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The Insurer for the Investment Management Industry

Insurance Considerations for Fund Independent Directors

January 2026

About ICI

The Investment Company Institute (ICI) is the leading association representing the global asset management industry in service of individual investors. ICI members are located in North America, Europe, and Asia and manage fund assets of US$50 trillion, including mutual funds, exchange-traded funds (ETFs), UCITS, closed-end funds, unit investment trusts (UITs), and similar funds in these different jurisdictions. ICI has offices in Washington DC, Brussels, and London.

IDC is part of ICI, and leverages the research, advocacy, operational, and other resources of ICI to amplify IDC's effectiveness in its mission to serve independent directors. IDC's activities are overseen by a Governing Council of independent directors of ICI member funds and are supported by dedicated IDC staff.

About IDC

The Independent Directors Council (IDC) serves the US-registered fund independent director community. Through its mission focused on education, engagement, advocacy, and public understanding, IDC promotes excellence in fund governance for the benefit of funds and their shareholders.

About ICI Mutual

ICI Mutual is the predominant provider of D&O/E&O liability insurance, independent directors liability insurance, and fidelity bonding for the U.S. mutual fund industry. Its insureds represent more than 70% 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.

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Nothing contained in this report is intended to serve as legal advice. Each investment company board should seek the advice of counsel for issues relating to its individual circumstances.

Introduction

A well-designed insurance program is invaluable for funds, their directors, and affiliated service providers. It protects against financial losses and enhances stakeholder confidence, demonstrating robust risk management practices that contribute to the fund's overall stability and success.

Independent directors play an integral role in the insurance process. Evaluating insurance options involves the exercise of business judgment and consideration of a range of issues, as discussed below in greater detail.

This paper is designed to assist independent directors in better understanding the protections available to them, and the funds they oversee, through indemnification and insurance. The paper also includes a series of questions to aid directors in being effective participants in the selection and approval of insurance coverage.

Indemnification for Independent Directors

Indemnification by a fund affords a strong first line of protection to independent directors against the direct financial impact of regulatory investigations, regulatory proceedings, and civil litigation. Indemnification allows independent directors (1) to be reimbursed, from fund assets, for liabilities (including legal expenses) they incur as defendants, respondents, and/or witnesses in fund-related proceedings; and (2) to receive "advances" from fund assets to cover their ongoing legal and associated expenses as those expenses are incurred during the course of the underlying proceedings. Typically, indemnification is subject to certain conditions, such as a director acting in good faith and not having engaged in willful misconduct or illegal activities. Indemnification is very common in the fund industry.

Insurance for Funds and Their Directors and Officers

As a second line of protection, insurance safeguards funds and their directors and officers, offering financial protection against legal claims. D&O/E&O (directors and officers/errors and omissions) insurance is crucial, with independent director liability (IDL) insurance providing specialized coverage solely for independent directors. In addition, the Investment Company Act of 1940 (1940 Act) requires a fund to purchase fidelity bond coverage to protect it from financial losses caused by larceny or embezzlement by employees.

Indemnification and Insurance

Indemnification for directors and insurance for funds are interlinked. Indemnification protects directors from liability for good faith actions on behalf of a fund. Insurance is designed to make a fund "whole" if it must use its assets to indemnify a director.

Questions and Considerations for Directors

This paper provides independent directors with a series of questions and considerations in evaluating the insurance process generally, as well as more specific questions and considerations in evaluating the core insurance products.

Appendices

To further assist independent directors in evaluating insurance options, this paper includes (1) an appendix that describes key fund industry risks and related insurance considerations and (2) a glossary of common insurance terms and concepts.

Fund Indemnification

Fund indemnification plays a crucial role in protecting independent directors from personal financial exposure that can arise during regulatory investigations, regulatory proceedings, and civil litigation. Essentially, indemnification allows directors to use fund assets to cover legal expenses and other financial liabilities they might incur as defendants or non-party witnesses in fund-related cases. This protection is vital in ensuring that qualified individuals are willing to serve as directors, knowing they have a safety net in place.

Moreover, indemnification provides a practical benefit by allowing independent directors to receive advancements from fund assets to cover ongoing legal and associated expenses. This means that, as legal and associated expenses are incurred during ongoing proceedings, directors can access the necessary funds to cover these costs on a timely basis and without waiting until the end of the proceedings for payment. Indemnification provisions are common in all types of corporations and are integral to maintaining the directors' ability to effectively manage their responsibilities without the looming concern of financial ruin due to legal battles.

The risk of independent directors facing non-indemnifiable loss—loss for which the funds cannot indemnify them—is relatively low. Fund charters and bylaws are often tailored to grant the broadest possible indemnification rights under applicable laws. In some instances, independent directors and the funds they oversee may enter into separate agreements to further solidify and preserve these indemnification rights. Because funds typically have minimal risk of insolvency, indemnification generally affords even stronger protection to independent directors of funds than to directors of operating companies. This comprehensive approach helps to create a secure environment for individuals in these pivotal roles and to attract qualified persons to serve as directors.

Under state indemnification statutes, funds are typically required to indemnify directors in certain circumstances (so-called "mandatory indemnification") and are permitted—but not required—to indemnify fund directors in other circumstances (so-called "permissive indemnification"). Provisions in fund charters and bylaws typically grant independent directors the broadest indemnification rights available under applicable law, thus effectively converting permissive indemnification into mandatory indemnification.

Indemnification rights remain subject to certain restrictions under state and federal law, particularly that the director must have acted in good faith. Historically, however, these restrictions on indemnification have rarely left independent directors at personal financial risk in regulatory proceedings or civil litigation.

Insurance

Insurance affords a second line of protection against the direct financial impact of civil litigation. While there is no legal requirement that they do so, most funds arrange to purchase professional liability insurance, which typically provides coverage for indemnification of liabilities that funds are obligated to pay resulting from negligence or breach of duty by fund directors or officers in the good faith performance of their duties (though not for liabilities resulting from their fraud, dishonesty, or similar misconduct). As with indemnification, D&O/E&O insurance allows independent directors (1) to be reimbursed for liabilities, including legal expenses, incurred by them in fund-related civil litigation and (2) to receive "advances" to cover their legal and associated expenses, as those expenses are incurred by them in the litigation. Unlike indemnification, advancements covered by D&O/E&O insurance are paid by a third party, rather than directly out of fund assets.

