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Compliance Review

Ongoing compliance updates for independent advisors

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Advisor Services

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Key insurance considerations for investment advisors

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I. Introduction

Investment advisors bear significant compliance burdens associated with obligations under the Investment Advisers Act of 1940 and the fiduciary duty they owe to their clients. However, investment advisors, as business owners, also face a host of business risks. Good business practices can help an investment advisory business grow and flourish, but they will only go so far in protecting the business from liabilities both foreseen and unforeseen. To address these risks, investment advisors, like most professionals, regularly rely on insurance.

Some of the insurance policies of interest to investment advisors are of general interest to most business owners, regardless of the nature of their business. For example, nearly every employer in the U.S. is required to purchase workers' compensation insurance to compensate employees for work-related injuries. Likewise, employment practices liability insurance, known in the insurance trade as EPL insurance or EPLI, provides coverage to employers against claims made by employees alleging discrimination, wrongful termination, harassment, and other employment-related issues. Similarly, investment advisors, like most business owners, would likely want to carry commercial general liability insurance to cover claims for bodily injury and property damage, as well as for certain other liabilities depending on the terms of the policy.

Perhaps the fastest-growing line of insurance, cyber insurance, is also of great interest to investment advisors. Policies are now widely available that protect not only against third-party claims arising from data breaches and other covered events but also against losses that the policyholder itself incurs (such as costs to investigate, costs to remediate destroyed files and computer systems, and the costs associated with notifying clients). Cyber insurance is of particular importance to entities that hold personally identifiable information, which may include investment advisors and/or their vendors. Cyber insurance could be the subject of its own paper, but for the purposes of this paper, it is important to note that an increasing number of investment advisors are securing insurance against cyber risks and that consultation with an experienced broker is necessary because the forms and coverage available under cyber insurance policies can differ in many material ways.

Read more about cyber liability insurance

Schwab Advisor Services™ offers a Cybersecurity Resource Center that features a variety of educational materials, actionable tools, and third-party resources. Review the planning tool focused on supplementing cybersecurity infrastructure with cyber liability insurance.

In addition, some forms of specialty insurance are of particular interest to investment advisors. For example, investment advisors often purchase fidelity bonds, which may cover losses arising from employee theft or other malfeasance. Specifically, a fidelity bond covers the loss of property held by an investment advisor and provides funds that can be used to reimburse a client in the event of employee theft. As such, fidelity bonds mitigate risk to both the investment advisor and its clients.

It is worth noting that fidelity bonds (or analogous insurance) may be mandatory for certain investment advisors under applicable law or as a result of certain business relationships. Investment advisors should therefore ensure that they are complying with any legal or contractual requirements when securing fidelity bonds.

Also, although frequently based on a standard form, fidelity bonds can include extensions of coverage to address specific risks or potential situations that often result in coverage disputes. For example, insurers have declined coverage for fraudulent transfers achieved by a third party impersonating an insured company's employee. Although coverage for this sort of impersonation fraud is not entirely settled under traditional fidelity bond coverage, a policyholder can secure an extension of coverage that specifically includes these sorts of risks. Other extensions of coverage may also be available, and the insurance industry regularly introduces new forms of coverage intended to address the latest fraudulent schemes. Accordingly, investment advisors should work closely with their brokers to ensure that their fidelity bond coverage takes into account emerging trends and evolving risks.

Further, investment advisors may be subject to the bonding requirements of the Employee Retirement Income Security Act of 1974 ("ERISA") if they advise ERISA plans or have the right or power to exercise discretionary authority over purchases and sales of plan assets.[1] The bond is intended to protect a plan's assets against loss due to fraudulent or dishonest behavior and is calculated based on the amount of funds handled by the fiduciary.[2]

Perhaps the most critical form of insurance for investment advisors to consider is professional liability insurance, which is commonly referred to as errors and omissions ("E&O") insurance. E&O insurance is intended to protect an investment advisory firm and its officers, directors, and employees from claims arising from the investment advisory services offered by the firm. E&O insurance is the primary means for addressing these sorts of risks, and it is the policy that is most likely to protect an investment advisor from claims brought by clients or regulators arising from professional errors. As discussed throughout this paper, it is not enough for an investment advisor to secure an E&O policy. To obtain the full benefits of this coverage, the investment advisor should understand how these policies work, what risks are covered under these policies, and how to secure a policy with favorable policy language. It is also important that the advisor understand how the claims-handling process works in order to maximize coverage.

