D&O/E&O INSURANCE COVERAGE FOR SHAREHOLDER DERIVATIVE DEMAND INVESTIGATIONS

FREQUENTLY ASKED QUESTIONS

ICI Mutual has introduced a new "SDDI Endorsement" that adds coverage under ICI Mutual's Directors and Officers/Errors and Omissions Liability Insurance Policy ("Policy") for expenses incurred by registered investment companies and other insureds in connection with shareholder derivative demand investigations. This guide is designed to respond to frequently asked questions regarding this new ICI Mutual coverage.[1]

1. What is a Shareholder Derivative Demand?

A "shareholder derivative demand" is a demand made by a corporate shareholder on the corporation's board of directors to bring a lawsuit (or other "action") to enforce a right or seek a recovery that belongs to the corporation, but which the corporation has not brought on its own behalf. In the fund industry, a shareholder derivative demand typically calls on the board of a fund to authorize and pursue a lawsuit, on behalf of the fund, against the fund's adviser and/or the fund's officers or directors, to remedy alleged violations of law by the adviser and/or the officers or directors with respect to the fund.

2. What is a Shareholder Derivative Demand Investigation ("SDDI")?

In response to a shareholder derivative demand, the board of directors of a fund will frequently appoint a special committee of independent directors (sometimes referred to as a "demand investigation" committee or a "special litigation" committee) to conduct an SDDI. The purpose of the SDDI is to investigate the relevant facts and law regarding the alleged violations in order to permit the committee to make an informed judgment as to whether the fund should (1) take over and pursue, on behalf of the fund, the claims made by the shareholder (thereby displacing the shareholder), (2) pursue an alternative remedy, or (3) reject the shareholder's demand.

3. What is the typical cost of an SDDI?

A SDDI is typically conducted by outside counsel retained by the board's special committee. In some cases, other experts may also be retained to assist the special committee in its investigation. In addition, the individuals or entities targeted by the shareholder derivative demand (e.g., the fund's adviser) may themselves retain counsel to assist them in responding to the SDDI. The total cost of a specific SDDI will necessarily depend on the particular facts and circumstances involved. However, ICI Mutual's own claims experience, and ICI Mutual's informal conversations with outside counsel involved in the area, suggest that absent unusual circumstances, the expense of an SDDI in the fund industry can range from a few hundred thousand dollars up to $2 million at the higher end.

---

[1] The Frequently Asked Questions provide an overview of the new coverage. The terms and conditions of the SDDI Endorsement itself will govern any coverage questions arising in a particular claim situation.

4. Is the cost of an SDDI covered under standard mutual fund D&O/E&O policy forms?

Insurers generally view the legal fees and other costs associated with an SDDI as *not* being covered under the standard language of mutual fund D&O/E&O insurance policies. Separate and apart from specific policy wording in support of this result, insurers view the fees and costs of an SDDI as "offensive" rather than "defensive" in nature, and therefore outside the scope of coverage for which D&O/E&O policies are designed.

Stated another way, insurers generally view the fees and costs of an SDDI as a customary business expense (i.e., expense that a fund, like any corporation, must expect to incur in deciding whether to *initiate and pursue* civil litigation, on its own behalf, against one or more other parties), rather than as an expense of the type for which D&O/E&O coverage is designed (i.e., expense incurred by a fund in *defending* itself against third-party claims).

5. What are the key features of ICI Mutual's new SDDI coverage?

- The SDDI coverage will be provided at no additional cost to insureds.
- The SDDI coverage will apply to shareholder derivative demands made against any registered investment companies that are insureds under the Policy.
- ICI Mutual will reimburse insureds for 50% of all qualifying SDDI expenses that result from shareholder derivative demands that are made during the Policy period, subject to a maximum payment by ICI Mutual of $1 million under any single Policy.
- The SDDI coverage will be provided on a "first dollar" basis; a separate Policy deductible will *not* apply to this coverage.
- ICI Mutual's coverage extends to qualifying SDDI expenses incurred by insured registered investment companies, their boards of directors (or any committees thereof), their directors and officers, and any other insureds.
- Payments made by ICI Mutual under the SDDI coverage are part of, and not in addition to, the Policy's overall limit of liability.

