D&O/E&O INSURANCE COVERAGE FOR
EXPENSES OF CLAIM-RELATED INTERNAL CORPORATE INVESTIGATIONS

FREQUENTLY ASKED QUESTIONS

ICI Mutual has introduced a new "Claim-Related Internal Corporate Investigations" endorsement under its Directors and Officers/Errors and Omissions Liability Insurance Policy ("Policy"). The endorsement adds coverage to defray expenses incurred by insureds in "claim-related" internal corporate investigations—i.e., in those internal corporate investigations that are related (as detailed in the endorsement) to regulatory investigations, lawsuits or other "Claims" that are covered under the Policy. The new endorsement is being provided at no additional cost to insureds. This guide is designed to respond to frequently asked questions regarding this new ICI Mutual coverage.[1]

1. What is an Internal Corporate Investigation?

In general, an "internal corporate investigation" is an independent investigatory process that is undertaken by a company for the purpose of gathering evidence regarding, or otherwise investigating the basis for, perceived problems or potential liabilities that may affect the company. Internal corporate investigations can relate to various subjects, and may be initiated by companies in response to various triggering events. Such events may include, for example, concerns or allegations raised during company audits, in media stories, or by "whistleblowers."

For insurance purposes, it is important to distinguish between *internal corporate* investigations, on the one hand, and two other categories of "investigations" that may impact fund groups, on the other—namely, *regulatory* investigations and *fund shareholder derivative demand* investigations. ICI Mutual already provides separate and express coverage under its Policy for these latter two categories of investigations.[2]

[1] These Frequently Asked Questions (FAQs) provide an overview of the new coverage. In any particular situation, the terms, conditions and limitations of the endorsement itself (as well as any other applicable terms, conditions and limitations of the Policy) will govern any coverage questions that may arise.

[2] As regards these latter two categories: (1) the Policy's definition of "Claim" includes both formal and informal *regulatory* investigations—i.e., enforcement-oriented investigations pursued by the U.S. Securities and Exchange Commission ("SEC") or other governmental authorities or self-regulatory organizations; and (2) the Policy's "SDDI Endorsement" provides "co-insurance" coverage for *fund shareholder derivative demand* investigations ("SDDIs")—i.e., investigations initiated by registered funds in respond to demands made by fund shareholders that the funds pursue claims that the funds may have against fund advisers and/or other parties (e.g., fund directors).

2. Are the costs of Internal Corporate Investigations covered under standard mutual fund D&O/E&O policy forms?

Insurers generally view the legal fees and other costs associated with internal corporate investigations as *not* being covered under the standard language of mutual fund directors and officers/errors and omissions ("D&O/E&O") insurance policies. This result follows logically from two basic insurance principles. First, D&O/E&O insurance policies are generally designed to respond only to "claims" (e.g., lawsuits, regulatory proceedings) brought against insureds by third parties, and internal corporate investigations are not themselves third-party "claims." Second, because internal corporate investigations are not themselves "claims," the legal and associated expenses incurred by companies in conducting such investigations are not themselves "defense costs" incurred in the defense of "claims."

Stated another way, insurers generally view the fees and costs of internal corporate investigations as customary business expenses, rather than as expenses of the type for which D&O/E&O coverage is designed (e.g., expenses incurred by an insured entity in *defending* itself against a third-party claim).

3. Why is ICI Mutual providing Claim-Related Internal Corporate Investigations coverage?

ICI Mutual is providing the new coverage for two reasons. First, ICI Mutual recognizes that in certain situations—for example, where an insured entity initiates an internal corporate investigation into "whistleblower" allegations that subsequently give rise to a regulatory investigation or lawsuit that is covered under the Policy—the independent investigatory process may prove beneficial to the insured entity's later defense of the third-party "claim." Effective internal corporate investigations can thus sometimes assist insured entities in reducing the cost and/or severity of any associated third-party claims that may be made against them. Second, ICI Mutual believes that it is important to specifically address the scope of "internal corporate investigation" coverage available under the Policy, so as to avoid potential disputes with insureds over the nature and amount of coverage available to them in such cases.