Insurance is a vital component of any investment company's risk management program, providing a safety net against various risks associated with its operations. It helps protect the investment company's assets, directors, and officers, ensuring that they can perform their duties without the constant fear of financial loss due to unforeseen circumstances. There are several core insurance products that investment companies commonly purchase to mitigate these risks, including D&O/E&O insurance policies, independent directors liability (IDL) policies, and the investment company bond.

Core Insurance Products

- **Directors and Officers / Errors and Omissions (D&O/E&O) Liability Policy:** Protects individual directors and officers and insured companies against the financial impact of judgments, settlements, and legal defense costs incurred in shareholder lawsuits and regulatory investigations, and the costs of correcting certain operational errors.
- **Independent Directors Liability (IDL) Policy:** Provides comprehensive coverage tailored to address the concerns, and distinct insurance needs, of fund independent directors.
- **Investment Company Bond:** Protects insureds against specified losses caused by employee theft, third-party fraud, and certain other types of events, and meets the basic fidelity bonding requirement for funds under the 1940 Act.

D&O/E&O Policies

Broadly speaking, D&O/E&O insurance policies provide coverage for legal costs, settlements, and judgments arising from allegations of wrongful acts by directors or officers. D&O insurance specifically protects a company's leaders and decision-makers from personal financial loss stemming from their managerial or oversight actions. E&O insurance, on the other hand, covers the company and its employees from claims of negligence or mistakes in professional services provided.

In the fund industry, D&O and E&O coverages are typically combined in a single D&O/E&O insurance policy. These policies typically insure mutual funds themselves as well as their directors and officers. In addition, D&O/E&O policies frequently are structured to extend coverage to the funds' investment advisers and other affiliated service providers, along with the providers' own directors and officers.

D&O/E&O insurance plays a crucial role in protecting fund independent directors. This type of insurance coverage, often referred to as "Side A" coverage, comes into play when indemnification is not available to the directors. While "Side A" coverage is vital in many industries, its practical importance in the mutual fund sector is somewhat limited, mainly because funds rarely go bankrupt. Nonetheless, having this layer of protection often provides peace of mind and a sense of security for independent directors.

D&O/E&O insurance acts as a hedge, safeguarding the fund against potential losses of assets due to (1) the fund's indemnification obligations to its directors (including independent directors) and officers or (2) the fund's own liability exposure as an entity. By securing D&O/E&O insurance, independent directors protect not only themselves, but also the fund for which they are fiduciaries.

D&O/E&O insurance serves multiple purposes for mutual funds. It shields independent directors from personal liability when indemnification is not an option, and it bolsters the fund's defenses against potential financial liabilities. This dual function highlights the importance of D&O/E&O insurance as a critical component of a comprehensive risk management program for mutual funds and their leadership.

Key Insurance Coverages for Funds and Their Directors and Officers

- **Costs of defense in formal and informal regulatory investigations:** Regulatory investigations (e.g., SEC investigations) can be both formal and informal, and they often require substantial legal defense costs. Having insurance coverage for these costs ensures that funds and their directors and officers are not financially burdened by the expenses associated with defending against regulatory scrutiny. This coverage acts as a financial shield, allowing them to focus on compliance and their core responsibilities without the added stress of legal costs.
- **Costs of defense in prospectus liability lawsuits, plus costs of judgments and/or settlements:** Prospectus liability lawsuits can be particularly challenging, as they involve claims that the information provided in a fund's prospectus was misleading or incomplete. The costs of defending against such lawsuits, along with any judgments or settlements that may arise, can be significant. Insurance coverage for these expenses is crucial, as it helps protect the financial stability of the fund while ensuring that directors and officers can carry out their duties without fear of personal financial loss.
- **Non-party witness costs of independent directors:** Independent directors play a vital role in mutual funds, providing oversight and guidance. In this role, they may be called upon to serve as witnesses in legal proceedings related to the fund's activities. Insurance coverage for the costs associated with these non-party witness roles ensures that independent directors are not left to bear the financial burden of their participation in such proceedings. This coverage supports their ability to serve effectively and without hesitation.
- **Other (e.g., shareholder derivative demand investigation expenses):** There are various other risks that funds and their directors and officers may face, such as shareholder derivative demand investigations. These investigations can be complex and costly, requiring thorough legal and financial analysis. Insurance coverage for these types of expenses provides an additional layer of protection, ensuring that funds and their leadership can navigate these challenges without compromising their financial well-being.

IDL Policies

IDL, or independent directors liability insurance, is a strong safeguard for investment companies, providing a layer of protection specifically for the independent directors on a fund's board. It is designed to supplement the liability protections afforded to them by fund indemnification and by their funds' D&O/E&O liability insurance. IDL insurance mitigates the exposure of fund independent directors to various risks associated with indemnification and D&O/E&O insurance, including (1) indemnification risk (i.e., the risk that a fund will be financially unable or legally prohibited from paying indemnification to its independent directors) and (2) erosion risk, the risk that the underlying D&O/E&O insurance otherwise available for use by independent directors will be fully depleted through payments made on other covered claims.

In the fund industry, IDL policies are typically structured to insure only fund independent directors. IDL insurance thus serves as dedicated coverage for independent directors, and no other individuals (e.g., fund interested directors, fund officers) customarily have rights to collect under such insurance. As a result, in situations where underlying D&O/E&O insurance coverage is unavailable—such as when the policy limit has been exhausted—IDL insurance steps in to fill the gap. This ensures that directors are not left vulnerable and have the security they need to perform their duties effectively.

Two Types of IDL Insurance

- "Side A Only" – One type responds to non-indemnifiable losses of independent directors only.
- "Sides A and B" – A second type responds to both non-indemnifiable and indemnifiable losses of independent directors.

