HEDGE FUND legal & compliance digest

www.hedgefundlcd.com November 3, 2016

Addressing CCO Liability From an Insurance Perspective: A Q&A with Marsh's Machua Millet

Professional liability has been a pain point for chief compliance officers, particularly over the past several years, with various enforcement actions appearing to target those in charge of the compliance function for sometimes ill-defined failures. With a current of fear permeating the narrative of various surveys, conferences and conversations, the Securities and Exchange Commission has sought to assuage the nerves of CCOs with speeches and outreach programs designed to convey the message that, no, in fact, CCOs do not have targets on their backs. The success of the charm offensive is questionable, though, as CCOs seem more concerned than ever about the prospect of facing sole personal and professional liability for the misdeeds of others across the firm.

Faced with this trend, insurance companies have adapted their product offerings by tailoring products that cater to this newfound reality. In particular, Marsh, a global insurance broker, introduced coverage that protects CCOs above and beyond standard directors and officers insurance, and reflects their unique position in an enforcement environment in which they need not be directly involved in any misconduct to face consequences. With this in mind, the Hedge Fund Legal & Compliance Digest recently spoke with Machua Millett, chief innovation officer at Marsh's U.S. FINPRO practice, about the current environment of CCO liability, the fundamentals of a CCO liability policy and the coverage limitations inherent in these policies.

Where did the idea for an insurance product geared specifically toward chief compliance officers originate?

The impetus for the product was clients approaching us, either individual CCOs or their employers, and asking us if there was a solution from an insurance perspective for the exposure they saw their CCOs beginning to face from regulators as gatekeepers and targets in the event of a corporate compliance failure. There have been a number of examples of RIAs and other highly regulated financial institutions being targeted for investigation by different regulators such as the SEC or FinCEN for different compliance failures such as the Foreign Corrupt Practices Act or SEC trading issues or AML. As a follow-on to those investigations, we've seen a number of situations in which the individual CCOs were individually pursued. Clients inquired about how insurance currently responds to this situation, and then if there was something that can be a little more specific and more tailored to a CCO's particular exposure so that they can feel comfortable remaining in that role.

What are some examples of recent enforcement actions where this type of coverage would have come into effect?

So I think there is one textbook case in which the company was investigated for AML compliance failures, and the individual CCO was let go. Now that individual is the target of subsequent litigation, brought at the request of FinCEN, seeking a $1 million fine from that former CCO.

There are two other examples that we've seen in the RIA context with the SEC where the fines are smaller, but they are in a similar vein. They are by the SEC, seeking personal fines against CCOs for corporate compliance failures. And when I say corporate compliance failures what I mean is where an individual CCO is not alleged to have been aware of, or involved in, the underlying wrongdoing, like money laundering or violation of trading rules. Instead the allegation is basically if you had done your job better, you should have been able to figure out that this was going on and put a stop to it, but you did not. (Editor's Note: The two cases are: *In re Judy K. Wolf*, SEC Release No. 73350 (Oct. 15, 2014); and *In re Strategic Capital Group, LLC and N. Gary Price*, SEC Release No. 3924 (Sept. 18, 2014))

What does this insurance cover?

It is what we call Excess, Side A DIC. What that breaks down to is, it sits on top of the rest of the directors and officers liability insurance program, so it responds if the rest of the insurance program has been exhausted or does not respond. It is Side A, so it answers if the individual is not indemnified by the firm. And then "DIC" is Difference In Conditions, which means if the underlying insurance doesn't respond, and there is no indemnification, this will drop down and be primary. So it both answers if the rest of the insurance has been consumed, but also steps in if the underlying insurance is insufficient to protect the CCO.

The two primary aspects of coverage seem to be defense costs, and penalties. Is anything else covered, such as loss of wages from termination as a result of an accusation, and what are the dollar limits of these policies?

