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THE INSURANCE COMPLIANCE NEWSLETTER

7 Things You Need to Know About Investment Advisers Errors & Omissions Insurance

1. What is Investment Adviser Errors & Omissions Insurance?

Errors & Omissions insurance, also known as Professional Liability insurance, is designed to protect an investment adviser's business and personal assets from client claims based on or alleging negligent acts or unintentional breaches of fiduciary duty while providing professional services.

2. Who Does It Cover?

Although each policy differs, an Errors & Omissions policy insures the investment adviser entity as well as the directors, officers and employees of the investment adviser. Coverage is provided for claims arising from the performance of (or failure to perform) investment adviser professional services. Coverage may also be extended to independent contractors of the firm.

Directors & Officers liability insurance can be added to the investment adviser's policy (or a separate policy) and would provide coverage for directors and officers of the firm while performing business management responsibilities on behalf of the firm. Directors and officers have a duty of care, loyalty and obedience to the firm and to its shareholders which are different responsibilities than those of an investment adviser.

The Directors & Officers policy reimburses the entity for the costs incurred when it indemnifies its directors and officers and can extend coverage directly to the entity if it is named in litigation.

3. What Does Errors & Omissions Insurance Cover?

Coverage under an Errors & Omissions policy typically provides coverage for claims of a wrongful act in the performance of investment adviser professional services. This can include allegations of negligent acts, omissions or breaches of fiduciary duty. Policies vary in the definition of investment adviser professional services which affects the scope of coverage provided so it is important to pay close attention to this definition in your policy to ensure that it is broad enough to cover your professional services rendered.

Some examples of claims usually covered (subject to the policy terms & conditions) include those for violation of investment guidelines or restrictions set forth in a client agreement, improper ERISA investments, lack of diversification, lack of "suitability" and negligent investment strategies and techniques.

In some policies, an endorsement may be purchased for "Cost of Corrections." This coverage can be part of the Errors & Omission insurance policy and provides reimbursement to the insured adviser for certain losses, costs or expenses incurred by the insured to correct situations (for instance, a trading error that if not corrected would result in future claims and losses otherwise insurable under the policy).

4. What Is Not Covered?

Free advice is not covered. Policies typically require an executed investment advisory contract setting forth the scope of services and fees the adviser charges.

Policies also generally exclude coverage for claims based on intentional fraud, dishonesty or willful failure to act prudently. It is important, however, that your policy provide defense expense coverage up to the point of a final adjudication or a finding of fact as the defense costs are often hundreds of thousands of dollars in these cases.

Also not covered are claims for personal injury, emotional distress, libel and slander, and obligations assumed under a contract that extend beyond those liabilities that would have occurred in the absence of a contract.

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In addition, fines, penalties and punitive or exemplary damages are typically excluded. However, carriers are willing to extend coverage for punitive damages where insurable by law so investment advisers should ask their carrier to determine if punitive damages are insurable in jurisdictions where they conduct business.

Some carriers are now excluding "alternative investments." While this term is often undefined and willingness to offer this coverage varies by carrier, it can include investments in hedge funds, partnerships, exchange traded notes, foreign securities and other "non-traditional" investments. This area needs to be closely reviewed with the insurance carrier when negotiating your coverage.

5. What Is a Wrongful Act?

The definition of a wrongful act varies by carrier but it generally is any actual or alleged act, error, omission, neglect, misstatement or misleading statement or breach of duty unintentionally committed by an insured.

6. What Is A Claim?

Once again the definition of claim varies by carrier but it typically includes the following:

- Any written notice received by an insured
- Criminal proceedings
- Civil proceedings
- Formal investigations by regulatory agencies

7. What Are Some Types of Claims Against Investment Advisers?

The following are samples of the types of claims that can be filed against investment advisers:

Suitability Claims

- Unbalanced Account - A semi-retired client had investment objectives of modest growth, preservation of capital, and a balanced account. After year one, the client's account was 60% equities and 40% bonds. After year two, it was 80% equities and 20% bonds. The client sued alleging the adviser failed to reallocate and balance the mix of equities to bonds.

- Use of Model Portfolios - An elderly client alleged her adviser liquidated her "blue chip" portfolio and invested the proceeds in unsuitable technology stocks which caused her to suffer a large financial loss. The adviser advertised that he tailored accounts to individuals but in reality he used a model portfolio with growth emphasis. The client filed an arbitration claim.

- Change in Circumstances - An investment adviser had a long term client who suffered poor health and financial adversity. The client alleged that due to his health problems, the adviser should have moved him out of high tech securities into low risk securities and bonds. The adviser's documentation was poor in this regard and the client sought lost market value and lost profits.

Breach of Contract/Trading Errors

- Breach of Investment Guidelines - An investment adviser's software did not detect that its purchase of a Canadian company stock violated a client's investment guidelines that allowed only the purchase of US securities. The client sued the investment adviser to recover the loss from the Canadian stock.

- Adverse Tax Consequences - An investment adviser raised cash for a client from annuity accounts instead of raising it from taxable mutual fund accounts. This action triggered a tax penalty for the client and the client sued the adviser to recover the amount of the tax penalty.

- Administrative Errors/Miscommunication - A client requested a stop loss on certain stocks, which the adviser agreed upon. The stop loss order was only placed for a single day due to administrative error. The client demanded and was reimbursed for additional losses when the stop loss was not triggered.

This is a general synopsis. Coverage depends on the terms and conditions of your applicable policy.

Theodore Liftman Insurance, Inc.
Liftman Insurance Agency Co. (NC, TX, CA)   Liftman Insurance Agency (NY)
101 Federal Street, 22nd Floor, Boston, Massachusetts 02110-1827
Tel 617-439-9595 • Fax 617-439-3099 • Email: info@liftman.com • www.liftman.com