ICI MUTUAL **PUBLICATION**

Operational Errors and Insurance

A Guide for Investment Advisers

ICIMutual

Table of Contents

Introduction 1
Operational Errors in the Fund Industry 2
  Frequency of Larger Operational Errors 2
  Severity of Larger Operational Errors 3
  Characteristics of Larger Operational Errors 3
Legal and Financial Responsibility for Operational Errors 5
  Legal Considerations 5
  Other Considerations 6
Costs of Correction Insurance 7
  An Insurance-Related Dilemma 7
  How Costs of Correction Insurance Responds 7
  Costs of Correction Insurance Coverage Can Vary 8
  The Future of Costs of Correction Insurance 9

Note

The focus of this guide is primarily on larger operational errors reported to, and on costs of correction insurance as provided by, ICI Mutual. Many of the general observations in this guide, however, may also be relevant to operational errors reported to, and costs of correction insurance available from, commercial insurers operating in the mutual fund insurance market.

By necessity, this guide generalizes as to the issues discussed. As such, the guide is designed simply to be informative and should not be construed or relied upon as legal advice (for which interested parties should look to their own counsel). Of course, the terms and conditions of individual insurance coverages, as set forth in individual insurance policies issued by ICI Mutual or other insurers, will govern any coverage questions arising in the context of a particular insurance claim.

Introduction

Operational errors and other operational mishaps by advisers and/or their affiliates (collectively, "advisers") can and do occur in the fund industry, notwithstanding state-of-the-art compliance systems and protocols in place at fund groups. Where funds, private advisory accounts, or other clients are adversely impacted, issues of legal and financial responsibility for operational errors are typically resolved directly and without litigation by the parties involved. Given the complexity of fund industry operations and the sheer number of transactions that take place, it is not surprising that there are sometimes operational incidents serious enough to result in substantial "corrective" payments being made by advisers to affected funds or clients.

A specialized type of liability insurance—commonly referred to as "costs of correction" insurance—permits insured advisers, under designated circumstances, to pursue insurance recovery for such corrective payments, even in the absence of litigation being initiated against them. Costs of correction insurance has, for more than three decades, been a standard feature of the directors and officers/errors and omissions ("D&O/E&O") liability insurance policy ("ICI Mutual Policy") issued by ICI Mutual Insurance Company ("ICI Mutual" or "Company"). In today's mutual fund insurance market, this coverage is also generally available, in one form or another, from commercial insurers. Outside the asset management sector, it remains uncommon.

For many fund industry professionals, the interplay of operational errors and insurance remains something of a mystery. This guide is designed to demystify the subject. The guide (1) provides general information on the frequency, severity, and characteristics of larger operational errors in the fund industry, (2) outlines the various considerations that may come into play in assessing and resolving the issue of advisers' legal and financial responsibility for such errors, and (3) describes the role of costs of correction insurance in facilitating timely and efficient remediations by advisers of larger operational errors for which they bear legal responsibility. Intended primarily for risk managers, in-house counsel, and other advisory personnel at fund groups, this guide may also be of interest to outside counsel, insurance brokers, and other outside insurance consultants.

Operational Errors in the Fund Industry

As used in this guide, "operational errors" refer to errors, mistakes, oversights, or other mishaps by advisers in performing asset management-related activities for, and/or in delivering asset management–related services to, their managed funds, private accounts, or other clients. Because operational risk is "inherent in nearly every business activity,"[1] nearly all such asset management–related activities and services carry with them the potential for operational errors. Operational errors reported to ICI Mutual over the decades include, by way of example, mistakes in entering trade orders for portfolio securities, errors in responding to corporate action requests, inadvertent failures to adhere to investment restrictions (e.g., as set forth in fund prospectuses and/or private advisory contracts), oversights in voting portfolio securities, lapses in providing administrative services, and mispricing of portfolio securities.