Loss of wages is not covered by the policy. It covers defense costs, damages (including multiple or punitive), settlement, judgments and fines and penalties, to the extent insurable.

Significant limits are certainly available for both elements of Loss covered under the policy (defense costs and penalties/fines). While we could probably build a program as large as $75M to $100M in limits just for this exposure, most CCOs and firms I have spoken to are considering limits in the $5M to $10M range.

While the chief compliance officer is ultimately responsible for compliance failures, is coverage available for others on a firm's compliance team?

It is primarily for the individual CCO, the person who holds that title. However, we have had some situations where the CCO has said, "I would like this to cover myself and my three or four deputies in the compliance department." That can certainly be done as well.

What risk factors are the premiums based on? Do certain firms pay more or less? Are there actions a CCO can take that will lower the premiums?

Those aspects won't change the risk profile terribly. Since this is designed to be an excess insurance policy, the most important things are the same things that go into the calculation of your premium on your underlying D&O insurance program. Really what is done here is the potential insurers for this policy take a look at the materials that have been submitted on the underlying insurance program and, the pricing of that underlying insurance program, and they price off of that. So it's actually a fairly inexpensive product because it is your highest layer of insurance. It is usually a discount off of your current existing highest layer of insurance.

Is there a different risk profile for those CCOs who dual-hat?

There is no change to the risk profile, however in those circumstances we can tailor the policy to deal with those multiple capacities. Frequently, for example, hedge fund clients, where one individual serves as both the GC and CCO, or perhaps the CCO and the CFO, in those situations we can tailor the policy to ensure that individual will have protection in multiple roles. Whether the regulator is investigating them in their role as CCO, GC, CFO, the policy can be tailored to that individual for all those respective roles.

With many firms cost-conscious and/or not as concerned about CCO liability as the CCO him- or herself might be, can the individual CCO carry this insurance themselves?

I suppose it could be, and I've had this question from some individual CCOs, and what I've encouraged them to do is first talk to the folks who deal with cost around insurance because the cost is quite reasonable compared to what insurance normally costs in this space. So it is a situation where I really see it as a tool for the hedge fund to attract and retain the best CCOs out there. And the other part is that it really is exposure that the individual faces, not necessarily through any wrongdoing of their own, but just by sitting in the chair and taking on the name and role of CCO, you're taking on this risk. And so we do think of it as something that normally we would expect the firm to pay for. But if the individual is not comfortable asking the firm, or the firm said no, and the individual still wanted to buy it, that's certainly something we could do as well.

How does this insurance policy work beyond the standard D&O insurance? What would it cover that the D&O policy wouldn't (outside of a situation where D&O has simply reached its coverage limits)?

It makes sense to talk about how this D&O policy is different from other D&O policies. It's different in 4 ways.

1. It is specifically for the CCO. So the name insured under the policy is the chief compliance officer, and we talked about the ability to include a couple of other people in there. But it is the CCO. It is not what the underlying insurance policy layers would be, which is all the officers and directors and employees of a hedge fund, and often the hedge fund and the GP and the entities themselves as well. So you're not sharing the policy with a bunch of other folks and entities, this is just for you.
2. In the policy there is one definition that is changed to make sure that insurance companies cannot find a way to exclude coverage for what the regulators are alleging in these situations, and that is the definition of Wrongful Act. Typically the definition of a wrongful act in a D&O policy says that the officers and directors are covered for acts, errors or omissions in their status and capacity as such. That is status and capacity as a director or officer. This policy goes further and lays out exactly what the individual CCOs are being accused of in these situations which is failure to properly design, implement and oversee compliance policies and procedures including without limitation, and then a long list of the things that they oversee: Anti-Money Laundering, Foreign Corrupt Practices Act, trading practices, insider trading, etc… It goes through all those regulations. It's a long definition, but it lists out

exactly what the regulators are pursuing CCOs for allegedly having done wrong here.