6. How does ICI Mutual's SDDI 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 an SDDI as *not* being covered under the standard language of mutual fund D&O/E&O insurance policies. ICI Mutual understands that in some instances, commercial insurers may be willing to add specific SDDI coverage to a fund D&O/E&O insurance policy. Where available, such commercial coverage, like the ICI Mutual coverage, is typically provided on a "first dollar" basis. Although commercial coverages, where available, frequently reimburse 100% of qualifying SDDI expenses (as compared to ICI Mutual's 50% co-share), commercial coverages typically have much lower sublimits, or "caps" (e.g., $250,000 per policy, as compared to ICI Mutual's $1 million). Moreover, SDDI coverage provided by commercial insurers generally extends only to the expenses incurred by the company receiving the shareholder derivative demand (i.e., the fund) and by the committee or directors designated to conduct the SDDI, whereas ICI Mutual's

SDDI coverage extends to qualifying expenses incurred by them and by any *other* insureds under the Policy.

7. Why is ICI Mutual providing SDDI coverage?

ICI Mutual is providing SDDI coverage for two reasons. First, ICI Mutual believes that its new coverage will help to ensure that funds and fund directors have the necessary resources to conduct thorough and effective investigations of shareholder derivative demands. Thorough and effective investigations will, in turn, benefit funds, directors, and ICI Mutual, by reducing the risk that any subsequent litigation challenges to decisions made by fund boards in response to shareholder derivative demands will be successful. Second, ICI Mutual believes that it is important to specifically address the scope of SDDI coverage available under the Policy, so as to avoid potential disputes with insureds over the nature and amount of coverage available to them in responding to shareholder derivative demands.

8. Who is eligible to receive ICI Mutual's SDDI coverage and at what cost?

ICI Mutual will provide the SDDI Endorsement on all Policies on which registered investment companies are named as insureds. As noted above, the coverage will be provided at no additional premium.

9. Can you provide examples of how the SDDI coverage would apply in practice?

Example #1 – A Joint Policy: A fund complex purchases a "joint" Policy from ICI Mutual covering the registered investment companies and their investment adviser. During the Policy period, one fund board receives a shareholder derivative demand, calling on the fund to initiate a lawsuit against the adviser and the fund's officers and directors. A special committee for the fund board conducts an SDDI, in the course of which a total of $1.6 million in qualifying SDDI expenses is incurred. The insured adviser separately incurs a total of $260,000 in qualifying SDDI expenses. Under the Policy, ICI Mutual would reimburse to the insureds a total of $930,000 (i.e., 50% of $1.6 million + 50% of $260,000).

Example #2 – A "Funds Only" Policy: A fund complex purchases a "funds only" Policy from ICI Mutual, under which all registered investment companies are named insureds. During the Policy period, one fund board receives a shareholder derivative demand, calling on the fund to initiate a lawsuit against the fund's adviser and/or the fund's officers and directors. A special committee of the board conducts an SDDI, in the course of which the committee incurs a total of $900,000 in qualifying SDDI expenses. The adviser incurs a total of $150,000 in associated expenses. Under the Policy, ICI Mutual would reimburse $450,000 to the insured fund (i.e., 50% of $900,000). The adviser is not an insured under the "funds only" Policy, and therefore its SDDI expenses would not be eligible for reimbursement.

10. What happens to the SDDI coverage if there is a related lawsuit brought by the shareholder?

It is not uncommon for counsel representing a fund shareholder to initiate related litigation prior to the completion of an SDDI by a board's special committee. Under the SDDI Endorsement, coverage for qualifying SDDI expenses remains available if a related lawsuit (or related regulatory investigation) is initiated before the SDDI is completed.

Coverage for qualifying SDDI expenses does *not* reduce the coverage otherwise available to insureds for the "Costs of Defense" (as defined in the Policy) they incur in defending against the related lawsuit or regulatory investigation. In these circumstances, an appropriate allocation must be made between those fees and expenses that comprise qualifying SDDI expenses, on the one hand, and those fees and expenses that comprise "Costs of Defense," on the other. Coverage for the allocable SDDI expenses would be available on the terms outlined above. Coverage for the allocable "Costs of Defense" would likewise be available under the Policy, subject to the applicable Policy deductible and any other applicable Policy terms and conditions.