2014 was a positive year for asset manager professionals. With the Dow Jones Industrial Average and S&P 500 hitting all-time highs, advisors for mutual funds and separate managed accounts that were long on equities delivered robust returns. Similarly, private equity funds realized significant gains harvesting their portfolio companies in 2014 fueled by a heated IPO market and higher company valuations. Writing significant checks to their LP’s following an exit could be seen as a relief after some predicted the “wall of debt” would crush some companies. Looking strictly at returns, the only laggards were hedge funds, which at approximately 2% average returns, underperformed the S&P 500 in 2014. Strong overall performance is positive from an insurance underwriting perspective. Investors have less incentive to bring a claim against their advisors when they are making them money. However, investors aren’t the only source of claims. This report will examine other trends that shaped the 2014 asset manager D&O/E&O insurance market.

STABILIZING INSURANCE MARKET
The management and professional liability insurance market largely stabilized in 2014. Ever since the credit crisis of 2007-2008, there has been increased underwriting scrutiny for asset manager D&O/E&O insurance. Some clients encountered immediate whipsaw-type increases at the first sign of trouble, whereas other risks saw a steady creep in rates over the past few years. The end result is that by 2014, most insurance programs were adequately priced from an underwriting standpoint. Assuming this to be the case (exceptions would be clients with significant claims, exposure changes, etc.) incumbent carriers regularly quoted minimal increases in the 0-5% range. Clients who went out to market could obtain premium decreases from competitors or use the competition to leverage incumbent carriers to flat renewals on the primary layer of insurance. Excess layers of insurance are softer as a result of increased competition and claim trends that disproportionately affect the primary layer of insurance. Even when underlying layers of insurance were quoted with increases, excess layers often experienced modest decreases.

TRENDS IN POLICY TERMS
Asset manager professional and management liability insurance contracts are as broad as they have ever been in their history. If a risk is adequately priced, one way for competing underwriters to differentiate themselves is to provide broader coverage terms. Many of the new players in this space introduced state of the art policy forms to win new business, which has helped to advance coverage terms. The following are examples of the broadening scope of coverage:

• Insider trading exclusion – 10 years ago, this was a fairly standard exclusion. However, within the past five years, we were successful in getting the exclusion removed in about half of our placements. Today, most clients should be able to get this exclusion removed either from the incumbent carrier or within the market.

• Cost of corrections coverage – Historically touted as a significant benefit; however, restrictive terms, onerous coinsurance, high retentions and high cost significantly reduced its value. Currently, insurers routinely broaden the scope of coverage, reduce or eliminate (i.e., use the base policy retention) the retention applicable to cost of corrections claims, while reducing or even eliminating the additional premium to add this coverage.

• Investigations coverage – The coverage for investigations (formal vs. informal investigations, entity vs. individuals as targets) is a complex issue that should be reviewed with an insurance professional. Historically, entity coverage for informal investigations was only available for large premium accounts and generally difficult to obtain. Last year, informal investigations coverage was more frequently offered on moderate-sized accounts. When offered, the cost to add coverage will range from a 10%-40% additional premium and may also include higher retentions. The scope of this coverage varies significantly between underwriters, there are three different approaches:
  » Pre-claim coverage: This is a prelude to true informal entity investigations coverage and provides reimbursement-based coverage for expenses incurred during an informal investigation. Coverage is triggered once an investigation turns over to a formal investigation. At this time, the insurer will look back to reimburse the informal investigation expenses.

1. For purposes of this report, in the broad category of Asset Managers, we include Hedge Funds, Private Equity Funds, Mutual Funds and separate managed accounts
2. Bloomberg.com
Market Conditions

» Informal investigations coverage: There are two typical approaches for this coverage. One approach adds a separate insuring agreement that is triggered by an interview or a document production request by a regulatory entity. A second approach amends the definition of “claim” within the policy to reference informal investigations.

» Investigations coverage for related company targets: Asset Managers can still incur significant expenses during an investigation even when they may not be the target of an investigation. Two common examples would be a private equity firm brought into an investigation of a portfolio company and a hedge fund of funds being brought into an investigation of an underlying fund. This investigations coverage would be triggered by a related entity being the target of the investigation.

