Willis Towers Watson

Asset Management Market Update
D&O/E&O Insurance

Q2 2020

Executive summary

We are pleased to present FINEX's Asset Management market update for Q2 2020. In this issue, we explore the current state of the market for Directors' & Officers' and Errors & Omissions (D&O/E&O) liability insurance for Asset Managers and their sponsored funds. Many of the issues addressed in this edition apply to both publicly traded and privately held Asset Managers. However, the scope of our insurance market commentary does not extend to public company D&O insurance, which is addressed separately in our Marketplace Realities publication.

With the first half of 2020 now behind us, we can say with confidence that virtually all industries are in the midst of a challenged insurance market with no immediate relief in sight. Asset Management D&O/E&O premiums are generally increasing by 10-15% on a primary basis, with excess insurers either following the primary or pressing for greater increases when current premiums are deemed insufficient. With some exceptions, however, Asset Management is generally considered to be the most desired sub-sector of the Financial Institutions industry, often realizing more favorable renewal results than other sub-sectors, such as Insurance and Banking.

In this edition, we also highlight some of the new and emerging issues impacting the Asset Management industry more broadly. Noteworthy items discussed include the continued and evolving implications of COVID-19, the heightened Cybersecurity risks arising from the pandemic, and increased pressure on regulators regarding ESG-related disclosure requirements. The implications of these issues on a firm's risk profile and D&O/E&O insurance programs are also addressed.

We expect that both the D&O/E&O insurance market and the Asset Management industry will continue to face numerous challenges in the second half of 2020. However, we hope this publication offers valuable insights as to how to successfully navigate through these turbulent times. Should you have any questions or would like to discuss any of these issues in greater detail, please reach out to myself or any member of your Willis Towers Watson team.

Best Regards,

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Asset Management Market Update

D&O/E&O Insurance Market: Q2 2020 Update

Cost and retentions

- **Primary Premiums:** Typically increasing by 10-15% on primary layers for most asset managers.
- **Excess Premiums:** Some markets pressing for increases greater than those imposed by the primary if pricing is deemed inadequate.
- **Per Claim Retentions:** Generally remaining flat, though minimum retentions of $250K for middle market risks are now standard.
- **Exceptions:** Material changes in risk profile, including AUM (beyond general market volatility), M&A activity, and/or claim experience will result in more severe adjustments to renewal terms.

Capacity

- **Stable Capacity:** Significant capacity is keeping rates more competitive for asset managers than other financial institution sub-industries, though insurers are adjusting their deployment of limits, with many offering a maximum of only $10M for any one program.

Markets

- **Uniform Approach:** Markets holding firm on imposing rate increases, with very few willing to undercut pricing of their competitors.
- **Walking Away:** Some insurers exiting programs they deem underpriced, possibly creating a more challenging renewal process.
- **Relationship Considerations:** Breaking relationships with long-term partners may be required in order to mitigate premium increases.

Coverage

- **Stable to Narrowing Coverage:** Scope of cover generally remains broad, though some insurers are narrowing breadth of D&O/E&O coverage in some areas, including:
  - **Cost of Corrections:** Limiting applicability to trade errors only (vs. any operational errors).
  - **Silent Cyber:** Eliminating ambiguity for cyber-related claims by adding language clarifying what is (and is not) covered.
  - **Derivative Demand Investigation Costs:** Reducing/eliminating sub-limits for this cover under primary and excess policies.
- **Blended Programs:** The EPL and Fiduciary market is increasingly stressed, so D&O/E&O programs that are blended with these lines should expect added renewal challenges, including a more invasive underwriting process, narrowing cover and increased rates/retentions.