Advisers typically resolve issues of legal and financial responsibility for operational errors directly with their affected funds or clients, without litigation and with little or no publicity. Accordingly, there is no effective means to track the frequency, severity, or characteristics of all such errors on a fund industry-wide basis. ICI Mutual's claims experience does, however, provide useful insight into these questions as regards *larger* operational errors—defined here to mean those errors that involve (or that have the clear potential to involve) underlying dollar exposures substantial enough (1) to exceed the insurance deductibles of ICI Mutual–insured advisers (with deductibles typically in the mid-six figure to low-seven figure range, depending on the size of an adviser's fund group and other factors), and (2) as a result, to generate notices by them to ICI Mutual of actual or potential insurance claims.

Frequency of Larger Operational Errors

The overall frequency of larger operational errors reported to ICI Mutual has remained relatively stable over the decades. The Company has typically received up to half a dozen reports of such errors annually, year in and year out. Over its history, ICI Mutual has paid scores of "costs of correction" insurance claims in response to these reports; such claims account (by number) for approximately one third of all insurance claims paid by the Company.

---

[1] *See* Broadridge Financial Solutions, Inc., *Operational Risk: Tailoring the Right Model for Asset Management Firms* 3 (2015), https://www.sifma.org/wp-content/uploads/2017/05/operational-risk-white-paper-tailoring-the-right-model-for-asset-management-firms.pdf ("Operational risk is inherent in nearly every business activity; it touches every department, system and process."). In a sense, operational errors can be viewed simply as manifestations of operational risk, which is itself a term that eludes easy definition. Indeed, definitions of operational risk vary, and are in many cases either too broad or too imprecise to be of practical use to non-specialists concerned with risk management issues in the fund industry. Perhaps the most widely accepted definition of operational risk as it relates to financial institutions is set forth in the Basel II Accord (i.e., "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events"). Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* 144 (Comprehensive Version June 2006), https://www.bis.org/publ/bcbs128.pdf. The Basel II definition, despite its broad acceptance, is not without its critics. *See, e.g.*, Françoise Caclin, *The Operational Risk,* https://www.fimarkets.com/pagesen/operational-risk.php (last updated May 12, 2021) (noting that the Basel II definition's "scope seems so wide you do not immediately perceive the practical application").

Severity of Larger Operational Errors

Costs of correction insurance claims account (by dollars paid) for approximately one fifth of all claims dollars paid by ICI Mutual over its history. Until fairly recently, the severity of the larger operational errors involved in these claims had remained relatively stable, with the underlying dollar exposures rarely exceeding the mid-seven figures. Over the past several years, however, in a marked break from past experience, the Company has received multiple reports of larger operational errors involving (or that have had the clear potential to involve) underlying exposures of eight figures or more. The Company characterizes operational errors of this increased order of magnitude as *high severity*, in order to differentiate them from the historical norm.

No definitive statistical trend towards increased severity in larger operational errors can, as yet, be derived from the available claims data. However, as evidenced by recent experience, the risk of high severity operational errors in the fund industry has moved beyond the theoretical to the real. Moreover, with multiple high severity operational errors having now happened, it is logical to expect that additional high severity errors may happen in the future—an expectation that is consistent with risk theory regarding the potential for accidents in complex operational systems.[2] Indeed, it seems prudent to assume that the risk of high severity operational errors may now be inherent in modern fund industry operations, regardless of the strength of fund groups' operational risk management programs.

Characteristics of Larger Operational Errors

Based on its decades of experience in investigating larger operational errors in the fund industry, ICI Mutual offers the following general observations regarding the characteristics of larger operational errors.

- *Larger operational errors tend to be highly idiosyncratic.* Unlike shareholder lawsuits and regulatory enforcement actions, which sometimes manifest in "waves" of substantially similar lawsuits or actions that target multiple fund groups and involve substantially similar underlying allegations, larger operational errors tend to be idiosyncratic, "one-off" events.[3] Indeed, even larger operational errors within particular error categories (e.g., trading errors, corporate action processing errors) tend to differ widely in their underlying facts and circumstances.
- *Larger operational errors rarely have a single cause.* Larger operational errors typically result from a chain or confluence of underlying causative factors, each of which contributes to—but none of which, standing alone, would likely be sufficient to permit—the occurrence of the operational error at issue. Many larger operational errors can be traced to some combination of (1) one or more human errors, oversights, or derelictions, (2) one or more flaws or breakdowns in (or failures to implement sufficiently comprehensive) compliance or risk management processes and procedures, and/or

---

[2] *See generally* Richard I. Cook, *How Complex Systems Fail* (2000), https://how.complexsystems.fail/ ("System operations are dynamic, with components (organizational, human, technical) failing and being replaced continuously…. Complex systems possess potential for catastrophic failure…. The potential for catastrophic outcome is a hallmark of complex systems. It is impossible to eliminate the potential for such catastrophic failure; the potential for such failure is always present by the system's own nature.").

