H1 2022 Asset Management Update

D&O/E&O Insurance Market Overview and Notable Trends

Executive summary

As Q1 2022 comes to a close, we are pleased to report that the asset management D&O/E&O insurance market is finally showing signs of stabilization. Significant corrective actions taken by insurers over the past two years, primarily in the form of double-digit premium increases and material adjustments to retentions, have for the most part been implemented. As further discussed in this market update, such actions, combined with increased competition resulting from an influx of new excess capacity, means Insureds with favorable risk profiles should expect flat to modest premium increases on asset management D&O/E&O renewals in H1 2022, while retentions should remain stable.

Throughout this update, we also highlight new and emerging issues impacting the asset management industry. Noteworthy items include the risks associated with market volatility arising from the crisis in Ukraine, new and proposed SEC rules targeting Private Funds and Cybersecurity, regulatory updates in Europe, the growing focus on ESG & Climate risks, and, of course, the continued impact and evolving risks stemming from the COVID-19 pandemic. We also discuss the implications these issues may have for an asset manager's risk profile, as well as their D&O/E&O insurance programs.

While the D&O/E&O insurance market is improving, 2022 has already presented numerous challenges to the asset management industry and will likely continue to do so throughout the year. We hope that this update provides meaningful guidance to Insureds when preparing for upcoming renewals, managing stakeholder expectations, and assessing the impact industry events may have on D&O/E&O insurance programs. Should you have any questions or would like to discuss any of these issues in greater detail, please reach out to me or any member of your WTW team.

Best Regards,

Timothy M. Sullivan
timothy.sullivan@willistowerswatson.com

Asset Management D&O/E&O Liability

State of the U.S. market, and claims, legal and emerging trends

Rate Predictions

	Trend	Range
Primary	▲	**0% to +10%**
Excess	▲	**0% to +10%**

Risk Trends

Regulatory	Enforcement under the Biden Administration underscores the risk of both formal and informal investigation claim activity.
Cyber	Increasing regulatory focus on cybersecurity, notably the SEC's proposed rules for registered advisers and funds.
ESG & Climate	"Greenwashing" and evolving global regulatory regimes represent an area of growing underwriting focus.
COVID-19	Impact on portfolios, flows, and overall business operations; focus on plans for returning employees to the workplace.
Private Funds	SEC's proposed rules may impact the use of "hold harmless" agreements and indemnification by private funds.
Cryptocurrency	Limited insurer appetite, particularly for newly established advisers with crypto-focused investment offerings.
Russia/Ukraine	Sanctions may create divestment, valuation and settlement challenges for advisers with exposure to Russian securities.

What to expect...

Premiums:

Rates continued to increase in H2 2021, but we are seeing stabilization in H1 2022.

Retentions:

Generally remaining flat, though middle market risks continue to see minimum retentions of $250K.

Coverage:

The coverage available to asset managers remains stable, though a limited number of insurers have sought to apply language intended to eliminate ambiguity for cyber events by clarifying what is (and is not) covered.

Risk Profile:

Insureds with claims activity, material growth in exposure, negative performance and/or other significant changes to their risk profile may receive greater underwriting scrutiny and possibly less favorable renewal terms than average.

Markets:

Several new insurers have entered the asset management D&O/E&O space, creating meaningful competition on renewal programs, primarily on an excess basis.

Capacity:

Most insurers continue to limit their capacity to $10M, though some may cap their limit to $5M for more challenged risks.

Appetite:

Asset management, particularly registered investment advisers and registered funds, continues to be the most desirable subset of the financial services sector; however, interest in private equity, BDCs, and cryptocurrency risks remains limited.

Asset Management Industry Trends

Key issues to watch

Market Volatility

Observation:

Whether it's due to the COVID-19 pandemic, a short-selling revolution, soaring inflation, or political turmoil in the US or abroad, market volatility has played a prominent role in risk and insurance discussions over the past several renewal cycles, and will continue to do so in 2022.

Concern:

Regardless of the origin, when spikes in market trading occur, they are often accompanied by an increase in trading errors and, in turn, an uptick in claims activity under the "Cost of Corrections" coverage grant found within most D&O/E&O policies. If a trading error results in a direct loss to an investor, the Cost of Corrections coverage is generally intended to reimburse the investment manager for amounts incurred in making that investor whole. As a result, Cost of Correction matters continue to be a meaningful source of claims activity under D&O/E&O policies and an area of underwriting concern for insurers.