In this paper, we discuss:

- The reasons to purchase an E&O insurance policy;
- How E&O insurance policies work and the risks that the policies insure against;
- What insurance is available in the marketplace;
- How to secure the best coverage; and
- How to present a claim and pursue coverage under an E&O insurance policy.

II. Why do investment advisors need E&O insurance?

While there is no regulatory requirement for an investment advisor to carry E&O insurance, many investment advisors choose to buy E&O insurance to protect against claims made by disappointed clients. E&O insurance can protect against claims that arise from errors committed in the investment process (e.g., trade errors) as well as other errors related to the advisory services provided to clients (e.g., failure to maintain the confidentiality of client information). Unfortunately, even the most diligent advisors can make mistakes that can result in client losses. Moreover, even when an advisor has not made a mistake, clients who lose money can become unhappy with the services provided by their advisor and attempt to pursue claims to recover market losses. As long as financial markets go up and down and clients incur investment losses, advisors will face the risk that clients will assert claims, including claims for losses that did not arise from actual errors.

Defending against these claims, regardless of the merits, can be expensive, time consuming, and stressful and can expose an advisor to potentially significant damages. An E&O insurance policy can relieve some of these burdens by helping to fund the costs of defense and by potentially covering a resulting settlement or judgment. Further, many investment advisors appreciate the comfort of knowing that they are protected.

As noted previously, the most common claim faced by an investment advisor originates from a disappointed client who has suffered an investment loss. Industry veterans (and

[1] ERISA Section 412; 29 CFR § 2580 et seq.

[2] Some states also impose net worth and bonding requirements on investment advisors, whereby an insurer takes on secondary responsibility for a default or debt of the investment advisor. See, e.g., M.G.L. c. 110A § 202(e), 950 CMR 12.205 et seq. (Massachusetts bonding requirements); N.J.A.C. c. 13:47A-2.3 (New Jersey bonding requirement).

their counsel) tend to focus on traditional "trade errors," but client claims come in many forms and are asserted under a variety of theories. Some of the most common include:

- Claims against an advisor for breach of contract based on assorted breaches of the advisory agreement (which may or may not involve the investment process);
- Claims against an advisor for breach of fiduciary duty (statutory or otherwise) or negligence, including failure to disclose risks, self-dealing, conflicts of interest, or other unethical or unlawful behavior;
- Claims against an advisor that are related to errors in the trade execution process (traditional "trade errors") or failure to follow a client's investment guidelines or instructions; and
- Claims against an advisor arising from the actions of third parties (e.g., the advisor's service providers or trading counterparties).

Consider the following hypothetical claim. A client experiences $1 million in investment losses and, after consulting with a lawyer, files a complaint against its investment advisor, alleging a host of claims, including breach of fiduciary duty, breach of contract based on purported performance guarantees, and claims based on purported excessive fees and commissions. Even if the claims are without merit, it may take years to resolve the matter, and it may cost hundreds of thousands of dollars to defend the claims. Plaintiffs' attorneys often work on contingent fees and are motivated to pursue every last avenue to a recovery, and it will rarely be immediately apparent to a client or the client's counsel that a claim is without merit. If at least one of the claims has some merit, resolving the claims through settlement may require an additional large expenditure and additional time.

E&O insurance would potentially cover the defense of these sorts of claims and may provide coverage for some or all of a settlement or judgment. An investment advisor without E&O insurance would have to pay for its own defense and may not have sufficient funds to settle the matter prior to trial. Taking interest into account, this hypothetical claim could cost an uninsured advisor more than $1.5 million to resolve. Given the potential for client investment losses, it is not difficult to imagine scenarios that would have a significant impact on even a well-capitalized but uninsured investment advisor.