[3] *See generally* ICI Mutual, Shareholder Litigation in the Fund Industry: A Guide for Investment Advisers and Fund Independent Directors (2019), at pp. 8–9 (discussing "waves" and "one-offs" in shareholder litigation in the fund industry), *available at* www.icimutual.com.

(3) one or more design defects, miscodings, or malfunctions in technological systems. The increased transaction volume, complexity, and pace of modern fund industry operations also likely contribute, albeit indirectly, to the occurrence of operational errors by increasing the number of opportunities for human error, by reducing time frames within which operational errors can be detected and remedied before significant damage is done, and by making the design, implementation, and maintenance of fail-safe processes, procedures, and systems extremely challenging—and perhaps even impossible—to achieve.

- *Larger operational errors sometimes reflect recurring themes.* As noted above, larger operational errors tend to be highly idiosyncratic and rarely have a single cause. Yet certain broader factors sometimes recur to play a role in contributing, directly or indirectly, to such errors. Among those identified by ICI Mutual are (1) staffing outages or shortages, (2) overreliance on (and/or failures to understand limitations of) automated compliance systems, (3) system integration issues, (4) new (and/or "non-core") operational activities, and (5) incomplete or inaccurate communications (both internal and external).
- *Larger fund groups may be at greater risk.* The larger operational errors reported to ICI Mutual over the decades have disproportionately involved advisers in larger fund groups, as measured by assets under management. Moreover, and as likewise relevant here, all of the recent high severity operational errors discussed above have involved advisers in larger fund groups. While correlation does not imply causation—that is, while size alone should not be viewed as "causing" larger operational errors—ICI Mutual's experience does suggest that advisers in larger fund groups may be at greater risk in this regard. At a minimum, the experience evidences that advisers in larger fund groups are at no *lesser* risk for larger operational errors than are advisers in smaller fund groups.

As observations derived directly from ICI Mutual's experience with larger operational errors in the fund industry, the foregoing observations are instructive. But they are unlikely to strike risk management professionals as either surprising or controversial. ICI Mutual views them as consistent with risk theory regarding the potential for accidents in complex operational systems.[4]

---

[4] *See, e.g.*, BARRY STRAUCH, INVESTIGATING HUMAN ERROR: INCIDENTS, ACCIDENTS, AND COMPLEX SYSTEMS xii (2002 reissued 2018) ("[D]iverse and redundant layers of defences, barriers and safeguards … make it highly unlikely that accidents in complex systems can arise from any single factor, be it human, technical or environmental. The apparently diabolical conjunction of several different factors is usually needed to breach all of these defences-in-depth at the same time. This makes such events less frequent, but the causes more complex."); JAMES REASON, HUMAN ERROR 197 (1990) ("[Various case studies] … indicate that major disasters in defended systems are rarely if ever caused by any one factor, either mechanical or human. Rather, they arise from the unforeseen and usually unforeseeable concatenation of several diverse events, each one necessary but singly insufficient.").

Legal and Financial Responsibility for Operational Errors

In the aftermath of operational errors, affected funds or clients frequently expect their advisers to take corrective action, and in connection therewith, to compensate them for any financial losses incurred. Legal, business, and/or reputational considerations may enter into advisers' determinations as to how to respond to such expectations.

Legal Considerations

Although they are sometimes viewed as such by fund boards or clients, advisers are not guarantors against operational risk. Among the considerations that may be relevant in analyzing whether an adviser bears legal responsibility for a given operational error are the potential impact of federal securities laws and regulations,[5] the applicable standard of care (and/or other provisions) in the adviser's contract(s) with affected funds or clients,[6] and the potential applicability of fiduciary principles.[7] The specific facts and circumstances involved in any given operational error will likewise necessarily influence an analysis of legal responsibility.

