

Analyzing loss exposures isn't just for insurance professionals

Each year the Department of Labor observes a National Financial Literacy month, and while Investment Adviser Representatives are well-versed in assessing their clients' risk tolerances, the same care is not always taken when examining their own professional liability needs. The adviser who can speak to a client about the pros and cons of a general obligation revenue bond versus a government Treasury bill may not use the similar level of scrutiny when reviewing the risks faced by their Registered Investment Advisory (RIA) vis-à-vis the policy that is designed to cover it. Often, there are sources of potential losses that are not addressed by current coverage and are easily missed.

Establishing an enterprise risk management (ERM) program is regarded as an effective way for organizations to manage the various internal and external risks they face. One of the basic tenets of ERM is to analyze loss exposures, that is, to identify areas that will drain net income, reduce future revenue sources, or in some way negatively affect the business. While the value of an ERM approach over that of a traditional risk management approach is outside the scope of this article, the thrust behind it is to consider the impact of **all** types of risks: internal, external, cyber, and otherwise.



As the steward of not only their clients' assets but of the viability of their business, advisers should evaluate where risks exist and in what form they take, and be sure to take steps to address them. It is not enough to say, 'I have E&O insurance, I'm covered.' It's important to look at the services provided by the RIA and determine whether the policy will provide coverage should an error, loss, or data breach occur.



Here are 6 of the most important areas of risk faced specifically by RIAs; compliance-related matters, trading errors, wire fraud, data breaches, media liability, and management liability. As an RIA, in what areas are losses or expenses likely to arise and, most importantly, does the RIA's existing professional liability insurance help mitigate them?

Compliance-related risk

RIAs face potential loss exposures from many fronts. It can be difficult to keep up with the ever-changing regulatory environment. Accusations that the adviser fell short of his or her fiduciary responsibility, that disclosure of CDSCs and/or surrender charges weren't properly documented, or that unsuitable investments were recommended are among the most commonly litigated areas. Retaining a knowledgeable compliance professional, such as National Compliance Services, to help advisers in these areas proves valuable. Nonetheless, the cost to defend even spurious accusations can add up, so a policy that contains a "duty to defend" clause is essential.

Trade error risk

Discretionary advisers face loss exposures in their day-to-day trading activity. Even the most diligent adviser will occasionally make an error that imposes immediate monetary consequences, and Murphy's Law dictates that there's a good chance the erroneous trade will move against you. Most RIAs have a trade error policy, but not all insurance policies will cover this cost to "make your customer whole" when you sold instead of bought or neglected to buy or sell when instructed. Having a policy that covers this makes sense.





Wire fraud risk

Gone are the days when an email would inform you that West African riches from a Nigerian Prince would be wired to you, provided you replied with your personal bank account information. Today, cybersecurity risks take several more subversive forms. Most broker dealers require a client signature in order to release funds via wire transfer. What this amounts to is less a security measure and more a way for the B/D to limit their liability. Because it is the adviser that initiates the request, the onus on validating the legitimacy of the funds request is still on the adviser, and fraudsters are increasingly using deceptive means to misrepresent themselves in these transactions. This is a loss exposure that should be addressed.

Data breach and breach mitigation risk

Risks that a hacker may infiltrate the systems of an RIA that house client data are prevalent. This is due in no small part to the fact that the RIA functions as an intermediary of valuable, often liquid, assets. John Reed Stark, managing director in the Washington, D.C. office of the IT firm **Stroz Friedberg** and former chief of the SEC's Office of Internet Enforcement, says, "I think the risk to IAs is very scary. One breach can bring down an IA very quickly."¹ If an adviser is fortunate the occurrence of a breach will be noticed. Only then can the task of restoring breached systems be faced, and costs can add up



quickly. Forensic expenses, expenses incurred attempting to reverse harm done to hardware through malicious code, and the risk that malicious code is unknowingly being transmitted to others are just a few of the areas addressed by a properly constructed insurance policy.

Media liability risk

Increasingly, advisers are using social media as a way to advertise, reach potential clients, and keep current clients informed about important investment-related news. By posting information publicly, you now subject yourself to the risk of libel, slander, copyright infringement, and plagiarism, among other risks. As the laws governing electronic communication continue to come in line with ever-changing technology, the importance of addressing this liability cannot be understated.

Management liability

The chance of being sued in America is great and there is little in the way to stop you from the risk of being on the wrong end of a judgment. Being the owner or serving as a director or officer of an entity puts a larger bullseye on your back. Having Directors and Officers liability insurance is an advantageous way to protect you against allegations from your competitors or to assist while cooperating during a formal investigation by regulators. If you are fortunate enough to have shareholders and investors, then having D&O insurance is a necessity. Take some time with your insurance broker to review the risks unique to your RIA and be sure to build liability protection that is integrated across all of these various areas: compliance, trading, cybersecurity, and management liability. The Markel Cambridge Alliance team can address these significant exposures.

References

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¹ "Investment advisers make attractive targets for cyber criminals," IA Watch, March 31, 2014.