Considerations:

As policy language differs from insurer to insurer, it is important to review the scope and limitations applicable to Cost of Corrections coverage, particularly with respect to the reporting obligations applicable to these matters. Given the time sensitivity associated with trading errors, the reporting requirements for Cost of Corrections claims are typically more restrictive than those applicable to other claims under the policy. It is therefore important for Insureds to proactively familiarize themselves with these reporting requirements in order to mitigate the risk of coverage being denied due to late reporting.

Return to the Workplace

Observation:

With COVID-19 vaccines widely available throughout much of the world, and the Omicron variant starting to recede, many government-imposed restrictions are beginning to lift. After Omicron forced most companies to temporarily revert to a remote workforce, many employers are now focused on when, how, and in some cases, if, employees will return to the workplace.

Concern:

Numerous challenges need to be addressed when returning employees to the workplace, including whether vaccinations will be required, whether all employees will be required to return or only specific functions, and whether hybrid or full-remote work arrangements will be permitted. The potential for discrimination claims may arise if these decisions are alleged to have a negative and disproportionate impact on certain classes of employees.

Considerations:

Claims alleging discrimination typically fall under an Employment Practices Liability (EPL) policy. However, some Insureds maintain blended programs inclusive of both D&O/E&O and EPL coverage. Whether such coverage is purchased on a stand-alone basis or as part of a blended program, Insureds should anticipate additional questions from underwriters around these and other return-to-the-workplace issues.

Asset Management Industry Trends

Key issues to watch (continued)

Russia and Ukraine

Observation:

In response to the crisis in Ukraine, the U.S. Department of Treasury imposed a series of severe sanctions intended to have both immediate and long-term effects on the Russian economy and financial system. In addition to these and other sanctions imposed by Ukraine's global allies, some Russian banks have been blocked from the Society for Worldwide Interbank Financial Telecommunication (Swift) system, the financial-messaging infrastructure linking the world's banks. Such actions against Russia have created significant volatility and uncertainty that is being felt throughout the global financial markets.

Concern:

The actions taken against Russia have created compliance, divestment, valuation and settlement challenges for advisers and investors with exposure to Russian assets. These issues, combined with the potential for trading errors due to market volatility and potential investor claims arising out of negatively impacted investments, may lead to increased claims activity against the advisers and/or funds covered under D&O/E&O policies.

Considerations:

In advance of renewals, insurers will likely inquire about the extent to which an adviser and/or its sponsored funds has exposure to Russian assets, the impact of sanctions on the adviser's business operations, and the process in place to correct trade errors. Recognizing the situation is volatile and rapidly changing, Insureds must be mindful of the various reporting obligations under these insurance policies, particularly as it pertains to coverage for costs incurred to correct trade errors.

The China Evergrande Group (Evergrande)

Observation:

Since its creation in 1996, Chinese conglomerate Evergrande has grown to become one of the largest real estate developers in China. The company's rapid expansion was supported by its reliance on pre-selling properties before they were completed (allowing it to generate cash) while utilizing significant amounts of debt to finance other projects.

In 2020, the Chinese government introduced new rules aimed at controlling the amount of debt owed by real estate developers. To comply with these rules, Evergrande was forced to begin selling its properties at a significant discount. These actions, combined with the negative impact of the COVID-19 pandemic, left Evergrande struggling to meet interest payments associated with some of its $300B in liabilities.

Concern:

Evergrande's financial struggles have raised broader concerns about the impact to the Chinese and global economies if the company were to fail. Asset managers with portfolios exposed to Evergrande could potentially face complaints from investors relating to these investments, leading to possible claims activity under adviser and fund D&O/E&O policies.

Considerations:

For those asset managers with portfolios exposed to Evergrande and/or its properties, anticipate questions from D&O/E&O insurers regarding the extent and status of such exposure, as well as details of any communications or interactions with impacted investors.

Asset Management Industry Trends

Key issues to watch (continued)

Private Funds Regulatory Exams

Observation:

In its January 2022 Risk Alert, the SEC's Division of Exams identified several issues it observed during examinations of registered investment advisers to private funds. Noted observations include (i) failures to act in accordance with material disclosures to investors, (ii) misleading and inaccurate performance and marketing disclosures, (iii) inadequate investment and service provider due diligence, and (iv) the use of potentially misleading "hedge clauses" that purport to limit an advisers' liability under the Investment Advisers Act of 1940.

Concern:

Misrepresentations, misleading statements, and inadequate due diligence by investment advisers have historically given rise to claims activity under D&O/E&O policies. Registered investment advisers to private funds will need to be mindful of the issues observed by the SEC and the potential future claims activity that may arise as a result of them.

Considerations:

Insureds should review the breadth and scope of coverage afforded for both formal and informal investigations under D&O/E&O policies, as well as the limitations of coverage for such claims.