There are two basic types of IDL insurance available:

- "Side A Only" IDL: This type of IDL insurance responds exclusively to non-indemnifiable losses of independent directors. However, it is worth noting that, as discussed above, it is uncommon for financial or legal restrictions to prevent funds from indemnifying their independent directors.
- "Sides A and B" IDL: This type of IDL insurance is more comprehensive, as it responds to both non-indemnifiable and indemnifiable losses of independent directors. By covering a broader range of potential liabilities, this type of IDL insurance provides an extra layer of security and peace of mind for independent directors, ensuring they are protected regardless of the nature of the claim or the indemnification status.

IDL insurance can play a key component of a robust risk management program for mutual funds and their independent directors. By offering dedicated protection and addressing both non-indemnifiable and indemnifiable losses, IDL insurance ensures that directors can fulfill their roles with confidence, knowing they are well-protected against potential liabilities.

Investment Company Bonds

Bonds developed exclusively for investment companies are designed to protect insured entities against the financial impact of a direct actual loss of assets. Investment company bonds (often referred to as fidelity bonds) typically insure funds themselves and are frequently structured to extend coverage to the funds' investment advisers and/or other affiliated service providers.

The investment company bond is another crucial insurance product for investment companies. This bond offers protection against a range of risks.

Fidelity Coverage

Fidelity coverage, mandated by rule 17g-1 under the 1940 Act, is essential for registered investment companies. This rule requires funds to maintain bonding that specifically protects against employee larceny and embezzlement. This coverage ensures that a fund is financially protected if its employees commit acts of theft or embezzlement. By maintaining fidelity coverage, investment companies can mitigate the financial risk associated with dishonest acts by their "employees." Since virtually all funds are externally managed and have limited, if any, operations or employees of their own, investment company bonds typically define "employee" broadly, such that the definition often includes the officers, directors, trustees, partners, or employees of a fund's affiliated investment adviser, underwriter, transfer agent, shareholder accounting recordkeeper, or administrator (as well as certain other people, including the fund's attorneys).

Third-Party Fraud Coverages

While coverages for fraud by third parties (i.e., persons who are not fund "employees") are not required under the 1940 Act, these coverages are widely available and can be beneficial for investment companies. For example, investment company bonds typically include protection against losses resulting from the forgery or alteration of checks and other financial instruments by third parties. Additionally, investment company bonds often cover fraudulent requests for transactions in shareholder accounts (e.g., unauthorized redemptions of fund shares). By purchasing these coverages, a fund can safeguard itself against financial losses stemming from fraudulent activities initiated by external parties.

Coverage for Other Designated Risks

A fund complex may also qualify for coverage for other designated risks. For example, under a "computer security" insuring agreement, an insurer provides limited coverage for direct financial losses resulting from technology-related crimes committed by outside "hackers" or other unauthorized users (e.g., a hacker's transfer of funds from the insured's bank account to the hacker's bank account) through the unauthorized entry, deletion, destruction, or alteration of data within an insured's proprietary computer systems. While a computer security insuring agreement typically provides coverage for certain enumerated technology-related losses, it does not, for example, cover indirect losses and/or non-financial losses from hacks, such as business disruption expenses, remediation expenses, notification expenses associated with data loss, and ransom payments. As such, the computer security insuring agreement is not intended to, and does not, replace separate standalone cyber-liability insurance (discussed below).

Other More Specialized Liability Products

In addition to the core types of insurance described above, independent directors should be aware of several other specialized liability products (discussed below) that (1) protect fund advisers and/or other affiliated service providers and (2) may be bundled with core coverages (particularly at a small to mid-size fund complex). These include fiduciary or ERISA liability insurance, which safeguards those managing employee benefit plans, and employment practices liability (EPL) insurance, designed to protect against claims related to employment rights. Additionally, in our digital age, cyber-liability insurance has become more prevalent in protecting against the financial repercussions of cyber incidents.

While these other specialized liability products are not typically for funds, independent directors may wish to consider such products in connection with their assessment of the insurance coverage of fund advisers and/or other affiliated service providers. Fund boards typically consider insurance coverage of fund advisers and/or other affiliated service providers in connection with the contract renewal and approval process.

Fiduciary Liability Insurance

Fiduciary liability insurance is important for any organization managing employee benefit plans, including pensions, health insurance, and other welfare plans. This type of insurance, often referred to as ERISA (Employee Retirement Income Security Act) liability insurance, protects fiduciaries—those who have discretionary control over plan management or assets—against claims of breach of fiduciary duty. These claims can arise from alleged errors in the administration of an ERISA plan, such as improper advice, plan mismanagement, or conflicts of interest. In essence, fiduciary liability insurance ensures that the individuals entrusted with managing employee benefits can do so without the fear of personal financial loss if something goes awry.

Employment Practices Liability (EPL) Insurance

Employment practices liability (EPL) insurance is designed to protect businesses against claims made by employees, former employees, or potential employees regarding their employment rights. These claims can include allegations of discrimination, wrongful termination, sexual harassment, and other employment-related issues. In today's workplace environment, where awareness and sensitivity to employment practices are higher than ever, EPL insurance provides a crucial safety net. It covers legal costs, settlements, and judgments, allowing employers to navigate these complex and often contentious issues with confidence. By having EPL insurance, companies can ensure that they handle employment disputes professionally and fairly, minimizing the risk of significant financial impact.

Cyber-Liability Insurance

In an increasingly digital world, cyber-liability insurance has become an important component of a comprehensive risk management program. This type of insurance protects businesses against financial losses that can result from cyberattacks, data breaches, and other cyber incidents. Cyber-liability insurance typically covers expenses related to data recovery, legal fees, notification costs, and even public relations efforts to manage the fallout from a cyber incident. With the rise in frequency and sophistication of cyber threats, cyber-liability insurance has become more common. Cyber-liability insurance provides businesses with the financial support and resources needed to swiftly respond to and recover from cyber incidents, ensuring their operations can continue with minimal disruption.

Modular Liability Policies

Modular liability policies (sometimes referred to as basket aggregate or blended policies) combine D&O/E&O coverage with other liability coverages, such as employment practices liability (EPL), cyber-liability, and/or fiduciary liability. Each coverage module comes with insuring agreements, conditions, and exclusions that are specific to that type of coverage. These policies are often subject to aggregate limits of liability.