CLAIM TRENDS
Asset managers continue to do an effective job at risk management for traditional mismanagement of funds/breach of fiduciary duty type lawsuits. This is especially true in the private fund space where extensive work with legal counsel crafting offering and organizational documents has made it more difficult to bring traditional mismanagement lawsuits by investors. This of course has not eliminated claims against asset managers; rather it helped to shift the type of claim and source of claim to a relatively newer front, the SEC.

The SEC filed a record 755 enforcement actions in FY 2014 and collected $4.16B in disgorgement and penalties, compared to 676 enforcement actions and $3.4B, respectively in FY 2013. During this past year, the SEC filed many ‘first of their kind’ cases and has provided every indication that they plan on continuing their aggressive enforcement plan. It is important to keep in mind that the asset management unit within the SEC’s enforcement division is only five years old, consisting of 75 professionals. As this unit continues to learn and grow, it is likely that the amount of enforcement actions they file will increase as well. Conflicts of interest, in essentially all of its forms, were again the overarching focus of the SEC in 2014. Below is a review of what we observed in 2014, broken out by type of asset manager:

<table>
<thead>
<tr>
<th>Type of Asset Manager</th>
<th>Cases</th>
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<tr>
<td><strong>Private Funds</strong> – Valuations of investments, fees disclosure, insider trading and specifically for hedge funds, the Abbertrational Performance Inquiry Model were common sources of SEC actions.</td>
<td>Whistleblower – Paradigm Capital Management, Inc. - This action alleged retaliation under Dodd Frank’s Whistleblower provision in connection with a hedge fund’s alleged prohibited transactions with a related broker dealer.</td>
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<td>Expense Allocation – Clean Energy Capital - This Private Equity fund allegedly failed to adequately disclose certain expenses that were being allocated to the funds.</td>
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<td>Investment Companies – A common theme for 2014 focused on advertising of past performance, fee disclosure and conflicts of interest in fund distribution.</td>
<td>Advertising of performance data – F-Squared - The ETF advisor allegedly advertised an inflated performance record based on allegedly inaccurately compiled historical data.</td>
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<td>Investment strategy misrepresentations – Chariot Advisors - The Fund Advisor allegedly misrepresented their ability to conduct algorithmic currency trading, violating the required approval process by the fund board of the advisor.</td>
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<tr>
<td>Separate Managed Accounts – Priorities for the SEC centered on fee disclosure and disclosure of conflicts of interest.</td>
<td>Fee Structure – Transamerica Financial - The investment advisor allegedly failed to aggregate accounts for breakpoint fee discounts.</td>
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<td></td>
<td>Conflict of Interest – Shelton Financial Group - The investment advisor allegedly failed to disclose conflicts of interest relating to compensation it received through an arrangement with a broker/dealer.</td>
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4 - SEC.gov SEC’s FY 2014 Enforcement Actions Span Securities Industry and Include First-Ever Cases
5 - In re Paradigm Capital Management, Inc. et al. June 16, 2014
6 - In re Clean Energy Capital, LLC et al. Oct. 17, 2014
7 - In re F-Squared Investments, Inc. Dec. 22, 2014
8 - In re Chariot Advisors, LLC et al. July 3, 2014
MARKET CAPACITY
Years of firming pricing has continued to attract new capacity into this space. This is the result of entirely new insurance companies writing asset manager D&O/E&O and legacy markets deploying more capital to this line of coverage to grow their books of business. While most markets still prefer to write $5M layers of insurance, there is less reluctance than in the past when writing larger policy limits. For domestic capacity alone, there are now close to 20 markets that have the capability to write a primary asset manager policy, with many more capable of writing follow form excess coverage.

2015 OUTLOOK
We observed initial signs of a softening market in 2014 that will test the resolve of some underwriters in 2015. While underwriters willing to let tougher risks go to their competitors for lesser premium, the true test will come when underwriters are faced with the prospect of having to reduce rates in order to keep top tier risks. New players are looking to grow in this space; some underwriters even have very aggressive growth targets. While we have yet to see much ‘reckless’ aggressiveness that would support a very soft market, the increased competition will help keep rates in check and continue the push for expanded coverage.

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Important Note: This paper is not intended to offer legal advice. Any descriptions of insurance provided herein are not intended as interpretations of coverage. An actual insurance policy must be consulted for full coverage details.