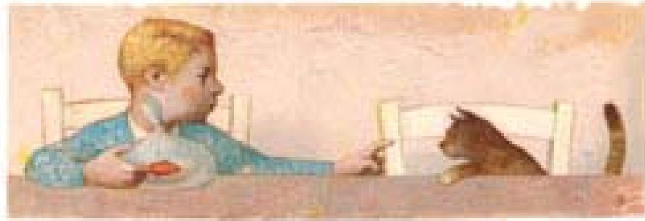

Protecting Your Assets

Twelve factors for RIAs to consider when purchasing E&O insurance

Advisers need to shield themselves from liability more than ever before. Regulatory scrutiny and an aggressive plaintiff's bar means it's likely that advisers' assets could be placed in jeopardy. Advisers to retirement plans covered by the Employee Retirement Income Security Act (ERISA) are particularly at risk because ERISA liability is personal, says Steve Saxon, a Partner at The Groom Law Group in Washington. This means that advisers' personal assets are at stake. "So, without proper insurance, you are personally at risk," he explains.

Being personally liable means that your personal assets are at risk, i.e., they can pierce the "corporate veil." Generally, when you operate as a corporation, LLC, or other business entity, if the business is sued, the plaintiff can only get to the assets of the corporation—the personal assets of the owners of the business are protected. ERISA, however, specifically says that fiduciaries are personally liable for breaches. According to Saxon, many plaintiffs' attorneys now are seeking personal liabilities as a tactic to get fiduciaries to settle faster.

Errors and omissions (E&O) insurance protects against alleged negligent acts, errors, omissions, or breach of duty arising out of the adviser's professional services. It can protect advisers against losses by helping with attorneys' fees, claims, and judgments, says Andrew J. Fotopulos, Senior Vice President of Starkweather & Shepley Insurance. Having E&O insurance is part of risk management, explains Brian Smith SVP, National Fiduciary Liability Insurance Practice Leader at The Segal Company in New York. Advisers, he says, should first try to identify, then eliminate risk by doing their jobs correctly, but mistakes happen and for that, E&O insurance is an option.

When shopping for policies, here are 12 things that advisers should know about E&O insurance.

You need it. We live in a litigious society and, if something goes the wrong way, someone would argue that there should be liability, says Smith. As long as we live in a litigious society, he says, advisers need E&O insurance to protect themselves and their businesses.

Additionally, having E&O insurance is a frequent requirement to get retirement plan work. Requests for proposals (RFPs) often ask advisers if they have E&O insurance, says

Saxon, and if advisers do not have E&O insurance, or a minimum amount of insurance, they are kicked out of the RFP process. So, not only do ERISA advisers need E&O insurance, they need the right amount, he notes. Registered representatives do get E&O insurance through their broker/dealers (B/Ds), he says, but if they have a fee business on the side, that business is not covered by the B/D's E&O policy.

Be an educated buyer. Advisers who are in the market for E&O insurance should educate themselves as to what different policies cover, who they cover, and when the coverage kicks in, says Fotopulos.

Understand the definitions in each policy and what is excluded from coverage. "The nuts and bolts are in how terms are defined," says Smith. E&O policy terms are not generic, he says, and every company defines terms differently. In particular, says Fotopulos, ERISA advisers should look at the definition of terms such as "Investment Advisory Services" as well as "professional services" to make sure that the definition covers all the services they provide to plan sponsors and participants. If the definitions of these terms do not cover all services being provided, he adds, advisers can work with their insurance advisers to get the definitions expanded. For example, says Saxon, if "professional services" does not cover advice given to participants, and the adviser provides that service, it would be prudent to have the definition of professional services broadened to include that.

Understanding the definition of "client" is important. Most policies define "client" broadly enough to include the sponsor, the plan, and participants, says Fotopulos, but, nonetheless, advisers should make sure it does.

Make sure that the insurance broker understands your business. E&O policies frequently have ERISA exclusions, meaning that claims arising out of the ERISA statute are not covered , says Saxon, so make sure the insurance broker understands you service ERISA plans and that you could be sued under ERISA. The broker also should understand how the business is run. For example, says Saxon, if the adviser's business is run with no cash buffer in the company, then first-dollar coverage on claims may be needed.