The size and structure of a fund complex may influence whether this type of product is appropriate. For example, small to mid-sized fund complexes sometimes choose to purchase modular liability policies. While such policies may be a cost-effective way to purchase multiple coverages, independent directors may wish to consider the potential risks and benefits of such policies (including, for example, the heightened risk of erosion of available D&O/E&O coverage due to amounts paid under other coverage modules).

Questions and Considerations for Independent Directors

Independent directors play an essential role in overseeing the process of selecting and approving insurance coverage for investment companies. In evaluating various insurance options, directors help to ensure that the coverage chosen aligns with the fund's risk profile and risk tolerance, adequately protects the interests of all stakeholders, and complies with regulatory requirements.

Set forth below are potential questions for directors to consider with respect to the insurance process broadly, as well as with respect to each of the core insurance products. The insurance decision-making process necessarily involves business judgments by independent directors, among others.

Questions and Considerations Related to the Insurance Process

How to structure an insurance program?

Structuring an insurance program for a fund complex involves a comprehensive assessment of the fund complex's risk exposures and overall financial health. This process begins with identifying key risks that the fund complex faces, such as operational risks, compliance risks, and market risks. Once these risks are understood, the next step is to determine the appropriate type and amount of coverage needed. This typically involves a mix of D&O/E&O coverage, IDL coverage, investment company bond coverage, and other specialized coverages. Ensuring that the coverage limits are adequate and that there are no gaps in protection is crucial. The structure of the insurance program should be reviewed regularly to adapt to any changes in the fund complex's risk profile.

Which entities to include as insureds?

There are two commonly used approaches—"funds-only" or "joint"—to configuring D&O/E&O and investment company bond coverages. Other variations may also be available.

A **"funds-only"** D&O/E&O policy (or investment company bond) typically covers all funds within a fund complex (or certain groups of funds, as when a fund complex has multiple boards), together with the directors and officers of those funds. A funds-only policy may make sense when the adviser and other non-fund entities already have coverage through their own parent company's insurance program (as may be the case when the fund complex is just one of several business units in a larger organization). Master series trusts, given their unique structure (e.g., their use of multiple unaffiliated advisers), generally choose to purchase funds-only policies.

A **"joint"** or **"joint plus"** D&O/E&O policy (or investment company bond) extends beyond the funds-only policy to include as insureds one or more affiliated advisers and/or other affiliated service providers (together with the affiliated providers' own directors and officers). Under a joint policy, coverage for service providers may be limited to services provided only to investment companies. Whereas, under a joint plus policy, coverage for service providers may also extend to services provided to others (e.g., private advisory accounts). Joint policies are often the most cost-effective approach to purchasing insurance and frequently permit individual funds (and their directors and officers) to secure more aggregate coverage at lower overall premiums than would otherwise be feasible for them.

A variety of factors may be considered in choosing between funds-only and joint insurance coverages. These factors may include (1) the overall premiums, (2) the potential for coverage disputes between and among insureds and various insurers, (3) the allocation of premiums and/or limits, and (4) the risk of service provider losses eroding policy limits that might otherwise be available to funds and independent directors.

How much insurance coverage to purchase?

Determining the amount of insurance coverage to purchase is a critical decision that requires careful consideration of several factors. These include the nature and size of the fund complex, the complexity of its operations, and the regulatory environment in which it operates. Since the cost of insurance premiums is reflected in a fund's expense ratio, it is essential to strike a balance between sufficient coverage to protect against potential losses and the cost of the insurance.

The question of how much insurance coverage to purchase may be influenced by a number of factors. As for a fund's own coverage, while management typically provides the directors with one (or more) suggested insurance programs, the ultimate responsibility for this decision rests with the fund's board, which may consider various factors, including:

- The amount of assets and types of fund(s) being insured;
- The scope of coverage being afforded (e.g., funds-only, joint, or joint plus);
- The structure of the fund complex's overall insurance program (e.g., is separate IDL insurance being purchased?); and
- The fund complex's claims history.

Peer Reports

Insurers and/or brokers often provide peer reports, upon request, to assist in the consideration of appropriate levels of insurance coverage to purchase. A peer report shows how an insured's insurance limits and deductibles compare to those of other fund complexes with a similar amount of assets under management.

D&O/E&O and IDL insurance policies are issued with specified aggregate limits of liability. This means that each individual policy is subject to a maximum dollar limit on the amount that the insurer may be required to pay, individually or collectively, to any and all insureds for any and all insurance claims under that policy. This maximum dollar limit is referred to as the policy's "limit of liability."

By contrast, investment company bonds typically have limits of liability offered on an "each and every occurrence" basis (often referred to as "per-occurrence" coverage) under most standard insuring agreements. This means that the full stated limit of liability is available for each and every covered "single loss," even if there have been other prior "single losses" during the bond period. Some investment company bonds may specify an aggregate limit of liability for certain insuring agreements. For example, grants of ancillary coverage, such as for social engineering fraud, may be subject to an aggregate limit of liability over a given policy period.

How to allocate insurance premiums?

Where multiple entities are covered by the same insurance policy, allocating the premium costs of insurance across different insured entities can be a complex task. While there is no single appropriate method of allocating such costs, the allocation should seek to reflect the risk exposure of each insured and ensure that the costs are distributed in a fair and equitable manner. For funds-only policies, for example, fund boards may consider whether it would be appropriate to allocate premiums among insured funds based on fund size or whether other criteria should also be considered. For joint policies, fund boards typically consider both (1) what portion of the premiums should be allocated to non-funds (e.g., an insured adviser) and (2) the allocation of premiums among insured funds. For instance, fund boards might consider some or all of the following: the extent to which private advisory assets are covered under the policies; the loss histories of covered fund service providers; prior allocations of premiums; or separate premium quotations for funds-only and service provider-only policies. Allocation determinations may evolve over time to reflect changes in, among other things, a fund group's business model, risk exposure, loss history, and an adviser's (or affiliated service provider's) level of access to other insurance.

How to allocate insurance limits?