A final consideration is client expectations. More sophisticated clients may expect—and many require—that their investment advisor carry E&O insurance. Some clients will only be at ease if they know that adequate insurance is in place, both to protect against losses that exceed an advisor's ability to pay and to mitigate the conflicts of interest that can arise in the error resolution process.

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III. The nuts and bolts of E&O policies

The basics

E&O insurance policies are written on a "claims-made basis." This means that an E&O policy provides coverage for claims that are asserted against an advisor during a specific policy period, normally a 12-month period. It also means that the operative policy for a claim will be the policy in place during the year that the claim was made unless the claim is related to a claim made in a prior policy period or relates to circumstances reported by the policyholder in a prior policy period that might result in a claim. For this reason, the date of the wrongful act, or the date that the claimant alleges that the advisor's improper conduct occurred, does not determine which policy responds to the claim. This structure also means that a policyholder must purchase a new policy every year to ensure that coverage is in place for any new claims that may arise in the current policy year.

E&O policies are intended to cover the costs of defending a covered claim (defined later), as well as the costs of resolving a covered claim, either by settlement or judgment. Under E&O policies, the insurer has an obligation to pay the policyholder's defense costs, which are generally subject to a specified deductible or self-insured "retention." Under some policies, the insurer has a duty to defend and the right to select counsel for the defense, in which case the insurer generally pays the defense costs directly to the defense counsel of its choice. In other policies, the insurer has an obligation to pay the policyholder's defense costs, which often operates as a duty to reimburse defense costs rather than as a duty to defend, with the insurer reimbursing the policyholder for defense costs that the policyholder has already paid. Under reimbursement policies, a policyholder generally has the ability to choose defense counsel, subject to the consent of the insurer, and retains greater ability to control its defense than it would under a "duty to defend" policy. Under most E&O policies, defense costs paid will reduce the total insurance limits available to the policyholder.

The obligation to pay for the costs of a settlement or judgment is referred to somewhat confusingly as an "indemnity" obligation and is distinguished from the

obligation to pay a policyholder's defense costs. The mechanism for paying a settlement or judgment can differ between policies, with some policies contemplating a direct payment from the insurer to the claimant and others contemplating the insurer reimbursing the policyholder for payments already made to resolve a claim. Under either scenario, and as a general rule, a policyholder must seek the insurer's consent prior to agreeing to resolve a claim, and the insurer cannot unreasonably withhold its consent to effect such a settlement. The costs of paying a settlement or judgment typically are paid from available policy limits, so if the limits are insufficient to fund a settlement or judgment, the policyholder will be responsible for any excess.

E&O insurance is generally structured to provide coverage for claims asserted against the business entity itself, as well as its employees, directors, officers, and certain other agents or affiliates. Business entities will often indemnify their officers, directors, and employees under bylaws, statute, or agreement. In recognition of this fact, many E&O policies provide not only direct coverage to individuals for non-indemnified claims asserted against them but also direct coverage to business entities for amounts that they pay to indemnify individuals for claims asserted against the individuals.

Often a single E&O policy is sufficient to address the risk profile of many investment advisors. For larger investment advisors that face larger potential exposures, it may be necessary to secure "excess" E&O insurance to provide greater limits of coverage. This may be because primary insurers are not willing to provide primary E&O insurance above certain limits or because the policyholder may consider it prudent to diversify risk among multiple insurers. In some cases, the total cost of coverage may be less expensive if an excess policy is used, because excess insurers can charge lower premiums based on the lower risk that their limits will be reached. For the most part, excess insurance "follows the form" of the primary insurance, meaning that once a claim reaches the excess layer, the terms and conditions of the primary policy will control the excess policy.