For those registered investment advisers utilizing "hedge clauses" within investor agreements, it is important to understand the potential implications such provisions may have on D&O/E&O coverage, particularly as it pertains to the Cost of Corrections coverage afforded under these policies.

SEC Proposed Private Fund Rules

Observation:

Citing the need to enhance investor protection, the SEC proposed new rules that would require greater transparency from, and impose additional reporting obligations upon, investment advisers to private funds. As summarized in the SEC's fact sheet, the rules would require (i) quarterly investor statements, (ii) private fund adviser audits, (iii) fairness opinions in adviser-led secondary transactions, (iv) the prohibition of certain activities, including seeking indemnification from private funds and the use of "hedge clauses" aimed at limiting or eliminating liability for adviser misconduct, and (v) the prohibition of preferential terms to certain investors regarding redemption rights and portfolio holdings if such info will have a material, negative effect on other investors.

Concern:

If adopted, advisers subject to the rule would be prohibited from being reimbursed, exculpated or indemnified for simple negligence and breaches of fiduciary duty, and would prohibit an adviser from waiving, disclaiming or otherwise limiting fiduciary duties under the Investment Advisers Act of 1940 or under state law, even if such limitation is expressly permitted. Such prohibitions would eliminate a defense to liability and further expose the adviser's balance sheet to potential losses.

Considerations:

If adopted as proposed, advisers will need to consider the rules' limitations on fund indemnification and the use of hedge clauses when making future insurance buying decisions. Such factors may also warrant a review of how insurance premiums are allocated between the adviser and funds going forward.

Asset Management Industry Trends

Key issues to watch (continued)

Environmental, Social & Governance (ESG)

Observation:

In February 2021, the SEC's Office of Investor Education and Advocacy issued a bulletin outlining the issues investors should be mindful of when investing in an ESG fund, while in March 2021, the SEC announced it created an enforcement task force focused on climate and ESG issues. These actions were followed by a risk alert in April 2021, in which the SEC identified deficiencies and weakness found in its examinations of advisers and funds related to ESG investing. So far in 2022, the SEC proposed a new rule in March 2022 focused on climate-related risk disclosure for public companies, with additional rules potentially to follow at both the state and federal.

Concern:

As the regulatory focus on ESG intensifies, particularly within the U.S. under the Biden Administration, so too does the risk of regulatory enforcement actions and possible follow-on civil litigation against asset managers. The recent investigation by the Department of Justice and the SEC into allegations that DWS Group overstated its sustainable investing credentials is one example of an ESG-related risk that may give rise to claims against asset managers.

Considerations:

The scope of coverage available under D&O/E&O policies for both formal and informal regulatory investigations, as well as the applicability of certain exclusions (e.g. pollution), should be reviewed and modified where appropriate. For those investment managers utilizing a screening approach to construct ESG portfolios, reviewing the scope of Cost of Corrections coverage, including the often-strict reporting obligations it imposes, is recommended.

Climate Change

Observation:

Climate change, like ESG, remains a top priority for asset managers and their various stakeholders, both internally (e.g. board of directors) and externally (e.g. investors and regulators). In response, climate-related frameworks have been implemented or proposed by regulators across the globe (including the SEC) with the goal of providing investors greater transparency into the potential impact climate change may have on an organization, including its climate-related physical, transition and liability risks.

Concern

As new regulatory frameworks are implemented, there is an increased risk of claims activity under D&O/E&O policies. Near-term concerns include the risk of "greenwashing" claims, where an asset manager overstates its own commitment to fighting climate change, leading to potential D&O claims, or misrepresents how "green" its investment products or services are to investors, leading to potential E&O claims. Longer-term concerns include an organization's ability to remain competitive and thrive as governments and regulators pursue a transition to a net-zero economy.

Considerations:

D&O/E&O underwriters may inquire about the steps being taken to prevent greenwashing, including the process in place to review and approve external climate-related statements, and to ensure products and services are as "green" as they claim to be. Insureds should be prepared to address these issues during meetings with underwriters, as well as their organization's strategic approach to managing its climate risks.

Asset Management Industry Trends

Key issues to watch (continued)

Cybersecurity

Observation:

The SEC has proposed new cybersecurity rules under the Investment Advisers Act of 1940 and the Investment Company Act of 1940. Advisers and funds subject to the rule, which includes registered investment companies and business development companies, would be required to adopt and implement cybersecurity risk management policies and procedures, and adhere to new cybersecurity incident reporting and disclosure requirements. Fund directors would be required to approve these policies and procedures, and any proposed material changes to them, and review reports on cybersecurity incidents.