3. In the policy there is one definition that is added, again to make sure that insurance companies cannot find a way to exclude coverage, and that is the definition of CCO Professional Services. This is what a CCO does on a daily basis to make sure that the insurer cannot argue this isn't really an allegation that you did something wrong in your status or capacity as an officer of the firm, it's really more an allegation that you provided subpar Professional Services to the hedge fund. So we wanted to make sure that was absolutely clear.
4. This policy will cover and expressly covers fines and penalties. The vast majority of D&O insurance products will not. This expressly covers fines and penalties, to the extent insurable. The policy is written out of Bermuda and London because they have a broader sense of insurability and there's very broad most favored nation language so as to ensure coverage for those fines and penalties so long as they are not based on intentional wrongful conduct. Why that's relevant is that in the cases we have seen, what the regulators ultimately seek from the individual is a civil fine ranging from $50,000 all the way up to the $1 million dollars in the AML case. That would be covered under the policy, so long as it's not based upon an intentional wrongful act.

Is there a situation where the CCO is ineligible for the protections afforded in the policy?

Historically, even if you were alleged to have engaged in intentional wrongful conduct the policy would not respond. This is designed to protect you against that allegation since usually it is an overly aggressive allegation, so it will protect you and cover defense costs against that allegation. There's nothing that could be alleged upfront that would knock it outside the coverage of the policy until there is a final non-appealable adjudication.

What are the circumstances where you are protected under this policy, versus when you are not protected? Essentially, what is "the line"?

Neither this policy, nor any insurance policy will protect you if you have engaged in intentional wrongdoing. That will be treated as uninsurable. You might be able to get some defense cost protection if you are alleged to have done so, short of being found to have done so. At the end of the day, the line on this policy is if you are alleged to have acted negligently or grossly negligently in doing your job—according to the regulators in 20-point hindsight—this will protect you. If you are found to have, or admit having, engaged in intentional wrongdoing, then the policy will not protect you.

If you are accused of intentional wrongdoing what, if any, protections are you afforded?

Certainly the insurer would say it won't pay anything going forward, but it would have to be a final, appealable adjudication in the underlying action, which is all code language for you have to have run out of appeals or reached a point where you're willing to admit you did something wrong. It is designed to help you fight those accusations and protect you if you did not engage in that activity, but instead it is a regulator trying to hold you responsible for something short of intentional wrongful conduct.

What happens on a claim? What are best practices for the first two or three things a CCO should do upon finding out they are the focus on an investigation?

In advance of any investigation, it is really important as an individual CCO to understand what your insurance program looks like, how you factor into that insurance program, if you factor into that insurance program, if at all. Part of that is understanding your indemnification rights as well. Do you have an indemnification agreement? What are your protections from the firm in terms of indemnification? Part of that is also understanding whether or not you qualify under the firm's organization documents as a true officer of the firm; that will give you some sense of how your existing indemnification and insurance responds if there is an investigation. Then there is a real analysis to be done as to how the insurance program you have in place responds in the event of a regulatory investigation and is it as strong as some policies can be in this space? The spectrum of insurance coverage for regulatory investigations in the hedge fund space is incredibly broad, all the way from no coverage all the way through very broad, early stage, regulatory investigation coverage for individuals and the firm itself. Once you have an understanding of what the insurance and indemnification looks like in advance it gives you some sense of what you need to do once the investigation comes in the door.

First thing when the investigation comes in the door from an insurance perspective should be to have a conversation with your insurance broker about noticing that investigation to your insurer as a claim or a circumstance—that is how you trigger coverage with your insurance company. You can't sit on that investigation and do it subsequently, you need to do it pretty much as soon as you know about it. Then there is the process by which you keep your insurance company advised of the developments of the investigation and making sure you keep them involved if there is any attempt to discuss settlement or resolution of that investigation.

At the same time, when that investigation first comes in, you're going to retain outside defense counsel to help you decide how to respond to the regulator.