Targeted segments

- **Appetite:** Asset management, particularly registered investment advisers/funds, is one of the few areas insurers are looking to grow.
- **Limited Interest:** Private Equity, BDCs, REITs, and managers with high exposure to CLOs, Real Estate and other stressed investments

Impact of COVID-19

- Insurers are generally are not taking broad negative actions in response to COVID-19, but are assessing each renewal on its own merits.
- Insurers are carefully reviewing the risk profiles of asset managers, including the composition and performance of investment portfolios.
- Expect extensive questions on the impact of, and response to, the pandemic, as well as plans for returning employees to the workplace.

Asset Management Industry Trends

Key issues to watch

Coronavirus/COVID-19: Market Volatility

Observation:

The pandemic has created intense global volatility resulting in extreme measures being taken to stabilize capital markets across the globe.

Concern:

Extreme volatility has historically been followed by a material uptick in claims activity, first in the form of trade errors associated with increased trading activity, then by litigation brought by unhappy investors and, potentially, regulatory activity against the adviser and/or funds.

Considerations:

Expect insurer inquiries related to how market volatility resulting from the pandemic has impacted operations and investment portfolios. Providing updates on trade error activity, investor complaints and/or regulatory interactions related to COVID-19 should be anticipated.

Coverage for the cost associated with correcting trade errors ("Cost of Corrections") is offered by the majority of Asset Management insurers. Such coverage is typically subject to narrow notification requirements, so Asset Managers should ensure their trade error manuals require immediate notification of such errors to the appropriate internal contact responsible for insurance.

Coronavirus/COVID-19: Return to the Workplace

Observation:

As some quarantine restrictions begin to ease, questions exist as to what the "new normal" will entail, particularly as it pertains to individuals returning to their place of employment.

Concern:

As individuals return to the workplace, there is the potential for an increase in claims activity, particularly within the Employment Practices Liability (EPL) landscape. Such claims may involve, for example, allegations of retaliation if employees feel they are being punished for voicing concerns about returning to the office, or claims of discrimination if certain protected classes of employees are disproportionately "encouraged" to return to the office while others are permitted to work from home (though remote working is not without its own EPL risks).

Considerations:

Whether EPL is purchased on a stand-alone basis or as an extension of a blended D&O/E&O program, Asset Managers should understand the scope, breadth and limitations of their coverage, as well as the applicable claims reporting requirements and how such cover interacts with other lines of insurance, such as Workers' Compensation and General Liability.

Asset Management Industry Trends

Key issues to watch (continued)

Fiduciary Standards

Observation:

Following the 2018 demise of its prior proposal, the U.S. Department of Labor (DOL) announced on June 29, 2020 that it's proposing a new exemption for investment advice fiduciaries from certain prohibited transaction restrictions of the Employee Retirement Income Security Act of 1974 (ERISA), and the Internal Revenue Code of 1986 (Code).

This proposed exemption (applicable to RIAs, B/Ds, banks, insurers, and their employees, agents and representatives that are advice fiduciaries) would allow investment advice fiduciaries to receive compensation and engage in principal transactions, that would otherwise violate the prohibited transaction provisions of ERISA and the Code.

Concern:

In addition to the DOL, the SEC's fiduciary standard went into effect on June 30, 2020, and various states have implemented or proposed their own rules, creating potential conflicts and confusion, higher compliance costs and greater risk of regulatory activity and litigation in various venues alleging violations of multiple regulations.

Considerations:

Insurers may inquire about compliance with existing rules and plans to comply with proposed rules. Regulatory cover should be reviewed as these fiduciary standards evolve.

Cybersecurity

Observation:

Cybersecurity remains key risk focus within the US and abroad, with new alerts being issued by regulators, and greater due diligence being conducted by counterparties and investors, particularly in the wake of COVID-19.

Concern:

With a significant amount of the workforce working from home as a result of the pandemic, cyber risks within most organizations have increased. In particular, phishing scams have evolved as cyber criminals seek to exploit distracted employees working remotely via stressed VPNs and Remote Desktop Protocols.

Considerations:

Insurers will inquire about steps taken to bolster an organization's cybersecurity risk management framework, particularly regarding the risks associated with remote working, and especially if a material amount of the workforce will be working remotely on a permanent basis.

