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Opinion

Why Funds' Risk Management Strategy Must Address Insurance

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Strategic management of fund exposures requires more skill than ever before, and all sources of protection, from industry and commercial D&O insurers to E&O insurance and fidelity bonds, have been called upon for record contributions.

The risk landscape faced by investment companies, their boards and their advisers has shifted dramatically in the last several years. Funds and advisers have been exposed to large and unforeseen risks. Regulators and the plaintiffs' bar have their sights firmly trained not only on funds and advisers, but also on directors and advisers' parent companies, affiliates and senior managers of advisers.

This environment has produced expensive defense efforts, stringent administrative orders, individual sanctions and settlements costing hundreds of millions of dollars. And in this environment, it's necessary for boards to make due diligence of insurance a greater priority.

The Risks and Exposures to Manage

Any strategic effort to manage today's risks and ensure adequate insurance coverage must begin with an appreciation of the breadth of those risks. For most fund complexes, the SEC's current examination and enforcement approach is the starting point. The range of products targeted by the SEC is noteworthy: fixed income; exchange-traded funds; inverse, leveraged, and municipal funds; and derivative investments of many kinds, just to name a few. The range of practices under scrutiny is equally broad – risk, leverage and volatility disclosures, as well as credit quality, liquidity, valuation and asset segregation practices, among many other areas. Aggressive pursuit of funds, advisers and directors, as well as individual defendants, in administrative and federal court proceedings continues to produce eight- and nine-figure settlements. Finra and state attorneys general only add to the complexity of the risk landscape.

The private bar has also produced its own wave of post-credit crisis civil litigation, which includes scores of federal class actions, Finra arbitrations, state-law claims, and derivative demands. The Commodities Futures Trading Commission has been active, too, alleging market manipulation by mutual funds engaged in the commodities and futures markets. Additionally, recent bankruptcy cases have produced creditor clawback claims against funds seeking purportedly fraudulent transfers made by the debtor years ago.

The strategic considerations raised for any fund complex in this environment are substantial and nuanced. Adopting the best strategies for resolving these exposures is critical. Some cases and proceedings have settled early, while an increasing number of significant disputes are being actively litigated through discovery. Still other funds and their boards have adopted more complex strategies, resolving regulatory actions while aggressively defending civil actions.

Recognizing the Insurance Component of Effective Risk Management

Any defense strategy should recognize the fundamental importance of insurance proceeds in paying defense costs and funding potential resolutions. Recent industry experience on this front has been uneven. A number of mutual funds and their advisers have been successful in obtaining insurance proceeds to defray the costs of the new risks; others have not. Careful attention to policy language, both when purchasing insurance and after a claim is made, and careful attention to policy requirements for notification, defense and settlement of claims may make a significant difference in the insurance available.

All forms of insurance policies in a mutual fund's portfolio should be examined for potential coverage for new liability risks. This needs to include an examination of separate insurance programs in place for funds and their advisers. In reviewing insurance programs, conventional wisdom about the scope of available coverage should be jettisoned entirely. Coverage available under D&O and E&O policies and fidelity bonds – which cover losses caused by fraudulent acts committed by individuals – has expanded dramatically in recent years. For example, fidelity bonds now provide coverage far beyond common-law employee theft, covering a far greater range of individuals and assets.

Similarly, after a claim is made, an insurer's statements concerning the breadth of any coverage must be critically evaluated. For example, any recent insurer statements that say their policies categorically do not cover such new risks as fund or adviser liabilities associated with excessive-fee claims warrant scrutiny. Reality and policy language are rarely, if ever, that simple, and in many recent cases, coverage for these kinds of risks has proven to be available.

One critically important development in this new environment is that anything close to a misstep by a board or its adviser in seeking coverage will be called out by an insurer. Close attention to notice requirements, cooperation requirements, and consent requirements under insurance policies is critical to avoiding costly disputes or an increase of the insurer's bargaining power at the settlement table. Nevertheless, boards and advisers should be leery of an insurer's assertion that an insubstantial breach of a policy requirement leads to forfeiture of insurance policy proceeds.

Ultimately, under D&O and E&O policies, boards and their adviser control the defense of the investigations and lawsuits instituted against them. The potential liabilities associated with these new risks argue strongly against allowing the financial considerations of an insurance company to outweigh the defense strategies that will protect boards and their advisers against potentially crippling liabilities. Insurance is only one component of any thoughtful defense strategy, but it is a sufficiently important ingredient to success that it deserves careful attention in order to maximize its benefits.

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