Insuring agreements and policy language

E&O insurers do not use so-called "standard" forms, and the policy language used by insurers differs considerably. A policyholder (and its broker) can oftentimes attempt to negotiate the policy language contained in E&O policies. This may be accomplished either through edits to the offered policy language or by endorsement, which is an amendment or addition to an existing insurance contract that changes the terms or scope of the original policy. Additionally, insurance policies are generally governed by state law, which can differ materially in the interpretation of certain insurance provisions, with the result that identical provisions can obtain different results in different states.

With these caveats noted, E&O policies tend to share a similar structure and are based on the same concepts. As an initial matter, E&O policies have one or more "insuring agreements" that may differ in language but uniformly set forth the basic coverage provided by the policy. The following is a typical example of an insuring agreement that could be found in an E&O policy issued to an investment advisor:

Typical example of an insuring agreement found in an E&O policy issued to an investment advisor

The "Insurer" shall pay on behalf of the "Insured Advisor" all "Loss" for which the "Insured Advisor" becomes legally obligated to pay by reason of a "Claim" first made against the "Insured Advisor" during the "Policy Period" ... for any "Wrongful Acts" by the "Insured Advisor" ... in rendering or failing to render "Professional Services."

In the example above, the terms within quotations are defined terms, and the definitions of those terms are critically important to understanding the scope of coverage. For example, the definition of the term "Loss" generally includes defense costs as well as settlements and judgments (or indemnity). However, the definition of "Loss" will also typically omit coverage for certain types of payments, such as fines or penalties, although courts have disagreed on how to interpret these terms.

The definition of the term "Claim" is also critical in determining not only the scope of coverage but also when coverage is triggered. The definition of "Claim" varies widely among insurers. In some policies, a "Claim" is defined broadly, generally as "a written demand for monetary or non-monetary relief." Notably, under this definition, a "Claim" generally does not need to be a complaint served on an investment advisor. A "Claim" could be a demand letter requesting damages or the return of fees, or even an email from a client demanding to be made whole for certain losses.[3] Policyholders should understand the definition of "Claim" in their policies so that they can provide any required notice of any "Claim" to their insurers and mitigate the risk of any "late notice" defense asserted by an insurer (see the discussion that follows in the "Policy conditions" section).

Next, the definition of "Wrongful Act" informs the coverage available under an E&O policy. The term is generally defined to mean any error, misstatement, misleading statement, act, omission, neglect, or breach of duty actually or allegedly committed or attempted by the advisor acting in its capacity as such.

[3] Some policies define "Claim" to include a request for an agreement to toll the statute of limitations applicable to a potential claim.

Last, the definition of the term "Professional Services" greatly impacts the extent of coverage. "Professional Services" is commonly defined to include giving financial, economic, or investment advice, including performing investment management services, and such services generally must be performed in exchange for a fee, commission, or other compensation. It is important that this definition appropriately track the services actually provided by the insured advisor. This is because investment advisors offer a host of different services and sometimes make use of third parties to provide certain services. To the extent possible, it is advised that the investment advisor discuss the nature of its business, including the use of third parties when providing services, with its insurance broker and/or legal counsel to ensure that this term is appropriately defined to maximize coverage.[4]

Additional or amended coverage available by endorsement

As discussed previously, E&O insurance can be negotiated to obtain preferred policy language and sometimes even broader forms of coverage. Many provisions in E&O policies can be improved by endorsement, and sophisticated brokers and legal counsel have the experience to suggest appropriate modifications.

In addition to these changes, some insurers are willing to offer additional grants of coverage, often through an additional insuring agreement. The most important for investment advisors is "cost of corrections" coverage, which requires the insurer to correct (or to reimburse an investment advisor for costs associated with correcting) a situation arising out of an alleged wrongful act before an actual claim is made. Cost of corrections coverage provides the policyholder (and the insurer) with a way to quickly resolve errors that would likely lead to claims down the road; it is especially important to the resolution of trade errors that can lead to catastrophic losses if not corrected promptly.[5]

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Exclusions limit coverage

In addition to definitions and conditions that may define the scope of coverage, E&O policies also typically contain exclusions that may bar coverage for certain kinds of claims. Courts typically hold that insurers have the burden of proof on exclusions, but insurers regularly rely on exclusions to deny coverage or to reserve their rights to deny coverage at a later date. Investment advisors should therefore pay particular attention to the exclusions in their E&O policies. Insurers may contend that certain exclusions restrict or eliminate coverage for the very claims that may be of most concern to an advisor and its employees, officers, and directors. A few of the most common and problematic exclusions are discussed next.

