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CCO Liability: Managing Liability: Navigating Indemnities and Insurance Options

By Janaya Moscony

Introduction

This is the third segment in our three-part series focused on Chief Compliance Officer liability, and managing the different sources of risk. In Part I [Dec 15, liability and outsourcing] of our series, we discussed CCO liability and CCO outsourcing including recent enforcement actions, and the benefits and concerns with respect to outsourcing the CCO position. In Part II [Feb 16, liability and outsourcing], we discussed important factors to consider when choosing a CCO, including the candidate's ability to assess the firm's risk and implement corresponding mitigating procedures. In this final installment, we discuss indemnifications and insurance as potential remedies to address the direct financial risks to a CCO.

It is not only investment advisers and fund boards that face regulatory liability; CCOs themselves are increasingly finding themselves in the SEC's crosshairs. Despite all the proper steps a Chief Compliance Officer can take to mitigate compliance risk and avoid an enforcement action, sometimes bad things happen to good people. Defending any regulatory enforcement action can be expensive, and there may be direct financial consequences for the CCO. Having negotiated a solid indemnification with the employer and/or having successfully transferred some or all of the personal financial risk to an insurance underwriter can be an important component to limiting personal financial liability.

In ICI Mutual's 2015 Annual Claims Trends[1], the company noted that 2015 saw an increase in the overall number of claims submitted to them by fund groups under their D&O/E&O policies. Further, ICI Mutual stated that nearly 25% of their insured fund groups submitted at least one claim notice during 2015. Over the five-year period from 2011 to 2015, approximately 50% of their insured fund group submitted at least one claim notice. The increase in claims by fund groups is alarming and highlights the need to ask the right questions when seeking or renewing insurance policies.

When considering insurance, Chief Compliance Officers first and foremost need to understand exactly what risks can be transferred. Careful attention must be given to matching the exact insurance products and riders to the risk sought to be transferred, and knowing where the pitfalls exist which could result in a claim being denied. E&O and D&O coverage have been around for decades and as such, have established standards and terms. However, other types of coverage such as cybersecurity insurance, do not have the same conventions as they are relatively new products. This article will review the three types of insurance many financial services firms consider today to help manage specific business risks.

Errors & Omissions (E&O) policies are widely used throughout the industry to help protect against claims by clients arising out of professional services provided by the insured. ***Directors & Officer Liability (D&O) coverage*** can be added to an E&O policy or purchased separately, to protect the firm as well as the directors, officers, partners and employees of the insured entity for claims arising out of business decisions, not investment decisions. D&O is where you would find coverage for "claims" (including formal regulatory investigations costs) by non-clients such as the SEC and US Department of Labor ("DOL") that are not triggered by a client complaint.

Side A, Independent Directors Liability ("IDL") Insurance typically serves as a supplemental policy to D&O coverage, and would come into play in circumstances where indemnification is not available or is refused. Side A IDL insurance helps fund independent directors mitigate liability and exposure to various risks associated with indemnification (when a fund is legally prohibited from paying for a director/officer's defense); erosion risk (when a D&O policy has exhausted its limits of liability); and coverage risk (when a D&O policy does not provide coverage for the situation). Depending on the indemnifications, CCOs may find themselves in a conflicting situation with their employers who could withhold these protections.

Cyber Insurance is a type of insurance designed to cover consumers of technology services or products. More specifically, the policies are intended to cover a variety of both liability and property losses that may result when a business engages in various electronic activities. Most notably, but not exclusively, cyber policies cover liability for a data breach in which client information is exposed or stolen by an individual who has gained access to the firm's electronic network. It is another type of insurance policy to consider, however, it has important limitations that you need to keep in mind.

1. ICI Mutual "A Review of Claims in the Mutual Fund Industry (January 2015-March 2016)" Claim Trends, 2015

About the Author

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Additional Riders

There are many insurance "riders" that can accompany the policies outlined above. An insurance rider is an available enhancement option that your broker can negotiate to be included in your policy. Riders can help supplement your existing coverage and provide additional benefits. Financial professionals need to understand policy definitions and exclusions, and discuss the various options available with their broker.

We presented several questions applicable to financial services firms to three experts in the insurance field. The questions and responses are below.

Expert #1 Andy Fotopulos, President at Starkweather & Shepley Insurance Corp. of MA
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Q: What terms and conditions should Chief Compliance Officers be aware of with respect to insurance policies and riders?