Make sure all employees and affiliates are covered. Many policies are drafted to exclude the Chief Compliance Officer (CCO), says Fotopulos, because the CCO is not providing investment advice. So, if the Securities and Exchange Commission (SEC) brings a claim against the CCO, then the advisory firm would not be covered for those costs under the E&O policy. "You may need to enhance the policy to get CCO coverage," he says. Additionally, says Saxon, if affiliates (e.g., a recordkeeping affiliate) are providing services to clients, advisers want to make sure employees and services provided by that affiliate are covered as well. "It's not beyond the realm of possibility that the Department of Labor (DoL) could go after an affiliated recordkeeper," says Saxon.

Claims and investigations by regulatory agencies need to be covered. Many E&O policies, explains Fotopulos, only cover claims made by a client. However, advisory firms often have to defend themselves in actions taken by the SEC, the DoL, state

securities agencies, and other regulatory bodies. Additionally, advisers want coverage to begin prior to an actual legal claim being brought. “You want coverage for defending yourself in an investigation,” says Saxon. An agency can start an investigation, and the adviser can incur significant legal fees, but most E&O policies will not kick in until a bureau files a claim, and oftentimes no claim is ever made. Therefore, he says, advisers want the broadest language possible that makes it clear that, when the adviser is the target of an investigation, that coverage kicks in. “You don’t want to have to wait until a claim is filed in court for attorney fees to be covered,” he says.

Understand the notification requirements. E&O policies generally require notification of anything that could eventually lead to a claim down the road. “Be aware of when you’re covered and when you have to pull the trigger to make a claim under the policy,” says Fotopulos. The insurance company generally requires that the adviser put it on notice of any incident that can possibly lead to a claim, says Saxon. If an adviser gets mixed up in any set of facts that could lead to a claim, then the insurance carrier should be notified, he says. Notifying the insurer does not affect premiums unless an actual claim is made, says Saxon, but if the insurer is not notified of the incident soon after it arises, it could take the position that the notice requirement was not met, and therefore not pay on the claim. “If the DoL even knocks on the door, you may want to let the insurance company know about it,” he says.

Understand the policy exclusions. For example, says Fotopulos, many policies say they cover “fiduciary breaches” but then the policy may define this as only applying to ERISA accounts. Advisers, however, owe a fiduciary duty to all clients, he says, so they may need to understand when this does and does not apply. Furthermore, he says, trading errors are not often covered because the error usually is discovered by the adviser so there is no claim by the client. To get that coverage, he says, the adviser would need to get a policy enhancement.

Know the investment exclusions. Advisers should read the investment exclusions and make sure that all the investment activities they engage in are covered, says Fotopulos. For example, if the adviser is working with a professional corporation that has open brokerage accounts in its retirement plan, the adviser may need to make sure that everything the participants are investing in is covered.

You do not want Indemnifications to be exhausted prior to making a claim. Sometimes the insurance contract has a provision that the contract will pay out only after all indemnifications have been exhausted. “You want them to pay first, prior to indemnifications, because you don’t want to get into the argument over who is going to pay first,” says Saxon.

Make sure all potential fines and penalties are covered. In addition to legal fees and judgments, ERISA advisers often are subject to fines and penalties, says Saxon. For example, he says, if an adviser settles with the DoL because an ERISA plan lost $100,000, the adviser may be required to reimburse the $100,000 and, in addition, the DoL could impose a 20% fine on top of that. Under the terms of some policies, he says,

that additional 20% fine may not be covered. Advisers should ask that fines and penalties imposed under ERISA section 502(l) are covered, says Saxon.

You want equivalent coverage from year to year. It's critical to assess every year how the renewal policy compares to the expired policy, says Smith. Do not assume that, just because you retained the same insurer, the policy is exactly the same as the previous policy year.

Make sure you are dealing with a reputable insurance company. In the end, advisers want to make sure they are dealing with an insurance company that will stand behind them. If advisers are not doing anything criminal but simply going about their business, and the DoL says "you shouldn't be doing that," then the insurance company should stand behind the advisers and indemnify them, says Saxon. There are financial ratings available through rating agencies such as A.M. Best and Standard & Poor's, says Fotopulos, but no rankings in terms of quality of insurers. This is when the input of the insurance broker is important, he says. A good broker should be able to provide an adviser with an opinion based on his experience as to how the insurer handles claims.

Finally, although advisers need E&O insurance, they never actually want to make a claim, says Smith. Insurance, he says, is a reserve parachute, it's not something you always want to pull out and use. E&O insurance, he says, can help to defend an adviser and pay attorney fees and claims, but it can't fix the emotional or professional damage, or do jail time. "It's always better to run the business in a way that you don't need to use your E&O policy," he says. —*Elayne Robertson Demby*