Fraudulent, criminal, or dishonest acts

E&O policies generally contain some form of exclusion for fraudulent, criminal, or dishonest acts. Insurers argue that the insurance is not intended to cover certain types of deliberate wrongdoing. The difficulty comes in determining whether the policyholder has committed a wrongful act that falls within the scope of the exclusion and, if so, when and how that determination can be made.

At its most draconian, the exclusion potentially applies to any claim that includes allegations that an insured engaged in deliberate fraud or other acts that fall within the scope of the exclusion. Insurers might argue that this approach limits coverage to negligent acts, which may not be in line with a policyholder's reasonable expectations. In contrast, many policies include a more favorable version of this exclusion that applies only if there is a final, non-appealable adjudication in the underlying action against the insured, establishing that the insured committed a deliberately fraudulent or criminal act. Under the latter approach, an insurer would have to cover defense costs through the conclusion of the matter, and the insurer could not rely on this exclusion if the policyholder settles the case prior to a final, non-appealable adjudication.

This exclusion is often structured to make it clear that the intentional conduct of one insured could not be imputed to another insured and could not act as a bar to coverage for an "innocent" insured. Absent this structure, an insurer could attempt to argue that some excluded conduct by one person could impact coverage for all of the remaining employees, directors, and officers, and for the entity itself, even though the offending conduct was limited to one person.

[4] For in-depth discussions of the structure of E&O policies, see Peter J. Kalis et al., *Policyholder's Guide to the Law of Insurance Coverage* § 12.01 et seq. (1st ed. 1997); William E. Wright, *Law and Practice of Insurance Coverage Litigation* § 49:1 et seq. (2017).

[5] Cost of corrections coverage generally requires the advisor to provide notice of the error within 24 to 48 hours of discovery and may require the advisor to pay a set percentage of the cost to correct the error. For further discussion of cost of corrections coverage in the context of investment management, see ICI Mutual Insurance Company, *Mutual Fund D&O/E&O Insurance: A Guide for Insureds* (2009), pp. 35–36.

Wrongful profit or ill-gotten gains

Most E&O policies include an exclusion that bars coverage for claims that are based on a policyholder gaining a profit or other financial advantage to which it was not legally entitled. Insurers argue that the rationale is that a policyholder should not be able to use insurance to allow it to keep its ill-gotten gains.[6] Similar to the deliberate fraud exclusion discussed previously, many of these exclusions apply only in the event of a final, non-appealable adjudication in the underlying proceeding and thus should not apply if a policyholder settles the underlying litigation.

Return of fees

Most E&O policies also contain an exclusion related to disputes involving fees, commissions, or other charges paid to the investment advisor by the client. One effective way for the insured to limit the scope of this exclusion is to include language that prevents the insurer from using it as a bar to coverage for defense costs, thereby limiting its application to settlements or judgments that amount to the return of fees.

Contract exclusion

Almost every E&O policy contains a breach of contract exclusion. This type of exclusion bars coverage for contractual undertakings that are outside of the professional services provided to a client. Generally, the contract exclusion should include exceptions or "carve-backs" that make it clear that the exclusion does not apply to any claim based on a contract to provide the professional services that are covered by the policy, such as an investment advisory agreement. Insurers may argue that this exclusion also acts as a bar to coverage for claims based on oral promises or guarantees of performance.