A: When purchasing or reviewing coverage, CCOs should always be aware of the following:

- Whether the insurance policy is for errors and omission only, or does include directors and officers;
- Whether there is an exclusion in the policy for claims brought by regulators (e.g. E&O vs D&O);
- How the policy defines an "Individual Insured" (i.e. outsourced CCO may not be covered);
- How the policy defines a "claim" and what event(s) trigger coverage. Some policies trigger coverage at the time of a subpoena. Others don't trigger coverage until there is a formal investigation. This is essential to understand because there could be a time period of several months in between a subpoena and formal investigation where there is a gap in coverage; and
- How the policy ensures that when new limits of liability are purchased, claims for past unknown acts are covered under those new limits.

Q: In order to maximize coverage benefits, what riders and coverage increases are available in the marketplace that firms, directors and officers can obtain for little or no cost?

A: Here are some things to consider:

- Request broader definitions: Ask an insurer to provide a broader definition of a claim, professional services and other important terms. This can help ensure that when a claim does indeed arise, you have a policy which casts the widest possible net.
- Costs of Corrections: Costs of correction coverage provides for indemnification to an insured company for its costs of correcting situations that, if not corrected, would result in legal liability on the part of the insured company. Additionally, verify that no action or other "claim" is necessary to trigger this coverage. The basic purpose of this coverage is to permit prompt correction by insured companies of operations-based errors so that more expensive problems or litigation can be avoided down the road.
- Pre-Claim Extension coverage: Pre-Claim Extension coverage can help supplement an existing insurance portfolio. For example, if a firm was to receive a subpoena but no individuals are named as being investigated or brought up on charges, many insurance policies are not triggered until such an event occurs or a formal investigation is declared. With 'Pre-Claim Extension' the insured can go back and be reimbursed for expenses that were paid prior to meeting the definition of 'Claim' – thus triggering coverage under the insurance policy. Be aware, however, that the retention amount is typically higher for such situations. Most D&O policies will trigger only after a formal investigation or an allegation of wrongdoing has been presented by a regulatory body. This means that it is likely that all expenses incurred during the audit or informal investigatory stages will be paid by the insured. The take-away is to be sure the firm's D&O policy has been enhanced with Pre-Claim Defense coverage, in order to cover those earlier costs in cases where the audit or investigation turns into a covered claim.

Q: What are the biggest mistakes a Chief Compliance Officer makes with respect to insurance coverage?

A: There are 5 typical mistakes CCOs and firms should be sure to avoid when it comes to their liability coverage.

1. Be very careful with joint policies. With a joint policy that includes an insured fund, board and adviser, one aggregate limit can be exhausted by a claim thus leaving nothing for the Chief Compliance Officer. For example, if the fund, adviser, administrator and CCO all are all being sued, the limits might not be enough. Often a joint policy is purchased when the adviser and fund complex are under common control. Independent directors often buy their own separate policies.
2. The obligation for an entity to indemnify a CCO depends on the state of incorporation so it matters whether or not the CCO is recognized as a "corporate officer" of the insured entity. Some states require that the CCOs are appointed in the bylaws of the insured entity as a corporate officer. Moreover, other states might require that the CCO also be appointed as a corporate officer in state filings. Of course, as the CCO, you believe you are covered under your firm's D&O, but have you verified this? A majority of CCOs are not subject to indemnification unless designated in the by-laws as a corporate officer or have a stand-alone agreement in writing guaranteeing indemnification. The take-away is that CCOs should review the state by-laws to make sure they are covered, as the title of Chief Compliance Officer alone doesn't mean he or she is a corporate officer of the firm for insurance coverage purposes.
3. Know the difference between E&O and D&O. The intent of an E&O policy is to cover claims by clients arising out of the firm's "professional services". The intent of D&O is to protect the insured entity as well as its directors, officers, partners and employees, against litigation arising out of business decisions. This is typically where to find coverage for the CCO for claims, including investigations by regulators. But just because an E&O policy may define an "insured" to include the Chief Compliance Officer, that doesn't mean they're covered for their professional services as CCO. The CCO needs to understand what they are covered for and what triggers coverage. In other words, consider who needs to bring the claim in order to have coverage. Quite a

few E&O policies will only cover the expense of a formal regulatory investigation against a CCO if the investigation is initiated due to a client complaint. The take-away is to ensure that D&O/E&O policy does not contain an exclusion for "claims brought by regulators."