Under joint or joint plus insurance policies (i.e., those covering multiple insureds), there is a potential risk that coverage for fund independent directors may be unavailable or constrained if policy limits are eroded by claims against other insureds. To address this possibility, independent directors may wish to consider a variety of mechanisms such as reserved limits, internal agreements, "priority of payment" provisions, or standalone IDL coverage to ensure that coverage remains available to them. Each of these mechanisms is described below.

- **Reserved limits** in an insurance policy refer to setting aside specific amounts of coverage for certain types of claims or individuals, such as independent directors. This ensures that coverage is available when needed, without being depleted by other claims.
- Independent directors may enter into **internal agreements** with other insureds (such as the fund's investment adviser) outside of the insurance policy, under which independent directors would be guaranteed some minimum amount of coverage and/or coverage would be pre-allocated among insureds in the event losses should exceed the policy limit.
- A **priority of payments** provision in an insurance policy dictates the order in which claims will be paid out and may be structured, for example, to ensure payment of directors and officers before other insureds are paid. This approach may limit the flexibility that a fund complex might otherwise have to coordinate when and how much each insured gets paid.
- An alternative (or supplemental) option for independent directors is an **IDL policy**, which typically sits above (i.e., in excess of) underlying D&O/E&O coverage.

How to choose an insurer?

Selecting the right insurer (or insurers) is vital to ensuring that the fund receives reliable and responsive coverage. Factors to consider include the insurer's financial stability, reputation in the market, and experience in providing coverage for similar funds. It is also beneficial to look at the insurer's claims handling process and its ability to provide tailored solutions that meet the specific needs of the fund. Building a strong relationship with the insurer can lead to better service and more favorable terms. Consulting with insurance brokers who have a deep understanding of the industry may also aid in making an informed decision.

Whom to consult on insurance issues?

When addressing insurance issues, it may be beneficial for fund boards to consult with a range of experts who can provide diverse perspectives and insights. This includes insurance brokers, legal counsel (including independent directors counsel), and financial consultants who specialize in the mutual fund industry. Engaging with professionals can help directors understand the nuances of different insurance products and their implications for the fund. Internal stakeholders, such as the fund's chief compliance officer and key risk management personnel, might also be involved in the conversation with the goal of aligning the insurance program with the fund's overall risk management strategy.

Whether to choose a single insurer or multiple insurers?

One basic insurance choice faced by many fund complexes is whether to place their D&O/E&O insurance with a single insurer or with multiple insurers in what is commonly referred to as a "layered" insurance program. The latter, often referred to as an "insurance tower," consists of a layered arrangement of multiple insurance policies, including a primary policy and various excess policies. When the limits of the primary policy are exhausted, the next layer is implicated. A variety of factors may be considered in choosing between a single insurer and multiple insurers, including diversification of risks, the financial strength of the insurers (and their reinsurers), and the relative convenience of the claims adjustment process. In addition, other fund complexes may choose to augment their programs with IDL insurance.

Questions and Considerations About D&O/E&O Policies

What deductible amount applies to losses?

When considering D&O/E&O insurance policies, it is important to understand the impact of deductibles. Deductibles are the amount that the insured must pay out of pocket before the insurance policy kicks in. Higher deductibles can lead to lower premium costs, but they also mean more out-of-pocket expenses in the event of a claim. The deductible levels for fund complexes' insurance policies reflect, among other things, different risk tolerances. Many fund groups seek D&O/E&O policies that have no deductible for such losses. This is because their own individual assets would be used to satisfy the deductible for such non-indemnifiable losses.

How does the insurer define a "claim"?

The definition of a "claim" in an insurance policy can vary from policy to policy. It is important for directors to understand how the policy defines a claim because the scope of what constitutes a claim can affect how and when coverage is triggered. For example, while the definition of claim typically includes formal regulatory investigations (e.g., where a regulator has filed a notice of charges or entered a formal order of investigation), it may or may not extend to informal regulatory investigations.

How does the insurer define "loss"?

The definition of a "loss" within an insurance policy is important to understand. This definition will determine what types of expenses, damages, or settlements are covered. It is essential to ensure that the policy's definition of loss is comprehensive enough to cover potential liabilities the funds may face, including legal fees, settlements, and judgments.

What are the key exclusions of the policy?

Every insurance policy comes with exclusions, which are scenarios or conditions not covered by the policy. Common exclusions in D&O/E&O policies include fraud and claims between insured parties. It is important to review these exclusions carefully to understand any potential gaps in coverage.

How does the policy treat fund independent directors that are non-party witnesses, such as in excessive fee litigation or regulatory investigations?

Insurance coverage for a non-party witness can be critical for fund independent directors, as they may be called upon to testify (or otherwise incur costs) without being direct targets of a lawsuit or regulatory investigation. Ensuring that the policy addresses these specific needs can provide additional peace of mind for independent directors.

How do claims by one insured impact others under the same policy?

Severability refers to the ability to separate different parts of a policy or application, so that wrongdoing or a misrepresentation by one insured does not affect the coverage of others. This is particularly important in cases of fraud exclusions and misstatement in the insurance application, as it ensures that others, such as independent directors not involved in the accusations and other innocent parties, remain covered.

What happens to the policy if the fund is acquired, merged, or liquidated?

Insurance policies can be affected by significant corporate transactions such as acquisitions, mergers, and liquidations. It is crucial to understand how the policy will respond in these scenarios. Some policies may terminate coverage or require additional endorsements. Planning ahead and discussing these potential changes with the insurer can ensure continuous coverage.

Is a fund independent director covered after retiring or leaving the board?

It is important to ensure that a director who retires or leaves the board is still protected by insurance coverage. A tail policy, or an extended reporting period endorsement, can provide coverage for claims made after a director has left the board, or the fund has been liquidated, merged, or acquired, and helps to ensure long-term protection

for the outgoing director. A tail policy extends the period during which a claim can be reported after the original policy has expired or after an individual has stepped down from the board. This extension is crucial for covering claims that arise from actions taken while the policy was in effect but are discovered after the director has left the board. This protection also helps in maintaining confidence among directors that they will not have personal liability after their board service.

How may a gap in coverage be avoided when changing insurance carriers?

Transitioning between insurance carriers can introduce risks, especially if there is a gap in coverage. Ensuring continuity of coverage requires careful coordination between the outgoing and incoming insurers. Policy provisions relating to prior acts and/or prior knowledge can help bridge these gaps and provide seamless protection during the transition.