Specific exclusions (Madoff-related losses/market timing/late trading)

E&O policies will sometimes contain specific exclusions regarding certain claims that insurers wish to exclude from coverage due to perceived exposures in the industry. For example, for many years, specific exclusions regarding claims based on Madoff-related losses were common, as were exclusions for claims based on market timing and late trading activity. For the most part, an investment advisor is in the best position to gauge its exposure to these sorts of claims and should negotiate the E&O policy taking these risks into account.

Other common exclusions

E&O policies typically contain exclusions that bar coverage for claims that are not based on the provision of investment advisory services. These exclusions bar coverage for, among other things, claims for personal injury, infliction of emotional distress, libel, or slander. E&O policies also typically exclude coverage for claims that would be covered under other types of insurance, such as claims arising under ERISA or employment practices claims, such as discrimination and harassment claims.

Policy conditions

In addition to exclusions, there are a number of policy conditions that an insurer may attempt to rely upon in denying coverage for what would otherwise be a covered claim. The most important coverage defenses that policyholders should be aware of are discussed next.

Late notice

E&O policies typically include a notice provision that relates to the policyholder's obligation to notify the insurer of a claim. Most policies do not require a policyholder to provide notice within a set number of days and instead obligate the policyholder to provide notice "as soon as practicable" or "as soon as reasonably possible." As a result, determining the exact number of days until notice is "late" is a fact-specific inquiry and may also depend on the specific policy language and the applicable state law.[7] Policyholders should be aware that insurers may attempt to deny coverage based on so-called "late notice." Because of this uncertainty, and as a general rule, policyholders should provide notice as soon as possible to preserve coverage.[8]

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[6] The public policy of many states prohibits insurance from covering these sorts of damages. See, e.g., Katherine C. Skilling, *Coverage for Ill-Gotten Gains? Discussing the (Un) Insurability of Restitution and Disgorgement*, 72 Washington & Lee L. Rev. (2015).

[7] A flexible "late notice" provision generally favors policyholders because it prevents an insurer from being able to definitively deny coverage on late notice grounds unless the delay was clearly unreasonable.

[8] The law of some states provides that a delay in providing notice will not result in a loss of coverage unless the insurer was prejudiced by the late notice, while other states allow an insurer to deny coverage without demonstrating prejudice. In all states, if a policyholder fails to provide notice of a claim within the policy period (or the specified grace period thereafter), coverage can be denied.

Consent to incur defense costs/make settlement offers

E&O policies typically include policy provisions stating that the policyholder should seek the insurer's consent before incurring defense costs. This provision allows the insurer to be involved in selecting or approving defense counsel and in approving or negotiating the rates charged by defense counsel. Similarly, most E&O policies require the policyholder to seek the insurer's consent before an offer of settlement is made or before a policyholder admits to liability, but they also state that the insurer cannot unreasonably withhold consent. Policyholders should be aware that insurers may attempt to deny coverage based on an alleged failure to comply with these conditions and, to mitigate any issues, should take good faith steps to comply with such conditions. When considering any notice to clients, policyholders should also consider the "consent" provisions in their insurance policies and attempt to work proactively with their insurers to avoid or mitigate any issues.

Duty to cooperate

E&O policies also typically include a condition that generally requires a policyholder to "cooperate." Policy language varies, but these provisions may obligate the policyholder to provide information and updates to its insurer and to generally cooperate with the insurer in the defense of the claim. The scope of this duty varies depending on the policy language and applicable law, but policyholders should be aware that insurers may argue that failure to cooperate will result in a bar on coverage. A policyholder can effectively mitigate this potential issue by, where appropriate, discussing issues with its insurer and by responding to reasonable requests for information in a timely manner.

Rescission

E&O insurers often require applicants for insurance to represent that their application for insurance is complete and accurate. If the application contains misrepresentations or conceals facts critical to obtaining insurance, the insurer may argue that it has the right to rescind coverage. Insurers will sometimes seek to rescind on inadvertent errors or on omissions that a policyholder may not have considered material when filling out the application. To protect against these issues, policyholders should be forthright and candid when filling out applications. Some insurers may also be willing to expressly forgo the right to rescind policies. If that improvement cannot be negotiated, some insurers will agree that misrepresentations or omissions will bar coverage only as to those individuals who made the misrepresentations and omissions (and not the entity and other individual insureds), or they may limit rescission to certain types of claims.

