Recent industry-wide scandals have sent shockwaves throughout the investment community and financial advisors are now scrambling to determine the adequacy of their errors and 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.

Here are some pertinent questions to consider:

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

Some basic E&O knowledge goes a long way in understanding the needs of your firm. In this article I will address the following key coverage features and their potential affects 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

**Coverage Triggers**

The intent of an E&O 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 advisor or mutual fund group, and typically it is added by an endorsement to the policy form. It amends the policy by expanding the coverage trigger to a potential loss situation discovered by the insured before 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 corrective medicine and avoid claims by your client(s). This coverage feature typically comes with separate reporting provisions, which may include receiving the insurer’s approval before 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 decision to review a case on mutual fund fees, Jones v. Harris Associates L.P., 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 also may 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.

**Insured Services**

It is important to understand who is being covered and for what services. Understanding which services are “insured services” under the firm’s insurance policy is crucial because of the complexity of features such as cost of investigations coverage and directors and officers (D&O) 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. But if you are the firm’s chief compliance officer (CCO), are your professional services considered as providing investment advice? Recent policies have been amended to include coverage for a CCO’s professional services. Older policy forms have extended this additional coverage via an endorsement to the policy. Read this coverage extension carefully to make sure that you are covered for those claims brought by the firms’ clients as well as for investigations and litigation brought by regulators, including the SEC. Coverage won’t
pay an SEC fine or penalty, but it should pay defense-attorney fees. A best practice solution is to include the CCO as a corporate officer under the bylaws and to purchase D&O liability insurance in addition to E&O insurance.

To clarify: E&O insurance is designed to protect your firm for claims arising out of your professional investment advisory services. D&O insurance is designed to protect your firm from claims arising out of business decisions. The typical D&O claim is a shareholder suit, which affects publicly held firms. At a privately held investment advisory firm, potential exposures can come from litigation brought by regulators and service providers, as well as employment practices allegations. In most cases, D&O liability may be added to an E&O policy for a 10- to 20-percent 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 collateralized bond obligations, collateralized mortgage obligations, 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” suggest, at a minimum, an annual review.

The definition section of the policy form—with its coverage restrictions—also demands your review. Important definitions to note include but aren’t limited to claims, investment advisory services, professional services, wrongful acts, etc. For example, do investment management consulting, financial planning, or wealth management services fall under the definition of investment advisory services? Does the definition extend 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 also may find restrictions in coverage based upon information contained within the completed application, including a completed warrant question or letter. By responding to any question pertaining to your knowledge on behalf of the firm and its 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, the carrier may deny coverage based upon those representations. Make sure that you are familiar with your policy’s continuity and retroactive date to facilitate a continuity of coverage. You also should 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, other insurers require a warranty statement from you on an annual basis. Your insurance broker should alert you to how these issues may affect your coverage.

It is practical not to assume coverage automatically applies to all services and entities listed in your application. Numerous clients believe they have coverage for broker-dealer activities, or services as trustee, simply by acknowledging the existence of these services on the application. If these areas of exposure 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 inconsistent. Policies that offer “duty to defend” wording require the insurer to appoint 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. Either wording has advantages and disadvantages, and either wording can be modified. The key is to ensure the selected attorney will fight to protect your reputation in the event of a frivolous claim rather than reach a settlement simply to mitigate the insurer’s ultimate expense.

Conclusion

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 who understands the intricacies and nuances of the investment industry. Most investment firms have either a chief compliance officer or chief operating officer handling 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 who 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 they can provide unparalleled quality of service.

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