are purchasing D&O/E&O coverage because their clients are demanding it, many firms use it as a selling point.

Peer Benchmark Analysis of D&O/E&O Insurance Coverage Limits

Through peer analysis and insurance market experience, an average limit/retention range is shown in the table below.

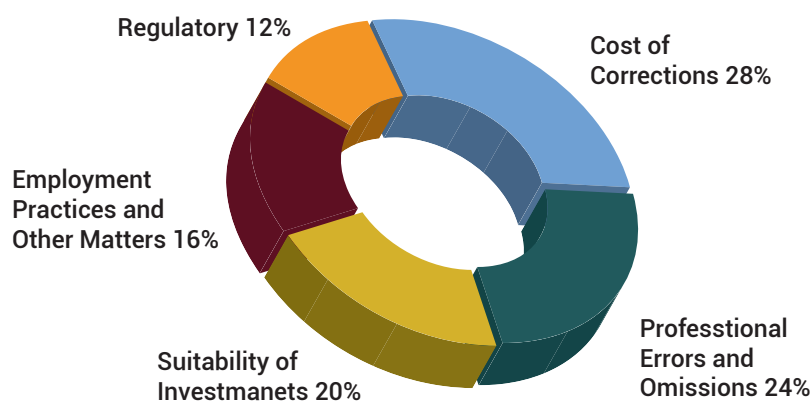
Assets Under Management	Limits of Liability	Retention
Under \$300M	\$1M to \$3M	\$10,000 to \$25,000
\$300M to \$900M	\$3M to \$5M	\$25,000 to \$75,000
\$900M to \$3B	\$5M to \$10M	\$75,000 to \$150,000
\$3B to \$10B	\$10M to \$15M	\$100,000 to \$250,000

Types of Claims Investment Advisors are Likely to Encounter

- Mismanagement
- Misstatements
- Negligence
- Fraud
- Breach of duty
- Failure to perform adequate due diligence in evaluating potential investments
- Failure to provide adequate disclosure of the investment risks involved Failure to follow investment guidelines
- Failure to invest
- Failure to redeem investor funds in a timely and orderly manner
- Manipulation or misrepresentation of historical performance
- Unsuitable investment recommendations
- Short selling
- Trading errors
- Contracting with substandard vendors/advisors
- Conflicts of interest/related party transactions
- Market timing/late trading insider trading
- Failure to comply with ERISA regulations
- Claims made by employees alleging discrimination, sexual harassment, or wrongful termination
- Claims by the SEC, state regulators or other regulatory bodies alleging violations of rules or statutes
- Failure to update ADV disclosures
- Improper fee practices or computations

Claim Frequency Trends

Investment advisors face legal exposures from numerous parties and claim trends are constantly evolving. The previous page noted potential errors and omissions exposures for investment advisors and the chart below shows specific sources of claims made under investment advisor professional lines policies.



As noted above, regulators represent a modest percentage of claims brought under investment advisor professional lines policies, but they cause a disproportionate share of paid losses. Legal fees responding to SEC formal investigations and proceedings can be substantial due to the level of sophistication required to properly defend against the proceeding or investigation and, in some cases, engage third parties. The SEC brought nearly 100 enforcement actions in the investment advisor space in a recent Fiscal Year and some of these actions arguably relate to minor or procedural infractions.

The chart also illustrates that cost of corrections issues are a frequent cause of reported claims, and depending on the exact wording offered by the insurer, cost of corrections coverage might extend beyond trade errors to include most wrongful acts by an advisor that caused a client to suffer financial losses.

Employment practices claims against investment advisors are infrequent but generally result in higher defense costs and settlement values due to the compensation levels involved.

Private Plaintiff Claim Examples

The following are examples of recent private plaintiff enforcement actions and coverage is of course governed by the specific terms and conditions of each individual policy.

Defined Contribution Plan Advice: An investment advisor assisted 401(k) plan committees with guidance on suitable mutual funds for inclusion in their plans. One plan committee was targeted in a purported class action by plan participants regarding the inclusion of target date funds with investment returns that allegedly lagged other target date funds. Discovery revealed that the investment advisor used an incorrect benchmark to evaluate the target date funds' performance. The plaintiffs in the underlying complaint made a written demand for the investment advisor to contribute to the settlement and the advisor agreed to make a substantial payment.

