The Investment Professional's Guide to

Errors & Omissions Insurance

By: Gary Sutherland, CIC, MLIS and Paul Smith, AIF
Presented by: North American Professional Liability Insurance Agency, LLC (NAPLIA)

September 2015

The Investment Advisor’s Guide to Errors & Omissions Insurance Offers Exclusive Insight Providing:

- Clarity to the Insurance Evaluation Process
- Specific Guidance and Roadmap to Improved Outcomes
- Risk Management Resources for your Practice

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Introduction

What are insurance underwriters looking for in an investment advisor's application for errors & omissions (aka professional liability) insurance? It is a question that we are often asked, and due to the complexity of the risk, the answer is never simple.

Applicants' unique risk characteristics are not always apparent – even to themselves.

The Investment Advisor's Guide to Errors & Omissions Insurance will help you anticipate areas of underwriter concern as it relates to your specific investment practice, helping you internally evaluate your risk exposures and better define your activities and professional services.

In several chapters we have offered our opinions which are based on 20-plus years of negotiating insurance coverages and working in the investment advisory space. Naturally, we cannot promise that all insurance carriers follow the same guidelines — or treat similar information uniformly — as we make clear in the following pages.

We have tried to anticipate questions — from the most basic to the more nuanced — while digging deeper into the prevailing wisdom of current underwriting concerns and carrier tendencies. We will update this guide as newly-defined and evolving risk exposures find their way into our applications.

The object of this guide is neither based solely on the reduction of premium or pricing, nor does it suggest altering your application in any way that is not 100% accurate to circumvent the concern of adverse underwriting (because doing so could potentially void coverage). It is critically more important to make sure coverage is correct and exposures are covered without gaps; or any deficiencies are understood and assessed appropriately.

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At the end of the day, understanding the nature of your firm's practice, and translating that clearly in the application process, is the key to placing your errors & omissions coverage with a well-matched carrier that will provide best in class protection at premium pricing that appropriately fits your risk exposures.

4 Basic Guidelines for Completion of your Application

The application is the strongest part of the underwriting submission process, and yet it is often the weakest link. Think of your application like a cover letter accompanying a resume — spelling errors, grammatical mistakes, and incomplete information will negatively impact the impression of the candidate, regardless of his/her qualifications. A quality professional presentation is important.

These simple guidelines are beneficial to consider when completing your application:

- Be honest and accurate with all questions.
- When additional details are requested, provide enough information that an underwriter — who may not be familiar with your firm — will be able to decipher and evaluate quickly the issues under review.
- With the assistance of your agent, anticipate questions that an underwriter may have and proactively address these items.
- Work with your agent. Your agent's role is to be your liaison and representative in the underwriting process.

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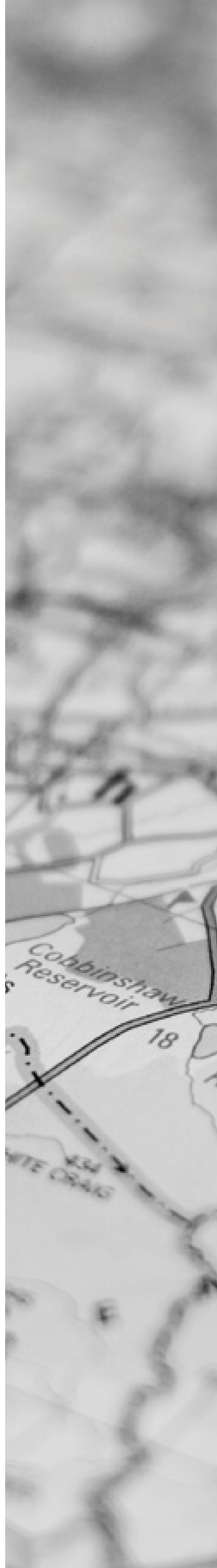

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Alternative Investments

Insurance carriers and underwriters read the same publications that advisors read, and therefore they see the same ominous headlines:

"Attorney General seeks millions of dollars from broker dealer for misleading clients on private REITS."

or

"Grandmother sues advisor for placing 50% of her assets in risky speculative investments."

