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SPOTLIGHT ON

Insurance and Bonding Considerations for Registered Investment Advisors

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Registered investment advisors often ask if they are required to maintain any professional liability insurance. The short answer is no, investment advisors are not legally required to maintain professional liability insurance (i.e., a so-called Errors & Omissions or "E&O" policy). Nonetheless, most registered advisors do maintain some sort of liability insurance. This is not only a best practice but may be required by institutional product vendors and others with whom advisors do business.

The states and the federal government may, however, require advisors to post certain types of bonds and/or meet minimum net capital requirements.

This Spotlight summarizes key considerations that advisors should keep in mind regarding E&O insurance and applicable bonding requirements.

What E&O insurance does and does not cover

E&O insurance is intended to protect an investment advisory firm and its officers, directors, and employees from claims arising from the investment advisory services the firm offers. This includes claims by clients for investment losses and other damages resulting from claims like negligence, breach of fiduciary duty in providing (or failing to provide) professional services, errors and omissions, breaches of the advisory agreement and failure to supervise brokers. For example, a client may allege that the advisor made unsuitable investments, traded in a manner inconsistent with the customer's investment objectives and/or failed to timely change investments as the customer's objectives changed; violated the trading guidelines and restrictions in the client's contract with the advisor; had a trading error; or breached some other contractual agreement with the client.

E&O insurance typically covers settlements, judgments, and defense costs associated with these types of claims. Some policies may also include "cost of corrections" coverage that requires the insurer to correct a situation arising out of an alleged wrongful act before an actual claim is made, something that may be especially important in the case of a trading error. E&O insurance policies typically do not cover fines, penalties, and punitive damages; in fact, many states prohibit insurance for these costs. (This is the rule in California, Colorado, Connecticut, Florida, Illinois, Indiana, Kansas, Massachusetts, New Jersey, New York, Ohio, and Pennsylvania, among others.)

Most E&O insurance providers will not provide coverage regarding alternative investments such as hedge funds, limited partnerships, private equity funds, REITs, exchange-traded notes, derivatives, foreign securities, and private placements.

E&O policies typically do not cover claims arising from the advisor's intentional fraud or dishonesty, willful or intentional failure to act prudently, or guarantees made regarding performance. E&O insurance also does not cover claims that go beyond the firm's advisory services, like claims for personal injury, infliction of emotional distress, libel or slander or discrimination or harassment. These policies also generally do not cover consequential or remote losses. E&O policies also typically exclude coverage for claims that would be covered under other types of insurance, such as claims arising under the Employee Retirement Income Security Act ("ERISA") or employment practices claims.

Finally, some insurers will only extend E&O coverage if the advisor has written executed investment advisory contracts with its clients that detail the scope of services and fees charges by the advisor.

Advisors should be aware that many standard E&O policies expressly exclude coverage for state-registered advisors, and should therefore carefully negotiate their insurance arrangements to ensure all of their activities are appropriately covered.

As you can tell from this summary, typical E&O insurance policies may exclude activities or advice that advisors might presume are covered. Advisors should research available policies or consider using an insurance broker to help them understand the available policies and select the policy that best protects their interests.

In recent years, E&O insurance premiums have fallen and several insurance companies specifically cater their E&O insurance offerings to investment advisors, often providing attractive discounts. Please keep in mind that advisors employing inexperienced investment advisor representatives ("IARs"), offering alternative investments, or with past regulatory or disciplinary issues may have to pay higher premiums.

State law considerations regarding E&O coverage

Advisors should also consider relevant state laws before buying a particular insurance policy. Insurance activities are regulated by the states and each state has its own laws and rules concerning insurance coverage for advisors and others. Advisors may wish to consult with legal counsel to assist them in this process.

Advisors may be subject to state and/or federal bonding requirements

As we noted above, the federal government and the states do not require that investment advisors obtain insurance. But they may require investment advisors to post a bond in certain circumstances. We discuss these requirements below.

State surety bonds
Unlike the Securities and Exchange Commission ("SEC"), some states impose net worth and bonding requirements on registered investment advisors. Many states have adopted the same approach, which we describe here:

- **Advisors with "custody" of client funds and/or securities (a topic detailed in our Spotlight on the Custody Rule) must maintain a minimum net worth of $35,000;**
  - Please keep in mind that advisors deemed to have "custody" solely because the advisor deducts fees directly from client accounts or is advising a pooled investment vehicle may not have to comply with the $35,000 net worth requirement if they meet certain conditions.
- **Advisors with discretionary trading authority, but no custody, over client funds and/or securities must maintain a net worth of $10,000;**
- **Advisors allowing clients to prepay advisor fees of more than $500 per client and six or more months' worth of fees must always maintain a positive net worth; and**
- **Advisors with "custody" of, or discretion over, client funds or securities who do not meet the net worth requirements listed above may obtain a bond to cover the deficiency (up to the nearest $5,000).**
  - This "surety" bond is essentially an agreement by the insurance carrier to take on secondary responsibility for a default or debt of the investment advisor. The bond makes funds available in case the state or advisor's clients sue for damages resulting from the advisor's violation of the state's security laws or other conditions of the bond.
  - State securities regulators often require the surety and/or its agent to execute a bond form or affidavit.
  - The bond must be issued by a company qualified to do business in the state and the bonded funds must be available for claims of all of the advisor's clients regardless of their state of residence.