Crime and Cyber programs should be reviewed, including applicable claim reporting protocols, the scope and limitations of cover and how they interact with other programs. If no Cyber program exists, stand-alone options or Cyber extensions to D&O/E&O policies can be explored.

Asset Management Industry Trends

Key issues to watch (continued)

Environmental, Social & Governance (ESG)

Observation:

The lack of consistent and comparable ESG data is creating uncertainty amongst investors evaluating investment options, as well as issuers trying to respond to ESG data demands. As such, pressure is increasing on regulators to take action.

In May 2020, for example, the Investor-as-Owner Subcommittee of the SEC's Investor Advisory Committee issued recommendations urging the SEC to "begin in earnest" an effort to update issuer disclosure requirements to include "material" and "decision-useful" ESG factors.

Concern:

A lack of uniform ESG reporting standards may contribute to increased "greenwashing" claims alleging breach of ESG investment mandates and/or misrepresentation of ESG factors being incorporated into a manager's operations.

Considerations:

Insurers may inquire about the investment analysis process in place to ensure adherence to ESG mandates, as well as the disclosure review procedures to ensure accuracy of ESG-related public statements.

Heightened focus on ESG warrants a review of the breadth and limitations of D&O/E&O insurance.

Private Fund Adviser Deficiencies

Observation:

In June 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) issued a risk alert outlining their observations from examinations of investment advisers that manage private funds. Three general areas of observed deficiencies involved inadequate disclosures of conflicts of interest, fees and expenses, and misuse of material non-public information policies.

Concern:

The OCIE noted that these exams resulted in a variety of actions, including, where appropriate, referrals to the Division of Enforcement. While each matter must be assessed on its own merits against the policy language, enforcement actions are likely to trigger elements of coverage under an investment adviser's D&O/E&O insurance programs.

Considerations:

The extent to which an asset manager is involved in OCIE examinations, and the outcome of such exams, is a key topic of interest for D&O/E&O insurers.

Reviewing the time sensitive reporting requirements, as well as the breadth of cover for informal and formal investigations, within D&O/E&O policies is recommended.

Asset Management Industry Trends

Key issues to watch (continued)

Disgorgement

Observation:

On June 22, 2020, in the case of Liu et al. v Securities and Exchange Commission (SEC), the United States Supreme Court ruled that a disgorgement award in a civil enforcement action brought by the SEC is "equitable relief" permissible under federal law, provided it does not exceed a wrongdoer's net profits and is awarded for the benefit of victims.

Concern:

As the near unanimous opinion appears to uphold the SEC's power to obtain disgorgement, the risks and potential costs associated with SEC civil enforcement actions may increase the exposures faced by asset managers and their directors and officers.

Considerations:

As each insurance policy is subject to its own unique terms and conditions, it is important to proactively review and understand the breadth and scope of coverage afforded under D&O and E&O policies as it pertains to government investigations and proceedings, including the limitations and exclusions applicable to coverage.

Outsourcing Risks

Observation:

Within the Registered Investment Company industry, outsourcing services to third parties is a common practice. More broadly, outsourcing is a key competitive enabler for financial institutions looking to provide faster and simpler customer distribution channels and to reduce costs.

Concern:

There are risks associated with contracting services to a third party and the transfer of data necessary for them to perform those services. As outsourcing has become commonplace and particular service providers dominate the market, the risk of systemic failure increases. It is therefore not surprising that outsourcing and its associated risks have appeared firmly on the agenda of many regulators globally as part of their focus on operational resilience.

Considerations:

Conducting thorough due diligence in respect of the service provider, putting in place measures to ensure quality control and policing the activities of the service provider is critical.

Understanding indemnification obligations of, and insurance maintained by, service providers is important. Insureds also should understand how their own insurance may respond to a claim caused by the acts of a third party service provider.

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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