In addition insurance companies track the genesis of claims. Suitability is cited more than 50% of the time as the main allegation or driver of claims. In the most general terms, suitability is such a difficult standard to define; it easily becomes the catch-all complaint for whatever doesn't work. Although many claims of suitability involve risk appetite, the examples above are relative to *Alternative Investments*.

Does this mean alternative investments are bad or never suitable? Of course not, but it does mean that when alternatives are present in the applicant's business model, a much higher level of scrutiny takes place during the submission and underwriting process. In addition, it is essential that you carefully review the policy and endorsements to determine how the coverage of alternative investments is handled, and if it correlates correctly with your business model.

How do underwriters and insurance companies evaluate *alternative investments*? What's the definition and where's the comfort or discomfort level? How do they rate the risk?

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In general, *alternative investments* are defined by three criteria:

- Not regulated
- Not valued daily
- Not liquid

Investments that fall within these criteria include, but are not limited to: Futures, Metals, Hedge Funds, Collectibles, and REITS, or other Real Estate Investments.

Private REITs (Real Estate Investment Trusts) are currently an alternative investment that generates increased scrutiny with insurance companies and underwriters. We will use them as examples of the potential impact alternative investments may have on your application process and policy coverage.

REITs are often excluded in policy coverage or offered terms outside the standard policy language through the addition of sub-limits and/or higher deductibles. For example, one major insurance company has the following provision:

Excluded are the following: private placements or any Securities exempt from registration with the SEC; however, this exclusion does not apply to any assets managed by you for others for a fee, provided that they were part of an existing client's portfolio and you do not promote, sell or recommended these instruments.

The first part of the Exclusion eliminates insurance coverage for the sale or recommendation of the *alternative investments* going forward. The second part of the Exclusion amends — or gives back — coverage for investments that are currently in the client's portfolio prior to your engagement.

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As you can see by the complexity of this coverage language, it is critical that you understand the policy language, and consider activities your firm does, and has done in the past, regarding private placements, alternative investments, and the overall nature of your professional services.

This example exemplifies the importance of not limiting the underwriter's review to your firm's current portfolio construction and activities, and highlights the necessity to understand how prior professional activities and recommendations can be crucial to an accurate application review.

If your firm currently — or has in the past — offered alternative investments, you should be aware that each insurance carrier's appetite and threshold is different. They may reflect this in their unique underwriting guidelines, premium pricing, and most importantly, their policy wording.

We offer the following specific recommendations relevant to the review of alternative investment activity in your errors & omissions insurance application process:

- Do not rely solely on review of your current application. Make sure to consier past activity in the alternative investment space, and review policy wording for relevant coverage (existing portfolio vs. current sales).
- Provide additional narratives that explain and detail the types of alternative investments in your client portfolios. Doing so provides you a platform to proactively address the underwriter's comfort level with the particular investment.
- Read and understand all of the insurance policy conditions, exclusions and endorsements.
- Do not rely on verbal communication that coverage is provided. Get it in writing and identify relevant policy language.

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Conclusion

Like you, we recognize the value of utilizing experts in a particular field of specialty. Therefore, our industry bias drives us to recommend that you work with an experienced agent to represent your firm. An experienced agent can address the previously discussed issues, as well as potentially negotiate policy and premium endorsements in your best interest.

Some suggestions for working with an agent:

1. Provide detailed narratives regarding your involvement with any alternative investments. The narrative should proactively and specifically address the underwriter's questions regarding your activity and demonstrate your knowledge and investment philosophy in the particular area.
2. Do not assume coverage exists for these investments. Obtain a complete understanding of the present risks and insurance solutions available in order to a make an informed decision.
3. When necessary, you may have to accept sub-limits, higher deductibles, and/or higher premiums to properly insure your alternative investment recommendations and holdings. Weigh these costs against having no coverage at all.All firewall changes must be agreed in collaboration with your firm's compliance manager as firewall administrators may not appreciate how rule changes affect your firm's information security commitments, and so engaging your compliance manager will ensure that these commitments are not jeopardized.

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Regulatory and SEC Audits

If your firm has undergone a Regulatory or SEC audit, it will be disclosed on your application and further evaluation will take place. In most cases, a series of questions relevant to the audit will be asked. The purpose of the examination is to determine if any specific disclosures require further review and to confirm if the regulatory recommendations have been addressed.

