Willis Towers Watson

Asset management market update

Q1 2020

Executive summary

We are pleased to present FINEX's Asset Management Market Update for Q1 2020. In this issue, we explore the current state of the Directors' & Officers' and Errors & Omissions (D&O/E&O) liability insurance market for non-publicly traded asset managers and their sponsored funds. In addition, we identify new and emerging issues within the asset management industry and discuss what impact those issues may have on D&O/E&O insurance policies.

As Q1 2020 came to a close, the entire world was responding to the unique and unexpected personal and professional challenges presented by the COVID-19 pandemic. Unprecedented in its scope, the virus itself, along with the market volatility that followed, has already had tremendous consequences for virtually all industries and all lines of coverage across the globe. It has been the most significant issue affecting both asset managers and the D&O/E&O insurance market this quarter and will likely continue to do so for the foreseeable future.

Though the full extent of the virus' impact on D&O/E&O insurance for asset managers is yet unknown, we do know that the pandemic has added a new layer of volatility on top of an already challenged insurance environment. As a result, insurers are taking a far more cautious approach to the renewal process and are expected to be far more invasive in their underwriting protocols than in years' past. Renewals will be challenging so beginning the renewal process early is critical, as D&O/E&O insurers will likely seek increases in both premiums and retentions, while carefully managing the limits they will provide and scope of coverage they will afford.

Although the COVID-19 pandemic is the most prominent issue currently, we have not lost sight of the fact that other new and emerging issues are also affecting the asset management industry. Noteworthy items addressed within this edition include the rise of various accountability regimes, such as the Senior Managers and Certification Regime, the increased focus on "greenwashing", cybersecurity and the rising concerns relating to fund liquidity. We discuss these issues in detail and identify the potential implications they may have on an asset manager's risk profile, as well as their D&O/E&O insurance policies.

There are many challenges facing asset managers this year. However, we hope this publication offers valuable insights to help you successfully navigate through these turbulent times. Should you have any questions or wish to discuss any of these issues in greater detail, please engage myself or a member of your Willis Towers Watson team.

Timothy M. Sullivan
timothy.sullivan@willistowerswatson.com

Asset management market update

D&O/E&O insurance market: Q1 2020 update

Cost and retentions

- **Overall:** Willis Towers Watson has found premiums are generally increasing by 5-15%, while retentions are remaining flat, though many insurers are now requiring minimum retentions of $250K for middle market risks.
- **Exceptions:** Asset managers with material changes in AUM, M&A activity, challenged risk profiles and/or significant claims activity will experience greater upward adjustments to premium and/or retentions.

Markets

- Key primary markets continue to aggressively push rate increases.
- Other primary and excess markets have largely aligned behind those key markets on pricing and terms, with some excess insurers seeking greater increases than the underlying, depending on existing pricing.
- Some insurers are voluntarily exiting programs they deem underpriced, possibly creating a more challenging renewal process.
- Breaking relationships with long-term primary and/or excess insurance partners may be required to mitigate premium increases.

Targeted segments

- **Insurer appetite:** Asset management is still the area that most carriers are looking to grow, with a particularly strong interest in the registered investment adviser/fund space.
- **Private equity:** One of the most challenged and least desired segments due to significant loss experience over the past several years.

Capacity

- **Stable capacity:** An abundance of capacity is keeping rates more competitive for asset managers than other financial institution sub-industries, though insurers are looking to adjust deployment of limits, with many offering only a maximum of $10M for any one program

Coverage

- **Stable to narrowing coverage:** Broad coverage is generally still available, though some insurers are reassessing their portfolio and making adjustments to the scope of coverage within their D&O/E&O policies. Notable coverage developments include:
  - **Cost of corrections:** Some insurers are narrowing this coverage so as to only apply to errors relating to Level 1 and Level 2 assets, while excluding errors relating to Level 3 assets.
  - **"Silent Cyber":** Some insurers are looking to eliminate ambiguity regarding cover for cyber-related events by adding language clarifying the breadth and scope of what is (and what is not) covered under the D&O/E&O policies.
- **Blended programs:** 401(k) proprietary fund cases are still resulting in significant losses, negatively impacting renewals of Fiduciary Liability programs, including blended D&O/E&O programs that include Fiduciary Liability coverage.