---

[5] For example, Section 17(i) of the Investment Company Act of 1940 prohibits contracts of registered investment companies from containing provisions protecting investment advisers and principal underwriters against liability to the companies and their shareholders "by reason of willful misfeasance, bad faith, … gross negligence, … or … reckless disregard" in the course of their duties. 15 U.S.C. § 80a-17(i).

[6] Although the Investment Advisers Act of 1940 does not impose a specific duty of care, an adviser's contract with a fund ordinarily does, such that the adviser is not liable for an operational error unless it has violated that standard. The standard of care may be expressly stated (e.g., specify a standard of ordinary "negligence" or "gross negligence") and/or be implied by a clause providing some degree of exculpation in favor of the adviser (e.g., excuse the adviser from liability for ordinary negligence).

[7] General fiduciary principles can be instructive in assessing whether an adviser's conduct has satisfied the applicable standard of care, inasmuch as certain advisers are considered fiduciaries under applicable law. *See, e.g.*, Kamen v. Kemper Fin. Servs., 500 U.S. 90, 93 (1991) ("The [Investment Company] Act requires … that the dealings of the adviser with the [investment] company measure up to a fiduciary standard…."); Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11 (1977) ("Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."). While it is not certain that common-law fiduciary principles necessarily constitute binding authority in the context of the investment management industry, such principles can clearly be instructive. *See, e.g.*, SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("Nor is it necessary in a suit against a fiduciary, which Congress recognized the investment adviser to be, to establish all the elements required in a suit against a party to an arm's-length transaction. Courts have imposed on a fiduciary an affirmative duty of 'utmost good faith, and full and fair disclosure of all material facts,' as well as an affirmative obligation 'to employ reasonable care to avoid misleading' his clients.") (footnotes omitted).

Other Considerations

Quite apart from legal considerations, advisers may face a number of business and/or reputational pressures to assume financial responsibility for operational errors. By reason of these pressures or otherwise, advisers may sometimes agree to compensate affected funds or clients for associated losses even when they—i.e., the advisers—are not legally at fault. (Similarly, advisers may sometimes agree to make payments in excess of the amounts for which they may otherwise be legally responsible.) Advisers are, of course, free to take business and/or reputational considerations into account in determining how they may wish to respond to any given operational error. However, as discussed in the next section, only considerations relating to an adviser's actual legal liability for an error are relevant in assessing whether, and to what extent, costs of correction insurance coverage may be available for any associated "corrective" payment that the adviser may choose to make.

Costs of Correction Insurance

Costs of correction insurance, a standard feature of the ICI Mutual Policy for more than three decades, is highly valued by ICI Mutual's insureds. Rarely found outside the asset management sector, this specialized type of liability insurance addresses an insurance-related dilemma otherwise faced by advisers. In so doing, the coverage plays an important role in facilitating their timely and efficient resolutions of operational errors.

An Insurance-Related Dilemma

Advisers typically prefer to resolve issues of legal and financial responsibility for operational errors directly with their affected funds or clients, without litigation and with little or no publicity. Under traditional D&O/E&O policies, however, insurance coverage cannot potentially be available unless and until an actual lawsuit is initiated against the insured (or under some policies, unless and until a formal demand is made by a third-party claimant to the insured).[8] In the aftermath of an operational error, this leaves an adviser insured under a traditional D&O/E&O policy facing an insurance-related dilemma: Should the adviser wait for its affected funds or clients to sue, thereby triggering the potential for the adviser's D&O/E&O insurance policy to respond? Or should the adviser proceed to unilaterally "correct" the error, thereby foregoing the potential for any D&O/E&O insurance recovery?[9]

How Costs of Correction Insurance Responds

Broadly stated, costs of correction insurance addresses the dilemma described above, by enabling an insured adviser to seek insurance recovery for certain corrective payments that it may make in response to an operational error, notwithstanding that no actual lawsuit (or demand) is ever initiated against it by affected funds or clients. The purpose of costs of correction insurance is, in large part, to facilitate an insured adviser's timely and cost-efficient legal and financial resolution of an operational error where the adviser's legal liability and resulting financial obligation to its affected funds or clients are certain. The coverage thereby spares the adviser (and by extension the insurer) the associated litigation defense costs that would be involved if the adviser were to be sued and were certain to be adjudged liable and required to pay the same or greater amount(s) in such lawsuit.