These questions are intended to go deeper than the standard application. They will expand the review to include anyone who provides professional services at the applicant firm, and will explore their relevant past history, in addition to the firm's history. Underwriters consider it a red flag when an undisclosed issue related to an individual, or the firm, is uncovered that should have been disclosed on the application. It is always better to fully disclose these types of issues up front in the submission process and avoid creating concern with the underwriter that other items may not have been disclosed as well. In addition, by not disclosing upfront, you miss the opportunity to proactively make a positive case in the initial review process.

When it comes to SEC audits, underwriters are not overly concerned with housekeeping type issues, unless they are pervasive in nature. An experienced insurance agent can position the SEC audit positively to an underwriter by tracking the process, and emphasizing the fact that a third-party has reviewed the firm. Once your firm has complied with any required corrections, the argument should be made that the firm is now a better risk than one that has not gone through a similar audit process.

However, SEC audits can also indicate a trail of bad record-keeping, conflicts of interest, lack of fee transparency, and written disclosures. This is where an extremely good narrative is required, one that provides a proactive bullet point response to the underwriter, outlines what corrections have been made and how the applicant firm has changed its prevailing culture.

Citing outside compliance assistance and expert guidance can clearly help elevate a negative portrayal of the firm. Applicant firms should be specific in naming the outside vendors. If compliance or ERISA attorneys were retained, adding these external experts' bios with the application is beneficial.

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Conclusion

Audits are a natural part of the investment industry. An audit in and of itself should not be considered a negative against your firm in the errors & omissions insurance process. Keep in mind when responding to an audit and the corrective measures that result, your responses and overall approach will be public. An underwriter will see this information and clarity and professionalism can make this record a positive.

Our suggestions:

1. Provide a detailed narrative regarding your audit experience. At this point you should see a theme developing about the use of narratives to proactively influence the underwriting process.
2. Even in negative situations, emphasize the positive steps that have been taken to address the original issue.
3. Include specifics regarding expert guidance utilized in the process.

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Claims, Fines, and Sanctions

Underwriters utilize past experiences to attempt to predict future claims. Therefore, review of your firm's past claims, fines and regulatory sanctions is one tool that is regularly used. While this may seem inherently unfair, studies have statistically proven that past history is an indicator of things to come. Clearly, there are exceptions to the rule, but underwriters will use this information to assess risk.

Underwriters are also aware that a firm may be fined or sanctioned for minor administrative missteps, simply because the regulatory agency feels a need to find something to justify their time spent with the entity being examined. This is one unfortunate cost of an audit. These nuisance fines should not play a major role in the review compared to more serious fines and sanctions that have real consequences and can heavily influence the underwriter's decision process.

As in all application areas, a positive message explaining the misstep — and more importantly steps taken to avoid reoccurrence of similar issues — is the productive approach. We would recommend not using any of the following claims narratives such as: *we did nothing wrong, the claim is totally frivolous,* and/or *the attorney who represented us was incompetent.* Although, any of these statements may contain some truth, acceptance of the underlying issue and proactive risk management steps will be more impressive to an underwriter.

When presenting a claims narrative stick to the basic facts:

- Who
- What
- Why
- When
- Where

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Clearly state your points, the outcome, and those internal steps taken to avoid future occurrences. The facts presented in clear professional business language will go a long way toward convincing the underwriter that you are a better risk than it may have otherwise appeared. Additionally, even in the case of a frivolous claim, lessons can be learned and passed along to avoid similar claims from happening again.

Most underwriters will want to see loss runs over a five-year period. A loss run is an insurance company's summary of claims activity for your firm. They almost always contain only dollar amounts incurred, or reserved (the amount set aside for future payments) for damages and legal expenses. They do not contain narratives or opinions on the case.

Many insurance companies only update loss runs annually. You and your agent should review these carefully for accuracy. Is the claim *closed* but showing *open* on the loss run? Did they accurately document the reserve and damage amounts paid? These additional details can be critical to getting best insurance terms, similar to reviewing your own credit report prior to applying for a mortgage.