Impact of COVID-19

- The impact of the pandemic on Asset Management D&O/E&O renewals is yet to be fully determined and is evolving daily.
- Generally, insurers are not taking broad negative actions across their book of business, but are assessing each renewal on its own merits.
- Allow for more time in the renewal process and expect several questions relating to both the impact of, and response to, the pandemic.
- Underwriters will focus on, among other things, regulator/investor interactions, exposure to stressed industries/products, liquidity, valuation practices and the effectiveness of Business Continuity Plans at both your organization and your key service providers.

Asset management industry trends
Key issues to watch

COVID-19: Market Volatility

Observation:

The pandemic has created intense global volatility resulting in extreme measures being taken to stabilize capital markets, including new measures taken by the Federal Reserve, as well as relief being given by the SEC with respect to regulatory lending restrictions and the timing of regulatory filings.

Concern:

Historically, periods of extreme market volatility result in greater claims activity, usually beginning with errors made during the associated spike in trading activity, followed by litigation brought by unhappy investors and, potentially, regulatory activity against the adviser and/or funds.

Suggestion:

Asset managers should ensure that their trade error manuals require immediate notification of such errors to the internal contact responsible for insurance. Cover for correcting such errors ("Cost of Corrections") imposes strict insurer notification requirements that must be met in order to preserve coverage under the policy. Reviewing the scope of regulatory coverage, as well as the applicability of certain exclusions, such as the bodily injury/property damage and pollution exclusions, are also recommended.

COVID-19: Impact on Business

Observation:

As the pandemic roils markets and works its way through the global economy, the near-term outlook is bleak: the risk of bankruptcy for some firms is rising, AUM is falling, investors are concerned, key person succession plans are being questioned, portfolio valuation and liquidation are being scrutinized and Business Continuity Plans (of both asset managers and their service providers) are being tested and challenged in unprecedented ways.

Concern:

The insurance market was already in a challenged state going into 2020. The global pandemic now adds a new layer of uncertainty to the renewal process, with insurers applying greater scrutiny to all aspects of an insured's business and the underwriting process expected to be far more invasive than in recent years' past.

Suggestion:

Beginning the renewal process well in advance of the renewal date, approximately 5-6 months in advance, is highly recommended. Conducting underwriter meetings is critical and engaging the appropriate individuals within the organization to speak thoroughly to each of the insurer's concerns will be imperative in order to mitigate the pandemic's impact on D&O/E&O renewal terms.

Asset management industry trends

Key issues to watch (continued)

Global Culture & Accountability

Observation:

The regulatory environment outside the US has given rise to multiple accountability regimes, including the Senior Managers & Certification Regime (SMCR) in the UK (applicable to asset managers as of December 2019), the Manager-in-Charge regime in Hong Kong and similar proposed regimes in Ireland and Singapore.

The focus on accountability will continue throughout 2020, as the FCA recently issued letters aimed at asset managers and alternative investment firms, stating that the standards of governance in both types of firms are below what is expected and progress will need to be made in order to protect customers' best interest.

Concern:

Increased regulatory requirements, and the potential for follow-on civil litigation, creates a heightened exposure for asset managers.

Suggestion:

Investigations coverage, definition of "Insured Person", consideration of a Legal Expenses Additional Protection (LEAP) policy (available for UK entities only) and locally admitted insurance requirements should be reviewed accordingly.

401(k)/Proprietary Funds Litigation

Observation:

According to the ICI Mutual's January 2018-March 2019 Claims Trends publication, at least 35 lawsuits relating to the inclusion of proprietary funds within their own 401(k) plans have been brought against asset managers and their affiliates (21 remain active) with preliminary/final settlements collectively totaling over $200M.

Concern:

The number of insurers interested in offering primary Fiduciary terms has contracted and the underwriting process has become increasingly more stringent, especially for asset managers that have, or had, proprietary funds within their 401(k). Some insurers are adding exclusions for this exposure.

Suggestion:

Consider marketing the program at renewal and hosting a specific underwriter meeting/call to discuss the process for selecting and monitoring investment options, whether lower cost non-proprietary funds were considered, and whether mandatory arbitration clauses (either on a class or individual basis) are included within plan documents.

Asset management industry trends

Key issues to watch (continued)

Fiduciary Standards

Observation:

The SEC adopted Regulation Best Interest (Reg BI) to enhance standards of conduct applicable to broker-dealers and investment advisers, to help retail investors understand and compare services offered and make an informed choice of the relationship best suited to their needs.