IV. What's available in the marketplace?

Many insurers offer E&O policies tailored to investment advisors, and the marketplace is competitive on price and terms. As discussed previously, policyholders (through insurance brokers) can and frequently do negotiate favorable terms of coverage that can significantly reduce risk exposure. In addition, E&O insurers are more readily offering additional forms of coverage, such as cost of corrections coverage to address trade errors, or coverage that expressly covers costs associated with certain regulatory investigations.

Some investment advisors may also find that insurers are offering attractive packages, which, in addition to traditional E&O insurance, may include other forms of insurance that are of interest, such as directors and officers ("D&O") insurance or EPL insurance. These packages may also include cyber insurance either as part of the E&O policy or as a stand-alone insurance product.

V. How do you secure the best coverage?

As discussed in this paper, E&O insurance can be very complicated, and the terms of the insurance can vary widely. To secure the best coverage, investment advisors should consult with an experienced insurance broker who is familiar with the investment advisory industry, the insurance markets that service it, and the policy terms that are available in the market. An experienced broker can also provide guidance on how to structure an insurance program. In addition, an experienced broker will be able to provide advice regarding the appropriate amount of insurance to purchase, which will be informed by the amount of assets under management, the services provided, and the risk profile of the investment advisor.

It is also important to evaluate coverage on an annual basis to address changing risk exposures, available insurance wording, and legal developments. Experienced brokers can assist with this role and will have a firm grasp on the types of coverage that are available in the market. In addition, investment advisors may consider consulting with experienced coverage counsel to review draft policies and provide advice on how to improve policy language.

VI. How and when do you present a claim to the insurer? What happens after the claim has been presented?

As discussed earlier, E&O policies typically contain provisions that govern how and when a claim must be presented to the insurer and that obligate the policyholder to cooperate with its insurer and seek consent before taking certain steps. In addition to the policy wording,

much of the claims-handling process is informed by the law of the relevant jurisdiction. An experienced broker or coverage counsel will generally be able to guide the policyholder through the claims notification process. The key steps for presenting and pursuing coverage for a claim are discussed later.

It is important to note here that although a broker can assist with certain issues, including the procurement of policies and the provision of notice, coverage counsel may be necessary for certain roles or if coverage becomes contested. Brokers generally are not lawyers, and even if a broker has a law degree, the broker cannot act as counsel for the policyholder because of ethical restrictions. Further, coverage counsel would be necessary if there is a coverage dispute that cannot be resolved and must be litigated.

Notice

As mentioned previously, E&O policies typically require that policyholders provide prompt notice to the insurer of any claim as soon as practicable. When it is clear that a claim has been asserted against a policyholder (such as when a policyholder is served with a complaint, arbitration demand, or even a letter containing a demand), the process of providing notice is relatively straightforward. Either a policyholder or its broker will transmit the claim to the insurer as specified in the policy. The insurer will acknowledge receipt of the claim and will most likely address coverage issues with the policyholder within the time allotted for response to the complaint, arbitration demand, or demand letter.

If it is less clear whether a claim has been made or if a policyholder becomes aware that a claim may be made, notice becomes a more vexing issue. Many E&O policies allow a policyholder to provide a "notice of circumstances," which allows the policyholder the option of alerting the insurer of a potential claim and ensures that any claim that relates to the notice of circumstances will be treated as if the claim was noticed in the policy period in which the notice of circumstances was provided. A notice of circumstances generally must include a description of the wrongful act and the facts and circumstances surrounding the potential claim. A policyholder should be very careful when providing this information to its insurer because the characterization of the wrongful act may impact the coverage available. Likewise, an investment advisor should also consider its fiduciary duty to provide timely notice of errors to affected clients. Ideally, the advisor would have an opportunity to discuss and resolve coverage matters with its insurer prior to providing notice of an error to its clients. However, this is rarely the case, particularly when no claim has been made, and questions regarding the presence or scope of coverage under an E&O policy are not a valid reason for a delay in providing notice to affected clients. A carefully crafted notice of circumstances may provide an opportunity to alleviate this tension.