Claims Story

Last year our agency worked with a firm that had five claims in a single year, while over the previous 25 years, there were no claims. Did the firm suddenly turn bad? What changed? The answer turned out to be a series of missteps. But the common core was linked to one rogue employee and the clear failure to adequately supervise that employee.

Without sharing specific details, at renewal we were able to demonstrate that the firm had taken substantial steps to mitigate claim damages; more importantly they fixed what appeared to be a lack of supervision and training. At their own expense, the firm hired a compliance expert and instituted several significant internal changes that demonstrated their commitment to running a clean, well-run shop. The underwriter gave them a fair hearing and reasonable renewal terms.

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One frequent misunderstanding in the process of renewal with your existing carrier is that your underwriter knows all the details concerning a recent claim. In reality, not only are the underwriting and claims department separate, but consider the following factors:

- Any internal changes in underwriting and/or claims personnel.
- Your legal counsel is not in direct contact with underwriters.
- The level of information shared between counsel, claims, and underwriting will vary dramatically based on carrier nuances.
- The typical underwriter reviews hundreds of files annually.

The best submission for a firm with claims, fines or sanctions, is an upfront, clear, and well-delineated explanation. Simply including multiple pages from the original complaint, anticipating them to review and interpret significant legal documents, is not recommended. Instead your goal is to provide the underwriter information so that he/she may quickly and accurately understand the relevant scenario(s).

Conclusion

The best advice that we can provide to a firm that has suffered claims, fines or sanctions, is to provide accurate, well-documented summaries outlining what the issues were, what steps the firm has taken to correct and prevent reoccurrence, and what internal controls have been instituted. Understanding this process should proactively help to answer any questions or concerns the underwriter may have regarding your submission.

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Discretionary Versus non-Discretionary Client Relationships

Every application for investment advisors and/or financial professional errors & omissions insurance requires that you break down your practice by *discretionary* and *non-discretionary* management of assets. Why is this import?

Each insurance carrier views the exposure (risk) from discretionary versus non-discretionary management of assets differently. Their position is typically determined by past claims experience — and severity and frequency — in either area. As a result, insurance companies have significant differences in approach and underwriting.

Some carriers specifically prefer that advisors operate with full discretion. This rational is based on the position that the advisor who is actively managing assets is constantly looking out for changes in the investment climate and making trades in real-time. In their opinion, this creates a more connected safeguard to clients' assets, and at the end of the day it is lower risk.

Contrast that to the advisor who meets with a client quarterly to review past performance after there were significant changes in their portfolio. Some carriers are concerned that despite the lack of discretionary authority, control is missing, and the advisor's accountability is compromised. Often in these consulting style arrangements, there is limited track record of performance.

Keep in mind that all carriers require that advisors work under a contract/investment policy of some kind and stay within those written guidelines. For the sake of this chapter "pure" discretionary authority is when the advisor utilizing an IPS or risk tolerance contract has the ability to buy and sell securities without their client's approval or consent.

As an agent it is not our position to make a determination on risk between discretionary and non-discretionary business models, but understanding each insurance company's underwriting appetite will make a significant difference in the submission/pricing process.

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Discretionary Versus non-Discretionary Client Relationships

One very large “A+”- rated insurance company we work with has analyzed their book of investment advisor claims over a recent ten-year period and quantified their risk, concluding a strong preference for advisors that utilize full discretion. They actively discourage advisor submissions with non-discretionary, or consultant style management.

This is in stark contrast to another “A”-rated carrier we work closely with that has come to the opposite conclusion. In what appears almost a prima facie tone, they clearly suggest their risk is lower when all trades are pre-approved by the client.

Maybe the answer to the disparate approaches lies elsewhere in the equation, and that discretion versus non-discretion wasn’t the primary driver for two dramatically different conclusions, but rather different looking books (retail versus institutional/qualified versus non-qualified). We are not in a position to emphatically defend either approach. The key is to understand the different carrier tendencies and work with our clients to match them with the appropriate partner.

When a claim arises out of a client relationship where discretionary authority over client’s assets exists, it can be complex and large in scope. Unfortunately theft of client funds, Ponzi schemes, and other fraud activity continues to wreak havoc in the investment industry and these risks can be difficult to underwrite. Most policies have coverage exclusions for illegal schemes, but more often than not criminal activity is seen more frequently when the advisor has full discretion.