4. What is the typical cost of an Internal Corporate Investigation?

It is not uncommon, in matters of significant potential import, for companies to retain outside counsel and/or other independent outside experts or specialists (e.g., forensic accountants) to conduct internal corporate investigations. (In addition, company officers or other individuals whose conduct is under investigation may themselves sometimes retain outside counsel to assist them in responding to inquiries made to them by the company during the investigatory process.) The costs and expenses associated with such outside counsel and experts in a specific internal corporate investigation will necessarily depend on the particular facts and circumstances involved. However, ICI Mutual's informal conversations with outside counsel involved in the area suggest that the cost of an internal corporate investigation in the fund industry can generally be expected to range from several hundreds of thousands of dollars at the lower end, up to several million dollars at the higher end (although in unusual circumstances, and/or in certain subject areas, the cost could be higher).

5. What are the key features of ICI Mutual's new Claim-Related Internal Corporate Investigations coverage?

- The coverage is being provided through a standard endorsement, at no additional cost to insureds.

- The coverage provides for 50% of the outside legal and expert expenses incurred by insureds in "claim-related" internal corporate investigations to be treated as "Costs of Defense" under the Policy, subject to a maximum insurance reimbursement for such expenses of $1 million under any single Policy.

- A "claim-related" internal corporate investigation is one that:

  (1) is authorized by the insured company's directors or a subcommittee thereof;

  (2) is initiated (i) prior to the date that a "covered claim" (e.g., an otherwise covered regulatory investigation, regulatory proceeding or lawsuit) is first made, or (ii) within six months after the date a covered claim is first made and before such covered claim is finally resolved;

  (3) is conducted by external counsel and/or other external experts retained by or on behalf of the insured company; and

  (4) is conducted for the purpose of gathering independent evidence regarding, or otherwise investigating the factual basis for, the "wrongful act(s)" at issue in such covered claim.

- Payments made by ICI Mutual under the coverage are part of, and not in addition to, the Policy's overall limit of liability.

- The coverage also includes additional provisions (1) to establish a per-Policy sublimit on claim-related internal corporate investigation expenses and defense costs payable by ICI Mutual in claims involving the Foreign Corrupt Practices Act, the U.K. Bribery Act of 2010, or analogous "anti-bribery" laws or regulations; and (2) to protect fund independent directors against legal fees or other costs that they might incur personally, in their capacity as independent directors, as witnesses in, or as subjects of, claim-related internal corporate investigations.

6. How does ICI Mutual's new Claim-Related Internal Corporate Investigations coverage differ from coverage that may be available in the commercial insurance market?

As noted above, insurers generally view the fees and costs associated with internal corporate investigations as *not* being covered under the standard language of mutual fund D&O/E&O policies. Although some commercial insurance companies have introduced insurance products that provide coverage for certain "internal investigations," these are separate products, and as such are separately priced.

"Pre-claim inquiry" or "pre-claim investigation" coverage may sometimes be available from commercial insurers under D&O/E&O policies. Such coverage, however, appears primarily designed to cover expenses incurred by directors and officers as *individuals* in *informal regulatory* investigations, rather than to defray expenses incurred by *entities* in *internal corporate* investigations.[3]

7. Can you provide examples of how the new coverage would apply in practice?[4]

Example No. 1 – A Claim-Related Internal Corporate Investigation Under a "Joint" Policy: A fund group purchases a "joint" Policy from ICI Mutual (i.e., a policy under which the registered investment companies and their investment adviser are named insured entities). The applicable deductible under the Policy is $500,000. The adviser's board initiates an internal corporate investigation in response to a "whistleblower's" allegations of misallocations of portfolio trades. The adviser incurs a total of $900,000 in outside legal and expert expenses in the course of the internal corporate investigation. Some months later, the SEC commences a regulatory investigation into the alleged misallocations. The adviser subsequently incurs an additional $800,000 in outside legal expenses in defending against the SEC regulatory investigation, and fund independent directors incur $400,000 in outside legal expenses as witnesses in (or as subjects of) the SEC regulatory investigation.

Under the coverage, ICI Mutual would reimburse the insureds a total of $1.15 million. This represents (1) 50% of the $900,000 incurred by the adviser in the "claim-related" internal corporate investigation (i.e., $450,000), plus (2)100% of the $800,000 in "Costs of Defense" incurred by the adviser in the SEC regulatory investigation, plus (3) 100% of the $400,000 incurred by the fund independent directors in the SEC regulatory investigation, less (4) the applicable $500,000 deductible.