Questions and Considerations About IDL Policies

Which type of IDL—Side A Only or Sides A and B—is appropriate?

As described above, there are two main types of IDL coverage: "Side A Only" and "Sides A and B". The former type (Side A Only) responds exclusively to non-indemnifiable losses of independent directors. This distinction is particularly important in cases where the directors are not indemnified by the funds they oversee. The latter type of coverage (Sides A and B) is more comprehensive and responds to both non-indemnifiable and indemnifiable losses of independent directors. By covering a broader range of potential liabilities, Sides A and B IDL insurance helps ensure they are protected regardless of the nature of the claim or the indemnification status. Understanding which type of coverage is being offered can ensure that independent directors are making a fully informed decision about the scope of coverage.

What are the limits of liability, scope of coverage, and terms and conditions of the fund's underlying D&O/E&O insurance?

An IDL policy generally sits in excess of a fund's D&O/E&O insurance. As a result, when considering an IDL policy, it is important to consider key attributes of the fund's underlying D&O/E&O policy, including its liability limits and any applicable deductibles, whether it is a funds-only or joint policy, and its terms, conditions, and exclusions.

Are there any special "drop-down" provisions in the IDL policy?

As noted above, an IDL policy typically sits in excess of underlying D&O/E&O coverage. Typically, an excess policy affords coverage only in the event the underlying coverage has been depleted through payment of claims. Some IDL policies, however, may include a drop-down provision to provide primary coverage for independent directors if the underlying coverage is:

- canceled by any insured other than the independent directors;
- terminated by reason of acquisition or merger;
- rescinded;
- uncollectible as a result of the underlying insurer's final determination that the loss is not covered; or
- uncollectible as a result of the underlying insurer's insolvency.

Can the IDL policy be canceled or rescinded?

Most IDL policies cannot be canceled or rescinded for any reason other than non-payment of premium; however, it is possible for them not to be renewed. By way of contrast, standard D&O/E&O policies can be canceled for any reason with adequate prior notice. Under standard D&O/E&O policies, there also is the possibility that coverage could be rescinded in the event the applicant makes a material misstatement in its insurance application.

Questions and Considerations About Investment Company Bonds

Consideration of investment company bonds is also essential, particularly in the context of the requirements of rule 17g-1 under the 1940 Act. This rule requires board approval and is a critical aspect of ensuring proper oversight and risk management within investment companies.

What is the breadth of fidelity coverage?

Registered funds are required to maintain fidelity bonding against larceny and embezzlement by employees. As discussed above, investment company bonds typically provide a broad definition of "employee" such that the officers, directors, trustees, partners, or employees of certain fund service providers are often included in the bond's definition of an "employee" of the fund. The fidelity coverage in investment company bonds is typically much broader (e.g., it may extend not only to larceny and embezzlement, but to any "dishonest or fraudulent act" committed with the requisite intent).

Is third-party fraud typically covered as part of investment company bond coverage?

Investment company bonds often include coverages for losses from frauds committed by third parties (i.e., by individuals other than "employees," as broadly defined). Such frauds may include the forgery or alteration of checks and other defined instruments (including written requests to redeem fund shares by shareholder impostors) or fraudulent requests for transactions made by phone, fax, or over the internet. These coverages may be valuable to a fund complex. Indeed, a substantial portion of amounts paid under investment company bonds typically is attributable to these types of bond losses.

How does an investment company bond work?

The standard coverages available under many investment company bonds are offered on an "each and every occurrence" basis (also known as "per occurrence"), which means that the full stated limit of liability is available to cover each and every single loss, even if there have been other losses during the coverage period. In contrast, certain specialized coverages available by separate rider, such as for social engineering fraud, may be subject to an overall aggregate limit of liability.

Conclusion

This paper is designed to provide an introduction to and overview of insurance for fund complexes. It is designed to assist fund independent directors in evaluating various insurance options and making informed business judgments in the process of selecting and approving insurance coverages. Fund independent directors may also wish to refer to the following appendices, which set forth (1) a description of key fund industry risks and related insurance considerations and (2) a glossary of insurance terms.

This paper is designed to provide key information to independent directors and should not be construed or relied upon as legal advice. Each situation is different and fund independent directors or other interested parties should look to their own counsel for guidance. Of course, the terms and conditions of individual insurance coverages, as set forth in individual insurance policies, will govern any coverage questions arising in the context of any particular insurance claim.

Appendix A: Fund Industry Risks

This appendix provides an overview of specific risks common to the fund industry based on claims ICI Mutual has seen involving funds and their independent directors. Broadly speaking, as discussed below, the three broad categories of claims for the fund industry are **regulatory investigations/actions, shareholder litigation,** and **operational errors.**

Regulatory Investigations and Actions

Investigations and actions by regulators such as the SEC are a significant source of claims within the fund industry. Regulatory matters may include (1) investigations, (2) administrative proceedings, and/or (3) judicial actions (civil and criminal). While the SEC is the primary regulator of the fund industry, other regulators, such the Financial Industry Regulatory Authority (FINRA), the Commodities Futures Trading Commission (CFTC), the Department of Labor (DOL), state securities regulators, and foreign regulators, may institute regulatory investigations and actions that may involve and/or implicate registered funds, their directors and officers, and/or their affiliated service providers.

A fund complex involved in regulatory investigations typically incurs costs of defense (which may be significant). Resolutions of regulatory investigations may involve settlement payments, disgorgement, fines, civil money penalties, and various non-monetary penalties. Generally speaking, D&O/E&O insurance coverage is potentially available for costs of defense and settlements, but not for disgorgement, fines, and penalties.

Insurance Consideration

Is insurance coverage available for informal regulatory investigations, as well as formal regulatory investigations?

Takeaway

Fund independent directors may be, but rarely are, implicated (or called as non-party witnesses) in regulatory investigations and actions.

Private Shareholder Litigation

Private securities litigation brought by fund shareholders is a perennial area of risk for funds, their advisers and other affiliates, and their officers and directors (including independent directors).