The SEC has stated it has no plans to amend the June 30, 2020 Reg BI effective date despite the impact of the COVID-19 pandemic. After the effective date, exams will be conducted to assess the implementation of Reg BI, as well as the newly required customer/client relationship summary (Form CRS), which must provide investors with an overview of the firm and its services.

Concern:

The SEC rule, plus numerous other new/proposed state rules, create the potential for conflicts and confusion, additional compliance costs and an increased risk of regulatory activity and litigation in various venues alleging violations of multiple regulations.

Considerations:

Insurers may ask about interactions with regulators and for a status update regarding compliance with these rules. Regulatory cover and policy limits should be reviewed in the context of these evolving fiduciary standards.

Cybersecurity

Observation:

The focus on cybersecurity for all industries, including asset management, remains strong within the US and abroad, with scrutiny coming from regulators, business counterparties and investors.

Concern:

State and foreign regulators are creating new regulations to address cybersecurity, resulting in potentially overlapping, confusing and conflicting rules/requirements. Further cybersecurity scrutiny is expected to increase going forward, particularly in light of the increased exposure arising out of the COVID-19 pandemic.

Considerations:

In January 2020, the SEC released their Cybersecurity and Resiliency Observations, highlighting their review of approaches taken by financial institutions to manage cyber risks. In the category of Incident Response and Resiliency, the evaluation of cyber insurance was noted as a safeguard considered by firms to address resiliency to cyber risks.

Existing Cyber insurance should be reviewed, including the scope and limitations of such cover and how it interacts with other programs. If no Cyber program exists, explore stand-alone options or Cyber extensions to the D&O/E&O policy.

Asset management industry trends

Key issues to watch (continued)

Securities Act of 1933: "Accredited Investor"

Observation:

The SEC has proposed expanding the definition of "accredited investor" (i.e. those eligible to invest in typically higher risk private securities) to include additional categories of individuals and organizations; if approved, this would increase the potential investor base for alternative investment managers and alternative investment funds

Concern:

Intended to protect the average investor from the higher risks associated with alternative investments, "accredited investor" is currently limited to high net worth individuals and qualified institutional buyers. Expanding the definition may result in increased claims activity by new investors less familiar with the risks, and less capable of bearing the potential financial loss, inherent with alternative investments.

Suggestion:

If approved, insurers may ask about the marketing materials, offering memorandum and disclosures made to investors encompassed within the revised definition. Depending on the impact to the investor base, insurers may seek to adjust premiums/retentions. Adequacy of D&O/E&O limits of liability should also be reassessed.

"Greenwashing"

Observation:

Responsible investing mandates and environmental, social and governance (ESG) products are a top priority for many investors, while shareholders are increasingly focused on the incorporation of ESG factors into an organization's own operations.

Concern:

As asset managers try to keep up with investor demand, the risks associated with this trend must be managed, including the risk of misrepresenting the characteristics of an ESG product and/or the extent to which ESG factors are incorporated into an asset manager's own operations (i.e."greenwashing").

Suggestion:

As the SEC has included this topic within their 2020 exam priorities, insurers may inquire about, among other things, the extent of ESG training asset managers are conducting for their sales and marketing staff and the process in place to mitigate the risk of greenwashing. Asset managers should examine and understand the breadth and limitations of coverage under their D&O/E&O policies, including cover for investigations and Cost of Corrections.

Asset management industry trends

Key issues to watch (continued)

Fund Liquidity

Observation:

Recently, notable funds have encountered liquidity issues, resulting in a freeze on investor withdrawals. Neil Woodford froze redemptions to his flagship LF Woodford Equity Income fund, as the famed UK fund manager struggled to sell illiquid holdings in order to meet outflows within the open-end fund. In October 2019, it was announced that the fund would be wound up and all cash returned to investors, subject to regulatory approvals.

Concern:

In its recent analysis of fund liquidity, MSCI found that at least 7 UCITS had the potential to be in a liquidity situation similar to Woodford, while the Bank of England stated in its July 2019 Financial Stability Report and Record that it "continues to judge that the mismatch between redemption terms and the liquidity of some funds' assets has the potential to become a systemic issue."

Suggestion:

Insureds should be prepared to address liquidity-related questions from insurers, especially in light of the COVID-19 pandemic. Fund managers and directors should review and understand the breadth of coverage under their D&O and E&O policies, particularly with respect to formal and informal investigations.