You can find the Model Rules on these net worth and bonding requirements on the website of the North American Securities Administrators Association ("NASAA") at http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Minimum-Financial-Requirements.pdf, and http://www.nasaa.org/wp-content/uploads/2011/07/IA-Model-Rule-Bonding.pdf.

Advisors should be aware that not all of the states have adopted the NASAA model rules on net worth and bonding, and stricter requirements may apply. For instance, some states require a bond (sometimes as high as $50,000) to be posted by all investment advisors maintaining custody or discretionary authority over client accounts, while others only require those same advisors to maintain a minimum net worth or a bond in the same amount as the required minimum net worth. Some states require all investment advisors registered in the state to maintain a surety bond. Other states require that all advisors, regardless of whether they have custody or discretionary authority, be solvent and maintain a positive net worth. And some states require advisors to submit copies of the surety bond to the state securities regulator.

When an advisor does business in multiple states with different state provisions on net worth and bonding, the advisor may take advantage of the federal home state rule. That rule provides that advisors registered and in compliance with the minimum net worth and bonding requirements of the state where the advisor has its principal office do not need to meet the (higher) requirements of any other states where the advisor does business. 15 U.S.C. § 80b-18a(c).

Because state rules on net worth and bonding requirements vary widely, advisors should research their state's specific requirements and/or consult legal counsel on this issue.

ERISA fiduciary bonds

Section 412 of the Employee Retirement Income Security Act of 1974 ("ERISA") requires every fiduciary responsible for managing a pension, profit-sharing or thrift plan and every individual or entity handling the assets of these plans to be bonded. Registered broker-dealers subject to the bond requirements of a self-regulatory organization, and certain trusts and insurance companies, are exempt from this requirement.

Investment advisors may be subject to ERISA's bonding requirement if they provide investment advice to ERISA plans for a fee (or other remuneration) or have the right or power to exercise discretionary authority over purchases and sales of plan assets. The ERISA bonding requirement may also apply to advisors providing these services to an ERISA plan participant directly, if the plan allows the participant's advisor to make investment decisions for some or all of his assets with the plan.

The bonding requirement protects a plan's assets against loss due to fraudulent or dishonest behavior. The bond must be at least 10% of the amount of the funds handled by the fiduciary up to a maximum of $500,000 per plan and a minimum of $1,000. If the plan holds employer securities, the cap is $1,000,000 (for plan years after December 31, 2007).

Advisors' other insurance options

There are a variety of other insurance and bond options available to advisors. Advisors should obtain the type of insurance that most closely matches the type of clients and investments they manage, and the types of claims advisors want to insure against.

- **Directors and officers ("D&O") insurance:** This covers claims against the advisory firm, its officers and directors for alleged breaches of fiduciary duty, errors in judgment, and other wrongful acts in the performance of their duties as officers and directors.
- Fidelity bonds: These bonds indemnify an employer for loss of money or other property caused by dishonest or fraudulent acts of bonded personnel, including larceny, theft, embezzlement, forgery, and misappropriation. Certain state and federal laws require fidelity bonds. For instance, the Investment Company Act requires fidelity bonds for officers and employees of registered management companies or mutual funds, and FINRA requires member broker-dealer firms to maintain fidelity bonds.
- Employment practices liability insurance: This insurance is designed to protect the advisory firm and its directors, officers, and current and former employees from claims involving actual or alleged violations of any federal, state, or local laws prohibiting all types of discrimination (based on age, sex, race or disability), harassment, wrongful discharge or termination, and negligent hiring or supervision of others.
- General commercial business liability insurance: This insurance protects a company from claims related to bodily injury, property damage, libel, slander, defamation, copyright infringement, and false or misleading advertising.
- Network security and privacy liability/cyber security insurance: This insurance covers against claims related to a data breach involving lost or stolen information of employees or customers. Depending on the specific details of each policy, it may cover the following costs associated with a data breach: notification to individuals affected, credit monitoring costs, third-party financial claims, regulatory fines and penalties, public relations expenses, data forensic expert costs, and expenses incurred in responding to a network extortion.

Insurers may allow advisors to add some of these additional types of coverage to their E&O liability policy.

This Spotlight is intended to provide investment advisors with basic, general information on the insurance options available to them. Advisors should consider consulting with legal counsel and/or an insurance broker to determine the type, scope, and amount of insurance coverage most appropriate for their investment advisory services and clients, and to ensure compliance with any applicable bonding requirements. Please keep in mind that insurance and bonding issues are heavily regulated by the states, and advisors should research the applicable provisions in their state(s) and keep informed of changes in state law.