Fund shareholders may file lawsuits about matters such as disclosure-based claims, fee challenges, or breaches of fiduciary duty (discussed below). These lawsuits may be brought under a variety of theories, alleging violations of federal and/or state law. Independent directors may be named as defendants. Even if not named as defendants, they may incur expenses as non-party witnesses in the lawsuits.

Non–Securities-Related Litigation

Fund complexes are, of course, subject to other types of litigation beyond securities-related lawsuits, including litigation arising from employment practices, supplier disputes, or other routine business matters.

Disclosure-Based Litigation

"Prospectus liability" lawsuits—i.e., shareholder class action lawsuits brought under the Securities Act of 1933 that allege misrepresentations or omissions in the disclosure in fund prospectuses—have long been a source of significant potential liability for funds and their directors, officers, advisers, and principal underwriters. Indeed, for independent directors, these lawsuits may be viewed as their primary liability exposure. Fund shareholders may also raise challenges to disclosure in class action "securities fraud" lawsuits brought under the Securities Exchange Act of 1934.

In disclosure-based litigation, defendants typically include funds, their directors (including independent directors) and officers, and fund advisers and other affiliates. These lawsuits may involve significant settlement amounts (and costs of defense); indeed, the industry has seen nine-figure settlements in disclosure-based lawsuits.

Insurance Consideration

Given the potential magnitude of prospectus liability lawsuit settlements (and associated defense costs), are the insurance limits sufficient?

Takeaway

Generally speaking, fund independent directors must demonstrate that they exercised "due diligence" with respect to fund disclosure.

Excessive Fee Litigation

Fee-based litigation, particularly under section 36(b) of the 1940 Act, poses another risk, chiefly to fund advisers. Section 36(b) imposes a fiduciary duty on investment advisers with respect to the compensation they receive for providing advisory services to registered funds. The statute expressly authorizes both the SEC and fund shareholders to bring lawsuits in federal court for breaches of this fiduciary duty. This type of litigation challenges whether the fees charged by a fund are excessive and not in the best interest of shareholders.

Excessive fee litigation typically is brought against fund advisers and, on occasion, other service providers to funds. The funds themselves and fund directors typically are not named as defendants. It is worth noting that independent directors, while not named as defendants, may be key non-party witnesses and may incur significant legal costs in such lawsuits.

Insurance Consideration

Is insurance coverage available for non-party witness expenses of independent directors in section 36(b) litigation?

Takeaway

A continued focus by independent directors on three fundamental principles—preparation, process, and documentation—can assist in managing "front-end" risk in section 36(b) litigation. A robust section 15(c) review process should reflect these fundamental principles.

Independent directors therefore should understand whether their funds' D&O/E&O policies (and IDL policies) will cover their legal costs as non-party witnesses.

State Law–Based Litigation

Lawsuits based on state or common law against fund complexes typically take one of two forms: either a derivative action purporting to be filed on behalf of funds themselves, or a class action purporting to be filed on behalf of groups (or "classes") of fund shareholders. In both cases, the named defendants typically include fund advisers, other affiliates, and fund directors, including independent directors, and officers. These lawsuits may involve significant settlement amounts (i.e., as high as eight-figure settlements).

In the case of a derivative lawsuit, applicable state law typically requires that shareholders make a so-called derivative demand on a fund's board of directors. In response, the fund itself—through appropriate fund representatives (e.g., a special committee of the fund board, outside counsel)—usually conducts a shareholder derivative demand investigation (SDDI) to determine whether pursuing litigation alleging violations of state and/or common law would be in the best interests of the fund. A determination not to pursue litigation that is "made in good faith by independent decision makers after reasonable inquiry" generally results in termination of the litigation by the courts.

Insurance Consideration

Is insurance coverage available for the costs of conducting shareholder derivative demand investigations?

Takeaway

The central role of fund independent directors in derivative litigation highlights the importance of acting in good faith, with due care, and in the best interests of the funds they oversee, while maintaining a robust decision-making process.

Recent examples of state law–based litigation include litigation involving closed-end funds, often initiated by activist shareholders of closed-end funds and typically focused on various governance issues.

Other Litigation (e.g., ERISA)

The plaintiffs' bar has also used ERISA as a legal avenue to attack the fund industry. In that regard, in the past fifteen years, there have been dozens of ERISA-based lawsuits challenging the inclusion of "proprietary" mutual funds within the offerings of in-house 401(k) or similar employee benefit plans sponsored by asset managers and/or their affiliates.

Insurance Consideration

Does the adviser and/or affiliated service providers have specialized fiduciary liability insurance to cover ERISA-based and similar claims?

Typically structured as class actions, these lawsuits frequently allege that the named defendants (which may include one or more entities, committees, and/or individuals) have breached their fiduciary duties under ERISA and/or engaged in "prohibited transactions," by including in their in-house plans proprietary mutual funds that allegedly have charged excessive fees and/or underperformed relative to purportedly similar nonproprietary

funds (i.e., funds offered by other asset managers). Neither funds nor their independent directors are typically named in these lawsuits. Nonetheless, the resolution of such lawsuits could have reputational and other implications for the adviser and the adviser's business and therefore be of interest to independent directors.

Takeaway

Fund independent directors are unlikely to be implicated in ERISA litigation.

Operations-Based Errors

Finally, operations-based errors, although perhaps less headline-grabbing, are a frequent source of insurance claims for the fund industry. These errors can include administrative mistakes, processing errors, or failures in operational controls by advisers and/or their affiliates. Where an operational error adversely impacts a fund, issues of legal and financial responsibility are typically resolved directly and without litigation by the parties involved.

Under traditional D&O/E&O policies, 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). 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 of either (1) waiting for its affected funds or clients to sue, thereby triggering the potential for the adviser's insurance policy to respond, or (2) unilaterally "correcting" the error, thereby forgoing the potential for any insurance recovery. Broadly stated, costs of correction insurance addresses this dilemma by enabling an insured adviser and/or affiliated service providers 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.

Insurance Consideration

Does the fund complex's insurance include costs of correction coverage for operations-based errors?

What are the scope, terms, and conditions of the coverage? For example, does the coverage respond to trade errors only or to other operations-based errors?