Underwriters also consider fidelity bonding when assessing a firm’s professional liability risk. Many underwriters require firms to carry a fidelity bond of at least $1,000,000 for non-ERISA accounts; and if they have discretionary authority over and handle qualified plan assets, they look for them to carry the appropriate ERISA 412 Bond.

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Discretionary Versus non-Discretionary Client Relationships

We believe this will continue to be a subjectivity issue when quoting professional liability insurance, as it is an effective way for professional liability carriers to insulate their exposure to complex crime and fraud issues.

A more recent question seen on advisor errors & omissions applications regards custody (the Madoff question). "Do you or any one in your firm provide discretionary or non-discretionary investment advice for accounts where you are also custodian of the funds?"

If the answer is yes, then a clear explanation of existing safeguards is required to avoid outright denial of coverage from most carriers.

Underwriters are more interested or likely to ask when you have discretion; who are your largest clients and what percentage do they make up of your total AUM? The concern is that if you are dependent on a single client, or a limited handful of large clients, you could be more likely to compromise your ethical standards for fear of losing the bulk of your revenues.

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Conclusion

Understanding the insurance carrier's appetite in the market is an important element of the submission process. Accurate tracking and reporting of your firm's percentage of discretionary versus non-discretionary relationships can have significant impacts over the errors & omissions premium rating depending on the carrier and its preference for one style of asset management over another.

Our suggestions:

1. Accurately classify your Assets under Management by discretionary and non-discretionary, and understand how your insurance carrier defines discretion.
2. Working with an experienced agent can impact your insurance premium by matching your firm with an appropriate insurance partner.

We are often asked, what is considered discretionary authority?

It is when you or your firm has the ability to buy or sell AUM without client knowledge or consent. In some cases what you classify as discretion may not be the case, and actually it may be considered non-discretion by the insurance carrier. This confusion is seen most in the ERISA space when the advisor is making recommendations on the overall investment lineup. When in doubt, provide a schedule of AUM total with descriptions.

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Fees Versus Commissions

Historically, commissioned sales result in more claims than fee-based sales activity. Our experience is that this may be true for the frequency (number) of claims, but not necessarily for the severity (amount paid). However, we do know that when clients are unhappy with the results of a specific investment and later learn that a large commission was paid, they become more frustrated, and are more likely to seek legal counsel and sue.

Commission sales also drive more conflict of interest claims, especially in the qualified plan space. Underwriters know they are harder to settle, and if they end up in court or arbitration, they are harder to defend. Fee agreements are generally easier to understand, and easier to explain to a judge or jury.

Underwriters use the advisor's annual fees/revenue for benchmarking, or predetermining premiums prior to reviewing and analyzing the full application. The percentage of fees to commissions will be of interest to the underwriter, given the bias toward fee-based business. This snapshot is particularly relevant when the advisor is working in a hybrid setting as both a registered representative and an investment advisor representative.

Underwriters look for compensation outliers on the very high or the low end of the spectrum. Consider two advisors with similar practices, where both offer 100% fee-only professional services.

- Advisor #1 has annual revenue of $180,000
- Advisor #2 has annual revenue of $430,000

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In most cases the advisor with a larger revenue base will pay more in premium since underwriters use revenues as a primary baseline for premiums — assuming that a consistent relationship between fees and AUM exists. Where the outliers come into play is when the revenue to AUM relationship is askew. One might expect advisor #1's AUM to be approximately $18MM, and advisor #2's AUM approximately $40MM. Underwriters become concerned when the fee to AUM balance is off, and they conclude that an advisor is receiving fees that are either significantly higher or lower than would be expected. Neither scenario is considered positive.

Using the same two advisors — assuming the fee to AUM ratios are normal — if advisor #1 has been in business for only two-plus years, and advisor #2 has had a 25-plus year practice, which one is the better risk?

There is no simple answer. Underwriters see very few claims from advisors who are newly established, and industry trends show advisors are more likely to be sued after practicing for 10 or more years. In our opinion the underwriter should also use designations, nature of practice, and other *important* but nuanced information to assess the risk, which makes that personal connection between agent and underwriter critical. Therefore, we emphasize these areas in our client submissions.