Private Placements and Non-registered Securities: A non-discretionary investment advisor recommended that its client purchase high-yielding foreign asset-backed fixed-income securities. The client suffered a substantial loss of income and principal on the securities and instituted an arbitration proceeding against the advisor. The arbitrator issued an award in excess of the client's actual losses.



Incorrect Strategy Allocation: An investment advisory services contract provided that the investment advisor would limit the percentage of client funds allocated to certain strategies. The advisor failed to properly note the strategy limitation in its system, which resulted in an overweight position in a volatile investment category. The investment advisor subsequently discovered the error and informed the client of the losses caused by the overweight position relative to what the returns would have been if the assets had been allocated to the correct asset class. The advisor sought coverage under the cost of corrections provision of their policy.

Employment Practices Liability*: An investment advisor terminated a female executive allegedly in retaliation for her missing various meetings after her jury duty commitment was extended. In her wrongful termination claim, she alleged that female employees were systematically treated less favorably than their male counterparts for compensation and promotion decisions. The advisor contended that she was terminated for performance reasons and that the termination decision was made prior to the jury duty extension. The case eventually settled.

** Employment Practices Liability is often available for an additional premium upon request*



Regulatory Claim Examples

The following are examples of recent SEC enforcement actions and coverage is of course governed by the specific terms and conditions of each individual policy.



Suitability: The SEC found that an investment adviser breached its fiduciary duty to retail investors and suffered compliance failures by executing purchases of leveraged ETFs for several retail clients over a three-year period. The ETFs' proxies disclosed that if shares were held for more than one day, the share price would not track a multiple of the relevant index and, in certain cases, move in the opposite direction. A majority of the adviser's clients were invested in leveraged ETFs, and

shares were often held for several months. The SEC alleged that the adviser had no reasonable basis to believe that the investments were suitable for the adviser's client base.

Failure to Establish Procedures: The SEC brought an enforcement action against an advisor that recommended and traded thinly traded equities for failure to establish, maintain and enforce written procedures designed to prevent the misuse of material non-public information (MNPI). The SEC noted that the investment strategy resulted in advisor personnel obtaining MNPI, rigorous procedures were required to safeguard the use of such information and that the advisor failed to properly maintain a list of prohibited securities for members' and employees' personal trading activities.

Wrap Fees: The SEC has brought numerous enforcement actions relating to wrap programs and wrap structures often appear in the SEC's annual list of topics that will be emphasized in the examination process. In a 2022 enforcement action, the SEC alleged that an advisor failed to monitor trading activity in wrap accounts as part of their suitability

analysis. In particular, the SEC alleged that in contravention of its written compliance policies, the advisor failed to establish adequate procedures to conduct suitability reviews. The SEC also found that some clients were improperly charged transaction fees.

Failure to Update the Form ADV: An investment advisor's Form ADV is required to provide a full and fair disclosure regarding its conflicts of interest when rendering investment advisory services. In a recent case, an investment advisor entered into an agreement with a mutual fund sponsor that provided for revenue-sharing payments to a broker-dealer affiliated with the investment advisor. The investment advisor initially failed to update its Form ADV to note this conflict of interest and when it later did modify its Form ADV for this disclosure, it did not identify this change in the summary of material changes provided to legacy clients. The advisor entered into a cease and desist order, was censured, and forced to pay a disgorgement amount, civil penalty and prejudgment interest.

Chief Compliance Officer: In a 2021 Enforcement action the SEC stated that a CCO: a) failed to require an investment adviser representative to submit a reporting form related to outside business activities after the CCO learned of the activities, b) failed to analyze whether the activity presented a conflict of interest as required by the adviser's compliance manual, and c) failed to review the transfer of assets from the adviser to the outside business activity after learning of the transfer. The adviser entity was censured and subjected to a financial penalty, and the CCO was personally subjected to a financial penalty.



Liftman Insurance has specialized in insurance for the investment industry since 1957. Investment advisors, mutual funds, hedge funds and securities broker/dealers all rely on us to obtain broad coverage at competitive premiums. Contact Liftman Insurance today to see how you can benefit from our vast experience and commitment to client satisfaction.

FINANCIAL INSURANCE COVERAGE

Errors & Omissions Liability
Directors & Officers Liability
Cyber Security
Employment Practices Liability
Fidelity and ERISA Bonds
State Surety Bonds
STAMP Bonds



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