Defense of the claim

In a perfect world, after receiving notice of a claim, an insurer will agree to cover the defense of the claim and will work with the policyholder to secure appropriate defense counsel for the claim. The terms of the policy will control whether the insurer selects counsel or consents to a selection made by a policyholder, and after some initial discussions, defense arrangements can be secured. Unfortunately, insurers sometimes do not take a coverage position until weeks or months after notice has been provided, and the policyholder may need to secure its defense without knowing the insurer's coverage position. Even in these frustrating circumstances, the policyholder should abide by the notice and consent provisions and provide information regarding defense counsel, including rates, to its insurer. If the insurer ultimately denies coverage, a policyholder will be able to control its own defense, but until the insurer takes that position, a policyholder should make efforts to coordinate on the defense of any claim.

Cooperate with the insurer and obtain consent prior to making a settlement offer or admission of liability

A policyholder generally has an obligation to cooperate with its insurer. During the life of a claim, this may mean that a policyholder has to provide the insurer with information, answer questions, and provide updates on the claim. It is important that a policyholder keep its insurer informed and cooperate with reasonable requests for information.

As a general rule, a policyholder should also obtain the consent of the insurer before making a settlement offer or admitting any liability. Failure to do so can result in the insurer arguing that coverage is barred. In certain circumstances, including those in which coverage is contested, it may be necessary to negotiate with the insurer to ensure that the policyholder can resolve the matter while preserving its rights against the insurer. It is advised that an advisor enlist the assistance of coverage counsel in these sorts of discussions.

Retain coverage counsel for coverage litigation

Many coverage disputes can be resolved during the pendency of a claim. The interests of policyholders and insurers often align, and many issues can be negotiated, such as selection of defense counsel or the reasonableness of defense counsel's rates. Unfortunately, sometimes the coverage disputes are intractable, and it may be necessary to initiate a lawsuit or an arbitration proceeding to determine the insurer's coverage obligations. In those circumstances, the policyholder should retain experienced coverage counsel familiar with the law of the applicable jurisdiction. By involving counsel at an early stage, a policyholder can work to effectively preserve its rights and help to maximize the coverage.

VII. Conclusion

In the operation of their businesses, investment advisors face significant potential liabilities, many of which can be addressed and mitigated by securing appropriate insurance. In cases involving employee theft, fidelity bonds or ERISA bonds can provide protection to an investment advisor and ultimately to any impacted clients. But one of the most significant risks to an investment advisor arises from claims brought by disadvantaged or disappointed clients. The primary bulwark against these claims is E&O insurance, which covers third-party claims arising out of a wide variety of professional errors. E&O insurance can be an effective protection against these claims, especially if an advisor secures a favorable policy by working with an experienced broker with knowledge of the risks faced in the investment management industry.

To best preserve coverage, an investment advisor facing a claim should be aware of the key provisions of its E&O policy and be prepared to provide prompt notice to its insurer. Further, should a coverage dispute arise, it's recommended that an investment advisor consult with experienced coverage counsel to represent its interests. By taking these steps, an investment advisor can place itself in the best position to preserve its assets and minimize disruption to its business.

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Michael McGrath is a partner in the Boston office of K&L Gates LLP. He practices in the areas of investment management, securities, and commodities law, including the representation of institutional investment firms, registered investment companies, private equity, and hedge funds. Mr. McGrath counsels SEC, CFTC, NFA, and FINRA regulation. His practice is focused on helping financial institutions design their compliance programs; supporting trading and investment management issues, including best execution, soft dollars, control of nonpublic information, and derivatives trading; and assisting with SEC and NFA staff examinations.

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