Concern:

This rule, along with the SEC's proposed rule for public companies, would be the latest in an ever-growing patchwork of cybersecurity regulatory requirements that must be carefully navigated by insureds. The potential to run afoul of these regulations, combined with the increasing cyber risks associated with the Russia-Ukraine conflict, has raised concerns not only within the Cyber insurance market, but within the Bond and D&O/E&O underwriting communities as well.

Considerations:

The SEC's proposed rules are a reminder that there are diverse insurance issues to consider as it relates to cybersecurity risks. From a D&O/E&O perspective, a limited number of insurers have sought to apply new language clarifying how such coverage is, and is not, intended to respond in the event of a cybersecurity incident. Any proposed cyber-related exclusions must be reviewed carefully to ensure the language is not overly broad in scope. If such language is overreaching, marketing the program to alternate insurers may be necessary.

Cryptocurrency

Observation:

As the demand for cryptocurrency and other digital assets increases, so too does the regulatory scrutiny of such assets. In its most recent Cryptocurrency Enforcement update, Cornerstone Research noted that the SEC, under new Chair Gensler, brought 20 enforcement actions related to cryptocurrency in 2021. Of those actions, 80% alleged an unregistered securities violation, 65% alleged fraud, and 55% alleged both. Scrutiny of cryptocurrency will continue to be a significant priority for the Biden Administration in 2022, as evidenced by President Biden's March 9th executive order outlining the government's plan to address the risks of digital assets and their underlying technology.

Concern:

The volatility and lack of regulation associated with cryptocurrency has stifled the willingness of many insurers to offer meaningful insurance risk transfer solutions for these risks. For established asset managers offering cryptocurrency as a relatively small part of a larger investment offering, some elements of coverage may be available in the insurance market on a case-by-case basis. However, newly created managers that are entirely or predominantly focused on cryptocurrency offerings will have limited insurance risk transfer solutions available to them in the current market.

Considerations:

It is highly recommended that asset managers who are considering entering the cryptocurrency market engage their WTW team early in the process, when possible, to discuss the potential solutions available to address these risks.

Asset Management Industry Trends

Key issues to watch (continued)

Alternative Investment Fund Manager Directive (AIFMD) II

Observation:

When adopted in 2011, AIFMD imposed new risk management and transparency requirements upon Alternative Investment Fund Managers (AIFMs) and the Alternative Investment Funds (AIFs) managed by them. Compliance with the regulation permits AIFMs to manage and market AIFs to professional investors across the EU with a single authorization from their home supervisor.

In November 2021, the European Commission issued its proposals to amend existing AIFMD rules. Such proposals include changes to delegation arrangements for authorized AIFMs, amendments to the National Private Placement Regime ('NPPR') framework, new substance requirements for EU AIFMs, and new loan origination, liquidity management, and investor disclosure requirements.

Concern:

Although not expected to be enacted before 2024 due to the lengthy EU legislative process, AIFMs across Europe (especially in the UK due to Brexit) and the rest of the world will follow these developments with interest. As asset managers typically delegate services to third parties, expect the EU to challenge the status quo of AIFMs delegating mandates to advisers outside of the EU to the UK, for example.

Considerations:

Much is uncertain as the industry watches how AIFMD II materializes but managers subject to the rule should review their D&O/E&O programs and ensure that appropriate locally admitted coverage is in place where necessary.

Financial Conduct Authority (FCA)

Observation:

With the Financial Services Act 2021 now being law, the FCA has continued its ambitious transformation program, putting consumer protection at the heart of its focus to become a "more assertive, innovative, and adaptable" regulator.Effective January 1, 2022, the UK's Investment Firm Prudential Regime (IFPR) represents a significant overhaul of the current rules, both in terms of the way investment firms are categorized from a prudential perspective and in terms of the requirements to which they are subject. IFPR aims to simplify requirements for firms regulated in the UK under MiFID (Markets in Financial Instruments Directive). The final rules can be found in FCA 2021/38 and FCA 2021/39.

Key points to note include increased regulatory capital requirements, new reporting and remuneration rules, and increased disclosure requirements. Other developments for 2022 include proposals to improve regulated firms' oversight of "appointed representatives" or those firms/persons carrying on regulated activities on behalf of, and under the responsibility of, an FCA authorized firm.

Concern

Increased regulatory scrutiny for asset managers increases the chance of a regulatory investigation and potential claims activity under D&O/E&O policies.

Considerations:

Asset managers should refresh themselves regarding the scope of regulatory investigations coverage afforded under their D&O/E&O policies, while paying particular attention to how such cover is triggered and the extent to which the entities and/or individuals are afforded coverage.

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

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