Culture and past experience can play a big role in the underwriter's decision making process when rating fee versus commission advisors (or the balance of revenue in a hybrid arrangement). The late 1990s produced lots of claims from churning, poorly designed annuities, and high upfront commissioned products. Seasoned underwriters frequently mention this to their trainees, and both groups carry this biased perception with them today.

Commission revenue that changes dramatically from year-to-year is also concerning. In an effort to keep premium consistent, it's important to provide additional details on uneven commission sales. Was it a one-time commission sale based on years of work that caused the spike? The more information you can provide improves your position.

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Conclusion

It is important to understand that many underwriters are predisposed to think that fee-based advisors are a safer risk. Your agent will need to share additional details on your firm's commission sales to secure the lowest possible premium.

Our suggestions:

1. Accurately classify your revenue between fee-based and commission sales.
2. Proactively explain any discrepancies in revenue to AUM, especially if revenue is significantly higher or lower than 1% of AUM.

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Assets Under Management (AUM)

In all professional liability applications for investment professionals there are questions asking about assets under management (AUM). Generally AUM is broken down by the following classifications:

- Discretionary
- Non-Discretionary
- ERISA
- Non-ERISA

AUM is also classified by size:

Assets Under Management (AUM)	Size Class
$1MM - $350MM	Small
$350MM - $1B	Mid-size
$1B +	Large

Most carriers define their individual appetite based on these classifications (size of firm) and AUM type. Insurance companies will often have different underwriters handle different classes of business based on AUM; this is important to understand as it directly impacts premiums.

Many of the *standard* errors & omissions programs have AUM cutoffs at $1B, forcing an applicant with higher AUM into an institutional category where premiums can be double, or sometimes even triple the cost.

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Similar challenges occur when a seasoned advisor starts up a firm with relatively low AUM, but it grows quickly and will soon require an institutional level policy where there may be more investment flexibility and fewer exclusions. The disparity between their AUM and their sophistication level becomes a challenge given the minimum AUM requirements of the institutional divisions.

ERISA AUM tends to be handled differently; most insurance carriers will want to know if the applicant is bonded as may be required by ERISA's section 412. In addition, you will need to ensure you have coverage as a *fiduciary*, and that such coverage is clearly included in the definition of *professional services* or added by endorsement. ERISA exclusions are common along with exclusions for your status as a fiduciary. The ERISA/fiduciary space is an area of growing claims and cannot be overlooked.

Due to the complexity of ERISA law and potential lawsuits, underwriters often want details on your staff's experience dealing with ERISA clients. If possible, disclose in your application the name of your ERISA attorney and/or any outside compliance consultants. Several insurance companies will provide premium discounts for applicants who utilize these outside services, understanding that their presence makes your firm a better risk. If you have internal compliance support, be sure to inform the underwriter.

One common application mistake is when the applicant lists the total value of a large client's AUM rather than the portion they advise on. This can become clear when revenue is much lower than the reported AUM would support. Underwriters use a guide of 1% for calculating revenues based on AUM, and if your percentage is well outside of this parameter, you should provide an explanation.

Large percentage increases or decreases in AUM from year to year will also cause additional questions. Provide the underwriter reasons behind any significant changes in the AUM.

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Conclusion

Review your AUM prior to submission to confirm the accuracy of classifications, and any potential discrepancies from previous years.

1. Accurately classify your AUM by only listing the actual AUM of larger clients that you handle.
2. Accurately classify AUM between discretionary, non-discretionary, ERISA, and non-ERISA.
3. As previously stated, proactively explain any discrepancies in revenue to AUM, especially if revenue is significantly higher or lower than 1% of AUM.

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Conflicts of Interest

Conflicts of interest are three words which can make underwriters cringe, especially when referenced in the context of a claim. Conflicts of interest — like suit for fees — are almost always avoidable.

Underwriters use the application as a tool to properly try to assess risk. Questions regarding potential conflict of interest include, but are not limited to:

- Do you advise clients in investments in which you also have an ownership interest?
- Do you act as both trustee and advisor to any client?
- Do you advise clients in investments where you also serve as a director or officer?