4. The CCO may be in conflict with their firm at some point, and he or she may withhold indemnification. For example, if a CCO is terminated and brings an employment practices claim, the firm could retaliate and bring a defamation suit against the CCO. How would the CCO's legal expenses be covered? In another scenario, the employer may want to move on by settling a claim while the CCO is fighting to maintain his or her professional reputation and future employment. How will the insurance policy respond to such conflict between insured parties?
5. If the individual is an "outsourced" CCO or independent contractor, he or she needs to be sure that the insurance policy's definition of an individual insured is broad enough to include a non-W2 Employee.

Q: How much coverage is enough?

A: Ideally, the right coverage amount should equal the amount of a claim. In other words, there is no set rule, but one needs to remember that although fines and penalties are not covered under an insurance policy, legal defense costs can run much higher and should be covered with proper liability coverage. Insureds should request to receive proper benchmarking based on their particular niche of the investment industry from their insurance professional before obtaining any policy and/or rider.

Q: Are CCOs still covered once they leave a firm?

A: Most policies from leading insurers cover any past, present of future directors, officers, partners and employees. However, low cost insurance policies may not. A strong recommendation would be to negotiate such tail coverage in advance of placing the insurance policy as it will be far more reasonable if negotiated in advance of placing coverage.   If the firm waits until a litigation action is eminent, the availability for tail coverage may be limited or cost prohibitive.

Finally, firms should not open themselves up to the prior exposure of firms they may be acquiring. The best defense against this exposure is to ensure that the acquired firm purchases its own policy which extends coverage to match the various state statutes of limitations for bringing a claim.

Expert #2 Stephen T. Cohen, Partner at Dechert LLP
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Given Mr. Cohen's experience with registered funds, our focus shifted to liability specifically associated with overseeing these products.

Q: When can registered fund assets be used to cover legal expenses for the board and officers?

A: A fund generally can cover the members of its board and its officers for all expenses reasonably incurred or paid by him or her in connection with any claim, action, suit or proceeding in which he or she becomes involved as a party, or otherwise by virtue of his or her being or having been a member of the board or an officer. The members of the board and officers would only be covered to the extent that the fund has sufficient assets to reimburse or pay the expenses incurred with respect to a claim. Similarly, if a claim involves a particular fund that is one of several series of a corporation or trust, the assets of only that fund may be used to provide indemnification.

Under federal law, a member of the board or an officer who has been adjudicated by a court to be liable (or, in some cases, determined by the board as likely to be liable) to the fund or its shareholders by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office is not entitled to such indemnification. State law also may prohibit indemnification under similar circumstances.

Q: How are fund directors and officers covered against personal liability for official actions?

A: Fund directors and officers generally have two sources of coverage to protect themselves from personal liability for actions taken in their official capacity. First, funds generally provide their directors and officers with indemnification, which typically allows directors and officers to be reimbursed from fund assets for liabilities (including legal expenses) incurred by them as defendants or witnesses in fund-related actions, subject to certain limitations. A fund's indemnification protections are set forth in the fund's organizational documents and often times, provide directors and officers with the maximum indemnification permitted under state and federal law.

The other source of coverage is through insurance. Although there is no legal requirement that they do so, most funds arrange to purchase such insurance. A directors and officers/errors and omission ("D&O/E&O") insurance policy typically provides coverage for liabilities, including legal expenses, resulting from negligence or breach of duty by directors or officers in performance of their duties (though not for liabilities resulting from their fraud, dishonesty, or similar misconduct). It is common for D&O/E&O insurance policies to require a retention (or deductible) before the insurance policy will begin to cover claims, although certain types of coverage for directors and officers will respond without a retention.

Q: What costs and conduct are typically covered under fund indemnification and insurance arrangements?

A: Although indemnification and insurance arrangements generally cover personal liability and costs incurred in defense of fund directors and officers, such as legal or other defense costs, there are certain limitations to the amounts of coverage available to fund directors and officers, as well as the types of claims that will be covered by a fund's indemnification and insurance arrangements. For example, indemnification would be limited to the amount of fund assets available, and insurance would be subject to the maximum amount of coverage in the policy itself. In addition, as already mentioned, a fund's indemnification and insurance arrangement generally would not cover disabling conduct that may arise from bad faith, willful misfeasance or other similar types of misconduct in their official capacity and may be subject to certain other conditions. In fact, the federal securities laws expressly preclude such coverage.

Q: What factors may a board wish to consider in connection with approving or renewing a D&O/E&O insurance policy?