Example No. 2 – A "Claim-Related" Internal Corporate Investigation Under a "Funds Only" Policy: A fund group purchases a "funds only" Policy from ICI Mutual (i.e., a policy under which only registered investment companies are named insured entities). The applicable deductible under the Policy is $500,000. Fund directors, on behalf of a registered fund, initiate an internal corporate investigation in response to the adviser's report that a "whistleblower" has made allegations regarding valuation of certain of the fund's portfolio securities. The insureds incur a total of $900,000 in outside legal and expert expenses in the course of the internal corporate investigation. The SEC subsequently commences a regulatory investigation into the valuation of the securities at issue, in which the SEC investigates both the adviser's actions with

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[3] As noted at Question 1 above, ICI Mutual has long provided express coverage for both insured directors and officers and insured entities in both formal and informal regulatory investigations.

[4] The examples in this Question 7 assume that "shareholder derivative demands" are *not* made by any shareholders of registered funds; if a "shareholder derivative demand" is made by a fund shareholder, the separate "SDDI Endorsement" to the Policy, rather than the "Claim-Related Internal Corporate Investigations Endorsement," would govern the availability of coverage. Moreover, the examples assume the non-applicability of any other terms, conditions or limitations of the Policy that might preclude or affect the availability of coverage.

regard to valuations and the fund independent directors' oversight of the valuation process. The fund independent directors incur a total of $600,000 in outside legal expenses as witnesses in (or as subjects of) the SEC regulatory investigation.

Under the coverage, ICI Mutual would reimburse the insureds a total of $550,000. This represents (1) 50% of the $900,000 incurred in the "claim-related" internal corporate investigation (i.e., $450,000), plus (2) 100% of the $600,000 incurred by the fund independent directors in the SEC regulatory investigation, less (3) the applicable $500,000 deductible. (**Note:** The adviser is not an insured under the "funds only" Policy. Accordingly, neither the adviser's expenses in the internal corporate investigation, nor the adviser's "Costs of Defense" in the SEC regulatory investigation, would be eligible for reimbursement under the Policy.)

Example No. 3 – A Non-Qualifying Internal Corporate Investigation under a "Joint" Policy: A fund group purchases a "joint" Policy from ICI Mutual (i.e., a policy under which the registered investment companies and their investment adviser are named insured entities). The applicable deductible under the Policy is $500,000. The adviser's board initiates an internal corporate investigation in response to allegations by advisory employees of discrimination based on gender. The adviser incurs a total of $400,000 in outside legal and expert expenses in the course of the internal corporate investigation. Some months later, the employees file a lawsuit against the adviser alleging gender discrimination. The adviser subsequently incurs a total of $400,000 in outside legal expenses in defending against the lawsuit.

Under the coverage, no reimbursement would be available for any of the outside legal and expert expenses incurred by the adviser in the internal corporate investigation or in defense of the lawsuit. This is because the lawsuit—as an "employment practices liability" claim—is not a "covered claim" under the Policy.[5]

Example No. 4 – A Post-Claim Internal Corporate Investigation Under a "Joint" Policy: A fund group purchases a "joint" Policy from ICI Mutual (i.e., a policy under which the registered investment companies and their investment adviser are named insured entities). The applicable deductible under the Policy is $500,000. In January, the SEC commences a regulatory investigation into allocations of portfolio trades made by the insured adviser as between the registered funds and certain of the adviser's private advisory accounts. In May (i.e., within six months following the commencement of the SEC's regulatory investigation), the adviser's board initiates its own internal corporate investigation into the portfolio trade allocations. The adviser incurs a total of $1 million in outside legal expenses in defending against the SEC regulatory investigation. The adviser incurs a total of $800,000 in conducting its internal corporate investigation.

Under the coverage, ICI Mutual would reimburse the adviser a total of $900,000. This represents (1) 100% of the $1 million in "Costs of Defense" incurred by the adviser in defense of the SEC regulatory investigation, plus (2) 50% of the $800,000 incurred by the adviser in its "claim-related" internal corporate investigation (i.e., $400,000), less (3) the applicable $500,000 deductible.

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[5] Unless specially endorsed, the Policy is not designed to cover employment practices liability claims (as reflected in the Policy exclusion at Section V.E).