The reason underwriters have heightened concern regarding conflicts of interest is the inherent guilt that is implied from the initial relationship. Even when a conflict is fully disclosed and consented to it is rare that an allegation resolves in favor of the advisor.

Attorneys who handle advisor claims dealing with conflicts of interest tell us — no matter how good the disclosures, outcomes, and communications — they generally have an unwinnable defense. Plaintiff attorneys will therefore use conflicts of interest, as well as breach of fiduciary duties, to enhance their claims narrative, putting pressure on defense attorneys. These issues are compounded when part of an ERISA claim.

In addition, current litigation trends imply that conflicts of interest will undergo more detailed SEC scrutiny in the near future.* This trend only heightens the concerns underwriters have for this peril.

**The Securities and Exchange Commission plans to take a close look at potential conflicts of interest in the investment-advisor practices. (Investment News Monday, February 25, 2013)*

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Conclusion

Regardless of your explanation, conflicts of interest will create heightened concern for underwriters. Whenever possible, they should be avoided in your business practices.

Our suggestions include:

1. Conflicts of interest claims are inherently difficult to defend and often unwinnable.
2. Try to anticipate what your client might think now and in the future, and make sure that there is full transparency and disclosure.
3. Disclosure forms should be signed in advance and updated annually.

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Custodian of Funds

Since the Madoff affair there is heightened scrutiny for advisors who provide investment advice and hold client funds. As a result, such scenarios are rarely seen in the RIA retail community where errors & omissions premiums fall into expected ranges. The hedge fund space is where this might be seen more often, but even there, prime brokers are involved and asset managers are separate entities from the partnership or LLC.

Changes to the applications themselves are usually driven by sudden changes within the risk exposures, and they usually follow a wave of claims that underwriters believe they can avoid with better applicant screening.

The Madoff case was a good example of a single event changing the Application. With all the press coverage surrounding the case, insurance carriers identified a critical weakness or exposure, and they made changes to the application to better protect themselves from large claims involving theft of client's funds, Ponzi schemes, and other forms of fraud. Keep in mind that errors & omissions insurance will not cover criminal activity, but the carriers inevitably incur legal fees and ancillary cost when their insureds are caught in the middle of a Ponzi scheme.

One major carrier's application now includes the custodian question below:

Are you associated with, or consult with any broker-dealer, investment advisor or investment manager who does not use an independent third party as a custodian for client funds?

This carrier not only wants to know if you advise clients and hold the clients funds, but it also inquires about anyone who is affiliated with your firm.

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Generally insurance policies are designed to cover one specific exposure. An errors & omissions policy is designed to cover mistakes made in rendering professional services (as defined in the policy), as opposed to theft related claims. Because of the potential of being involved in an unrelated claim, underwriters want proof that the applicant firm also carries a fidelity bond, ERISA bond, or other forms of employee dishonesty insurance.

We are often asked this common follow-up question: *does this mean I can never accept checks from clients or essentially handle or take possession of client assets?* Our response is no; however whenever possible avoid it, and have client funds sent directly to outside custodians.

Lost Accounts

Underwriters often ask about lost accounts to assess any potential problems or red flags with the investment professional's handling of their business. In the normal course of business accounts do come and go. However atypical volume of client turnover will raise underwriter concern. A typical volume includes:

- A high number of accounts leaving as a percentage of the advisor's business, or
- Large dollar assets leaving the firm as a percentage of the firm's AUM.

Your application may include questions such as:

1. Number of accounts lost in the last twelve (12) months?
2. Total assets for accounts lost in the last twelve (12) months?
3. Reasons for loss of accounts: ______________________________

Often the answer is simple and easily understood, and addresses any concern. As we have stated be fore, the key is to provide a clear, definitive explanation, and to avoid any lingering underwriter doubts.

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Conclusion

Understand that inadequate answers regarding lost accounts may give rise to either higher premiums or outright rejection of your application. Consistently detailed explanations are recommended, rather than appearing to avoid the legitimate cause for concern.