A: It is important for boards to consider appropriate factors and information in connection with approving or renewing a fund's D&O/E&O insurance policy. Certain relevant factors and information generally would be common to all funds, such as the cost of the coverage, the parties covered as insureds, the amount of fund assets, the types of strategies pursued and the reputation of the insurance carrier(s). In addition, fund boards may wish to consider the evolution of regulatory and legal risks and exposures applicable to fund directors and officers generally, as well as the particular funds overseen by the board. For example, a board may wish to take into account evolving risks, such as cybersecurity risks, or changes in regulatory initiatives and the focus of the plaintiffs' bar in determining whether to increase the level of coverage. Boards may also wish to take into account whether a stand-alone or joint policy is preferable; that is whether the policy covers only a fund and its directors and officers or whether it extends to service providers, including the fund's adviser. If the full limit of liability is available to the fund and its directors and officers, the adviser would need to arrange and maintain its own insurance.

Q: Will D&O/E&O insurance policy assets be utilized before Fund assets?

A: Generally, a D&O/E&O insurance policy serves as the second line of defense after indemnification, and the typical sequence involves the fund initially providing indemnification for covered expenses and the insurance policy compensating the fund for those expenses, subject to a deductible (or retention). Although this is typically the sequence, a D&O/E&O insurance policy also may advance covered expenses to a member of the Board or an officer, under certain circumstances.

Q: What are the most common situations when Fund Directors/Officers need to tap into insurance/fund assets?

Typical claims include, among others, allegations by shareholders of a fund that members of the board or officers breached their duties to the fund or mismanaged the fund, allegations of material misrepresentations in a fund's prospectus, and allegations of failure to appropriately supervise a service provider to a fund.

Q: What are the protections/defenses in place for fund directors? Are CCOs afforded the same protections? Also, is outside counsel ever subject to potential liability?

A: Provided they have exercised reasonable care and are reasonably informed, and have acted under the reasonable belief that their actions are in the best interest of a fund, the members of the board and officers generally will not be responsible or liable for the outcome of their acts or omissions or negligence or wrongdoing. CCOs, however, are subject to certain responsibilities under the federal securities laws that may not afford them the same level of protections for their actions. Outside counsel is subject to potential liability arising from negligent acts or omissions that sufficiently prove legal malpractice that causes harm, in this case, to the fund and shareholders. Outside counsel commonly purchase insurance coverage for claims of legal malpractice.

Q: Are Fund Directors ever found personally liable or are they covered by fund assets and/or D&O/E&O insurance policies?

A: As a result of limitations of liability under law and charter documents as well as the protections afforded under indemnification and D&O/E&O insurance policies, it is rare for a member of the board to be personally liable in connection with actions taken in his or her capacity as such. In almost all instances, a board member is covered by fund assets and/or D&O/E&O insurance policies.

Expert #3 Michael Brice, Co-Founder BW Cyber Services
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As cybersecurity insurance has begun saturating the market, advisers should understand the options. Advisers need to be aware of their specific cyber risks and how their cyber policies mitigate those risks.

Q: What is the biggest misconception about cyber insurance?

A: The biggest misconception is that cyber insurance will transfer cyber risk, and is an alternative to having a strong cyber program. Many advisers (and investors) are under the impression that a cyber insurance policy will mitigate their lack of cyber controls or lack of in-house competency with respect to cybersecurity. If anything, it's the exact opposite situation. The policy will only go into effect once a certain minimum level of cyber competence has been met. While not comprehensive, some requirements of cyber competence include:

- Executive understanding (e.g., signature on a policy statement) and oversight (e.g., annual review of the policy) of a formal cyber program;
- Certain industry best practices are considered standard operating procedures these days such as: firewall, AV & Malware with periodic scans, timely software updates & patches, password policy and basic encryption of data. There is no specific framework, but these are some of the basic controls an insurer wants to see is in place.
    - Cyber Risk Assessment and implementation of corresponding controls to address the highest risks
    - A breach response process;
    - Security training for all employees;
    - Documented policies related to the above items and supporting evidence that the policies are reviewed and enforced;
    - Some basic control testing like a penetration and vulnerability testing - especially if a client has a webpage or web portal, and;
    - An understanding of the amount of PII and where/how it might reside and be protected.

Conclusion

Boards and CCOs should always consult with experienced insurance brokers, compliance consultants and fund counsel to ask the right questions and work to ensure they have the best coverage in the event of a legal or regulatory issue. It is essential to understanding the available protections. It is rare for a CCO or member of the board to be personally liable in connection with actions taken in his or her capacity as such. In almost all cases the director or officer exercises sound judgment, indemnities assets or D&O/E&O insurance policies will cover those confronted with legal issues. ★