---

[8] This is because D&O/E&O insurance policies are typically written on a "claims made" basis, meaning that the availability of coverage for an insured adviser can be triggered only when an actual lawsuit or other third-party "claim" is made against the adviser during the policy period. *See generally* ICI MUTUAL, MUTUAL FUND D&O/E&O INSURANCE: A GUIDE FOR INSUREDS (2009), at pp. 35–36, *available at* www.icimutual.com.

[9] The adviser's dilemma may be further complicated by the potential for heightened regulatory scrutiny and/or regulatory enforcement activity in the aftermath of an operational error.

It follows that, in order for costs of correction coverage potentially to be available, the insured adviser must, among other things, have *actual legal liability* resulting from the operational error at issue.[10] This requirement for actual legal liability is fundamental and critical. Costs of correction insurance is *not* designed or intended to extend to payments that may be made by the insured adviser as a business accommodation, or to avoid reputational damage, or to reduce the possibility that a lawsuit will be initiated against it, or for any other reason apart from the adviser's own actual legal liability.[11]

Costs of Correction Insurance Coverage Can Vary

Costs of correction coverage is an "errors and omissions" (E&O) coverage and thus is available only to insured entities (and not to insured individuals). Because operational errors in the fund industry can typically be traced back to the acts or omissions of advisers (or other third-party service providers), costs of correction coverage is generally regarded as a coverage for insured advisers rather than for insured funds themselves.[12] The types of operational errors to which ICI Mutual's costs of correction insurance potentially responds are typically coextensive with those types of errors to which an adviser's ICI Mutual Policy would otherwise respond if the errors were to result in actual litigation being initiated by affected funds or clients.[13]

---

[10] A costs of correction situation, by its very nature, lacks the various safeguards that are normally built into an error-resolution process that involves an actual lawsuit (or other third-party "claim") being brought by an affected fund or client against an adviser—namely, the assurance that the underlying dispute between the affected fund or client and the adviser over responsibility for the operational error is a legitimate dispute in which the factual and legal positions of both parties will be examined carefully (and, if necessary, adjudicated and resolved) by a disinterested third party such as a court or arbitration panel, rather than simply decided privately between the affected fund or client and the adviser. The absence of such safeguards underscores why, from an insurance perspective, costs of correction coverage requires, among other things, that there be actual legal liability on the part of the adviser in order for the coverage potentially to be available.

[11] Similarly, costs of correction coverage is not designed or intended to respond to all ancillary or associated costs or expenses that an insured adviser may incur to "correct" an operational error. Rather, under the ICI Mutual Policy, the coverage provides insurance reimbursement for direct compensatory payments made by the insured adviser to the affected claimant(s) (and for certain costs and expenses incurred to calculate and deliver such payments) where such amounts are "reasonably and necessarily incurred" and are otherwise covered under the ICI Mutual Policy.

[12] Given the nature of operational errors in the fund industry and the nature of costs of correction coverage, it is extremely difficult to envision "real life" situations in which an insured fund could have a legitimate costs of correction insurance claim of its own. The ICI Mutual Policy does not attempt to identify or specify those rare (and perhaps purely theoretical) situations in which a fund might have such a claim. Rather, the ICI Mutual Policy leaves open the possibility that there could conceivably be situations (however remote or unlikely) in which an insured fund might seek to pursue such a claim. Thus, even where a fund group chooses to structure an ICI Mutual Policy as a "funds only" policy (i.e., a policy under which the insureds are limited to funds and fund directors and officers only), costs of correction coverage is typically included as a standard feature.