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Areas of Practice Coverage –
Unrelated to Advisors errors & omissions

Not every application that we look at neatly fits into one type of insurance criteria or policy. Sometimes applicants have other types of business ventures that co-exist with their main business activities.

Some polices allow for flexibility in the description of professional services, or they can be modified with manuscript endorsements to fit the particular need. This is generally done when the other professional services are similar in nature to the core business activities.

On occasion an insurance carrier will recognize services that are ancillary to the core business, and they will provide standard endorsements to create a solution for the other professional services.

Some standard business endorsements for investment advisors include:

- Mortgage broker
- Tax advice or return preparation
- Escrow agent
- Business consultant or advisor
- Divorce consultant or advisor
- Legal advisor

The difficultly lies when the other professional services are not similar and are outside the scope or breath of the advisor policy. Some examples that fall into this category include:

- Real estate agent
- Property and casualty agent
- Business broker
- Private banker

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Areas of Practice Coverage – Unrelated to Advisors errors & omissions

There also are professional service areas where it may depend on the nature of the specific services being rendered. Lawyers and CPAs can secure coverage under an investment professional's policy provided that the services rendered are incidental as compared to their investment practice. Some areas of practice that may be included are the following:

- Wills and estate planning
- Trust documents
- Court appointed receiverships
- Tax returns
- Tax advice related to investments
- Structuring of ERISA plans
- Employee benefits
- Consulting within the investment arena
- ERISA Consulting

When the underwriter reviews the application, a key ingredient allowing for the inclusion of coverage for outside activities requires that it meets the incidental component test in relationship to the core business services.

From the applicant's perspective there can be pros and cons to providing coverage on one policy form. The applicant must conduct careful analysis weighing the strategic value of combining coverage and selecting the best fit to avoid coverage gaps.

We recommend considering all of the following when making this assessment.

- **Ownership:** this can be complicated if different owners are involved in the ancillary
- **Limits and retention:** a separate policy for the ancillary business may offer better terms than combining coverage with the core business policy. Limitations of coverage may exclude or significantly limit some professional services that are offered. Additionally, applicants run the risk of eroded limits if a claim hits from the ancillary service and reduces, or exhausts, the limits available for the core business.

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- **Claims:** a paid claim may impact the premium or coverage availability (non-renewal issues) for the core business if a paid claim is made on the ancillary services.
- **Distinction of Professional Services:** one of the biggest challenges to purchasing two separate polices is the ability to separate which "hat you were wearing" when providing professional services. If the claim does not clearly delineate core business services from any other professional services then you may have a fight between insurance companies.*

**Whenever possible we often recommend purchasing both polices from the same insurance company to avoid finger pointing.*

Conclusion

Never make a coverage determination for an ancillary business service under an existing policy based on premium. Understanding the coverage limitations and/or enhancements of a stand-alone policy, and the impact on your core business should be the driver.

Our recommendations include:

1. Review the available policy endorsements to add coverage for ancillary services. Obtain a premium quote for a stand-alone policy. Weigh the coverage issues in conjunction with premium costs to make an educated decision.
2. Whenever possible utilize the same carrier if purchasing multiple policies for ancillary services. This potentially minimizes conflict between carriers when there is an overlap in services.

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Contact

Paul Smith, AIF is the Senior Vice President – Investment Advisory Division of North American Professional Liability Insurance Agency, LLC (NAPLIA). He can be reached at pauls@naplia.com or 508-656-1315.

Gary Sutherland, CIC, MLIS is the Chief Executive Officer of North American Professional Liability Insurance Agency, LLC (NAPLIA). He can be reached at garys@naplia.com or 508-656-1350.

About NAPLIA

Established in 1998, North American Professional Liability Insurance Agency, LLC (NAPLIA) specializes in providing professional liability insurance, errors and omissions insurance and related products to the financial industry. Our focused approach makes us leaders in the industry. NAPLIA has been named to the INC 5000 list of the fastest growing private companies in America for five consecutive years.

Additional Resources

Using your Insurance as a Marketing Tool (for Investment Advisors)
http://www.naplia.com/resources/insurance-marketing-tool.html
Investment Advisor ERISA Bonds; An Overview
http://www.naplia.com/resources/advisor-erisa-bond-overview.html

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