Cross-selling to Plan Participants

Observation:

In April 2018, a higher education institution agreed to settle a claim for $14.5M in which the university was accused of, among other things, breaching its fiduciary duty under ERISA by allowing one of its four recordkeepers to utilize data it collected to market the recordkeeper's products to plan participants. A similar claim was brought against another university but was defeated and is under appeal.

Concern:

In a recent Ignites1 article, Jerome Schlicter, a leader in retirement plan litigation and the plaintiffs attorney in one case, warned "I expect that you will see this issue come up in cases going forward" and that plan sponsors "should be prohibiting the recordkeepers from doing whatever they want with the data, including selling products and services".

Suggestion:

Insurers may focus on the relationship, processes and controls that exist between plan sponsors and recordkeepers, and how plan participant data is collected, maintained, managed and monetized. Further, as new and evolving privacy rules are introduced, insurers may inquire about the ability of plan sponsors to effectively modify applicable policies and procedures accordingly.

1 Source: Hallez, E. (2019, June 10). Litigation Over Data, Privacy Next Up in 401(k)s: Lawyers. Ignites. Retrieved from http://ignites.com

Asset management industry trends
SEC: Notable activity

Top Exam Observations

In November 2019, the SEC issued a Risk Alert outlining the most often cited deficiencies and weaknesses found during recent examinations of registered investment companies. These involved the fund compliance rule (requiring policies be in place to prevent violations of the federal securities laws), investor disclosures, fund code of ethics rule and the board approval process involving advisory and service provider contracts.

Target-Date/Money Market Funds

Included within the November 2019 Risk Alert, the SEC noted that most of these funds were in general compliance, though issues such as potentially misleading disclosures related to asset allocations, glide path changes and conflicts of interest (such as the use of affiliated funds/advisers) were highlighted as potential weaknesses and deficiencies.

Asset Management Advisory Committee

Established in November 2019, the committee was formed to provide the SEC with diverse perspectives on asset management and related advice and recommendations. The committee is made up of outside experts, representing the views of retail and institutional investors, small and large funds, intermediaries, and other market participants.

Performance and Fee Disclosures

In October 2019, the SEC issued a statement describing several inaccuracies/shortcomings observed regarding fund performance and fee disclosures. Fund firms were encouraged to review/ensure accuracy of disclosures prior to filing with the SEC and providing to investors.

Securities Lending

In September 2019, the SEC charged the investment adviser subsidiaries of an insurance company with failing to disclose conflicts of interest and making misleading disclosures to the boards of the funds they advised. Seeking to benefit from certain dividend tax deductions, the adviser cost the funds millions of dollars in interest income when they temporarily recalled securities the funds had loaned out before their dividend record dates.

Revenue Sharing

In August 2019, the SEC charged an investment adviser with failing to disclose material conflicts of interest related to revenue sharing with the broker it required most of its clients use for trades. The SEC also cited a failure to disclose that there were either less expensive investments available or investments available that were not subject to revenue sharing.

Supervision Deficiencies

In July 2019, the SEC issued its observations following its exams of advisers that previously employed, or currently employ, individuals with a history of disciplinary events. The SEC encouraged advisers to consider the risk and disclosure requirements, as well as the effectiveness of compliance/supervision frameworks, when hiring persons with disciplinary histories.

Each applicable policy of insurance must be reviewed to determine the extent, if any, of coverage for COVID-19. Coverage may vary depending on the jurisdiction and circumstances. For global client programs it is critical to consider all local operations and how policies may or may not include COVID-19 coverage. The information contained herein is not intended to constitute legal or other professional advice and should not be relied upon in lieu of consultation with your own legal and/or other professional advisors. Some of the information in this publication may be compiled by third party sources we consider to be reliable, however we do not guarantee and are not responsible for the accuracy of such information. We assume no duty in contract, tort, or otherwise in connection with this publication and expressly disclaim, to the fullest extent permitted by law, any liability in connection with this publication. Willis Towers Watson offers insurance-related services through its appropriately licensed entities in each jurisdiction in which it operates. COVID-19 is a rapidly evolving situation and changes are occurring frequently. Willis Towers Watson does not undertake to update the information included herein after the date of publication. Accordingly, readers should be aware that certain content may have changed since the date of this publication. Please reach out to the author or your Willis Towers Watson contact for more information.

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Timothy M. Sullivan
Asset Management Industry Leader
Willis Towers Watson
D: +1 617 351 7435
M: +1 781 498 8196
timothy.sullivan@willistowerswatson.com

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