[13] For example, if a fund group chooses to structure its ICI Mutual Policy as a "joint" policy (i.e., a policy under which an insured adviser's E&O coverage extends to its services to insured funds and fund shareholders), costs of correction coverage could potentially be available to assist in the resolution of operational errors in the adviser's provision of such services. In contrast, if a fund group chooses to structure its ICI Mutual as a "joint plus" policy (i.e., a policy under which an insured's adviser's E&O coverage extends not only to its services to insured funds and fund shareholders, but also to its private advisory or other designated services to non-fund clients), costs of correction coverage could potentially be available to assist in the resolution of operational errors in the adviser's provision of those additional services, as well. In any particular case, of course, the availability of coverage would be subject to the applicable terms, conditions, and limitations of the particular ICI Mutual Policy at issue.

Historically, commercial insurance companies operating in the mutual fund insurance market have not always offered costs of correction insurance. At least in recent years, however, commercial insurance companies have generally made costs of correction coverage available to advisers, typically via separate endorsements to their D&O/E&O policy forms. The scope, terms, and conditions of the coverage can vary by commercial insurer.

Thus, for example, some commercial insurers may seek to limit the types of operational errors for which costs of correction coverage is potentially available—i.e., they may seek to limit coverage to a *narrower* set of errors than those to which the commercial insurers' D&O/E&O policies would otherwise potentially respond (e.g., trade errors only). Or, they may seek to impose other restrictions (e.g., abbreviated notice periods). General philosophies and approaches to handling costs of correction insurance claims may likewise vary by insurer.

The Future of Costs of Correction Insurance

As underscored by the fund industry's recent experience (see "Operational Errors in the Fund Industry" above), the risk of high severity operational errors may now be inherent in modern fund industry operations, regardless of the strength of fund groups' operational risk management programs. ICI Mutual recognizes the sensitivity of costs of correction insurance claims and takes appropriate steps to protect the confidentiality of associated claims-related information. But fund industry operational errors are not limited to advisers insured by ICI Mutual. And high severity costs of correction claims, when they occur, can impact multiple insurers and/or reinsurers. Commercial insurers, reinsurers, and insurance brokers are thus growing increasingly aware of the severity risk associated with costs of correction insurance claims, and of the underwriting and pricing challenges associated with transferring this severity risk through insurance.

ICI Mutual remains committed to costs of correction insurance coverage. As of the date of this guide, ICI Mutual has no current plans to restrict the scope or amount of costs of correction coverage that is provided under the ICI Mutual Policy. At the same time, ICI Mutual believes it is important to recognize the applicability in this context of a basic insurance principle—in order to promote the continued availability of suitable breadth of coverage and insurance capacity (supply) for a new or emerging severity risk, the cost of insuring the risk must necessarily be pooled and apportioned equitably over time between and among insureds and their insurers.

Practical Considerations under D&O/E&O Policies

If costs of correction insurance is provided under an adviser's D&O/E&O policy, relevant policy provisions generally detail the adviser's obligations with regard to a costs of correction claim. It is important to note that under many policies (including ICI Mutual's), the potential availability of costs of correction coverage is conditioned, among other things, on the adviser's receiving the insurer's prior consent to take corrective action. Policies may also specify time periods within which notice to insurers must be provided.

ICI Mutual is the predominant provider of D&O/E&O liability insurance and fidelity bonding for the U.S. mutual fund industry. Its insureds represent more than 60% of the industry's managed assets. As the mutual fund industry's dedicated insurance company, ICI Mutual is owned and operated by and for its insureds. ICI Mutual's services assist insureds with identifying and managing risk and defending regulatory enforcement proceedings and civil litigation.

ICI Mutual also serves as a primary source of industry information regarding mutual fund insurance coverage, claims, risk management issues, and litigation developments. Publications include an extensive library of risk management studies, the online *Litigation Notebook*, and the annual *Claims Trends* newsletter. Additional services include peer group profiles, coverage analyses, and assistance to insureds and their counsel in litigation defense.

1401 H Street NW, Suite 1000
Washington, DC 20005

800.643.4246
info@icimutual.com
www.icimutual.com

© 2021 ICI Mutual Insurance Company,
a Risk Retention Group