Takeaway

Fund independent directors are unlikely to be implicated in a costs of correction claim. This is a potential exposure for advisers and other service providers.

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 viewed as a coverage for insured advisers rather than for insured funds themselves. 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. It is even more difficult to envision circumstances under which independent directors would be implicated in this type of claim.

Appendix B: Glossary

- **17g-1 Bond** – This is a type of bond that specifically satisfies the fidelity bonding requirements of rule 17g-1 under the 1940 Act and covers employee larceny or embezzlement. As noted above, investment company bonds typically provide a broad definition of "employee" such that the officers, directors, trustees, partners, or employees of a fund's affiliated investment adviser, underwriter, transfer agent, shareholder accounting recordkeeper, or administrator (as well as certain other people, including the fund's attorneys) are often included in the bond's definition of an "employee" of the fund.
- **Advancements** – This refers to the pre-payment of legal expenses by the insurer as claims are being defended, rather than waiting until the case is resolved.
- **Claim** – This term refers to a lawsuit, arbitration, or other proceeding initiated against, or a formal (and, in some policies, an informal) investigation involving, an insured or a director or officer.
- **Claims-Made** – The term "claims-made" refers to the type of insurance coverage where a claim must be made during the policy period for it to be valid. This is common in liability insurance policies, such as D&O/E&O insurance. D&O/E&O and IDL policies often permit an insured to provide notice, before a claim has been made against an insured, of circumstances that may subsequently give rise to a claim being made. This type of notice, commonly referred to as a precautionary notice, effectively bookmarks the current D&O/E&O or IDL policy for a potential future claim.
- **Deductible (also known as a Retention)** – The "deductible" is the amount paid out of pocket before the insurance coverage is available.
- **D&O (Directors & Officers) Insurance** – This insurance protects individual directors and officers from personal losses if they are sued for alleged wrongful acts in the course of their duties.
- **E&O (Errors & Omissions) Insurance** – Also known as professional liability insurance, E&O covers the insured entity against claims for inadequate work or negligent actions.
- **Endorsement (or Rider)** – An "endorsement" (or "rider") is an amendment to insurance policy that changes its terms or coverage. This could be to add additional coverage for a specific risk or to alter existing coverage. Endorsements allow customization of policies.
- **Erosion Risk** – The risk that the underlying D&O/E&O insurance otherwise available for use by independent directors will be fully depleted through payments made by the D&O/E&O insurer on other covered claims.
- **Excess Policy** – A secondary policy providing additional coverage beyond the limits of the insured's primary policies.
- **Exclusion** – An "exclusion" is a provision in an insurance policy that eliminates coverage for certain risks, situations, specific types of payments or expenses, or particular behaviors.
- **Fidelity Bond** – While narrowly used to describe a bond covering losses from employee dishonesty, the term can also refer to a broader bond covering other types of losses.
- **Indemnification** – This refers to the protection against financial loss, where fund directors use fund assets to cover legal expenses and other financial liabilities they might incur as defendants or non-party witnesses in fund-related cases.

- **Investment Company Bond** – This bond both satisfies the rule 17g-1's fidelity bonding requirements and typically provides other types of coverages (e.g., forgery and alteration, unauthorized or fraudulent phone/electronic transactions).
- **Limit of Liability** – The "limit of liability" indicates the maximum dollar amount that an insurer may be required to pay under an individual policy during the policy period. In certain circumstances, insuring agreements and/or coverage grants may be subject to sublimits.
- **Loss**
  - In D&O/E&O policies, the term "Loss" broadly refers to amounts which a company or its directors and/or officers are legally obligated to pay (or for which a company is required to indemnify the directors or officers or for which the company has, to the extent permitted by law, indemnified the directors or officers) for a claim or claims made against the company or its directors and/or officers for wrongful acts. "Loss" typically includes damages, judgments, settlements, and costs of defense, but does not include fines or penalties or amounts deemed uninsurable under applicable law.
  - In IDL policies, the term "Loss" broadly refers to amounts which a company's independent directors are legally obligated to pay for a claim or claims made against the independent directors for wrongful acts. As under D&O/E&O policies, "Loss" typically includes damages, judgments, settlements, and costs of defense, but does not include fines or penalties or amounts deemed uninsurable under applicable law.
  - "Loss" is typically undefined in investment company bonds but is understood to be financial in nature.
- **Notice** – In insurance, "notice" is the formal process of informing an insurer about a loss or claim. Timely notice is often a requirement in an insurance policy, and failing to provide it can jeopardize coverage.
- **Premium** – The "premium" is the amount a fund complex pays for insurance coverage, typically on an annual basis. The amount and allocation of a premium vary across the industry and are influenced by various factors, including the level of coverage, claim history, and risk profile.
- **Professional Liability** – Insurance that protects professionals against claims of negligence or mistakes made in their professional services.
- **Side A (Direct Coverage)** – This coverage applies when the insured entity cannot indemnify its directors and officers. Although significant in the broader corporate world, it is less relevant in the fund industry where fund bankruptcies are rare, and indemnification is generally available.
- **Side B (Company Reimbursement Coverage)** – This coverage allows the insured entity to seek reimbursement from the insurer for indemnification amounts it pays to its directors and officers due to claims made against those individuals.
- **Side A-Only IDL** – This policy specifically covers non-indemnifiable exposures of fund independent directors when the fund's underlying D&O/E&O insurance does not respond.
- **Sides A and B IDL (Safety Net IDL)** – This policy is designed to cover both non-indemnifiable and indemnifiable exposures of fund independent directors when the fund's underlying D&O/E&O insurance does not respond.
- **Tail Policy** – A tail policy extends the period during which a claim can be reported after the original policy has expired or after an individual has left the organization. This extension is crucial for covering claims that arise from actions taken while the policy was in effect but are discovered later.

- **Underwriting** – The process by which insurers evaluate the risk of providing insurance and determine the appropriate premium and coverage terms.
- **Wrongful Act** – A "wrongful act" encompasses any action or omission that can result in a legal claim. In the context of liability insurance, this could be anything from professional negligence to breach of duty. Knowing what constitutes a wrongful act in the policy can assist in understanding what is and is not covered.