Markel Cambridge Alliance
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Investment advisors

Risk management news

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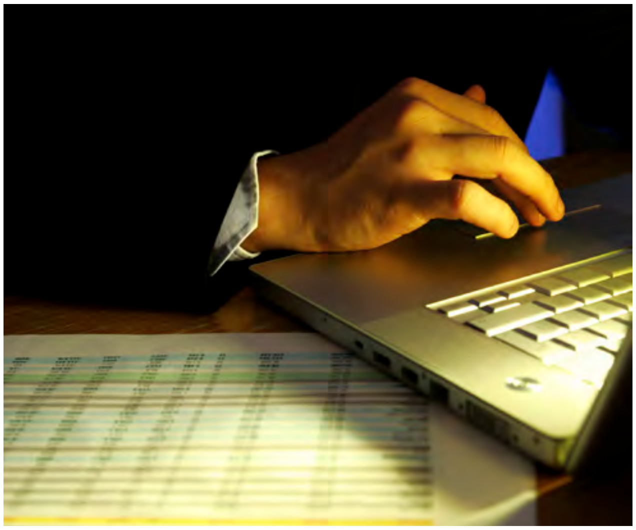
Analyzing loss exposures isn't just for insurance professionals

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

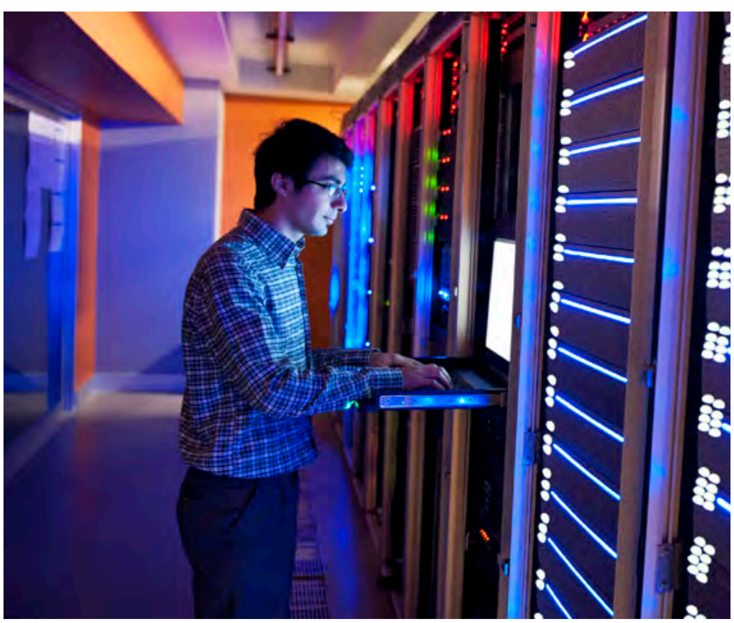
Discretionary advisers face loss exposures in their day-to-day trading activity. Even the most diligent adviser will occasionally make an error that imposes immediate monetary consequences, and Murphy's Law dictates that there's a good chance the erroneous trade will move against you. Most RIAs have 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

Regulator Scrutiny – fixed annuity sales receiving extra scrutiny from regulators. http://www.investmentnews.com/article/20140502/FREE/140509979?utm_source=IssueAlert-20140504&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text

Customer complaints - http://www.investmentnews.com/article/20140422/FREE/140429982

Custody risks - http://www.investmentnews.com/article/20140505/FREE/140509954

Importance of Compliance – 5 big compliance lessons from recent SEC cases - http://www.investmentnews.com/gallery/20140507/FREE/507009999/PH?utm_source=Daily-20140507&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text#

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

Important considerations for succession planning

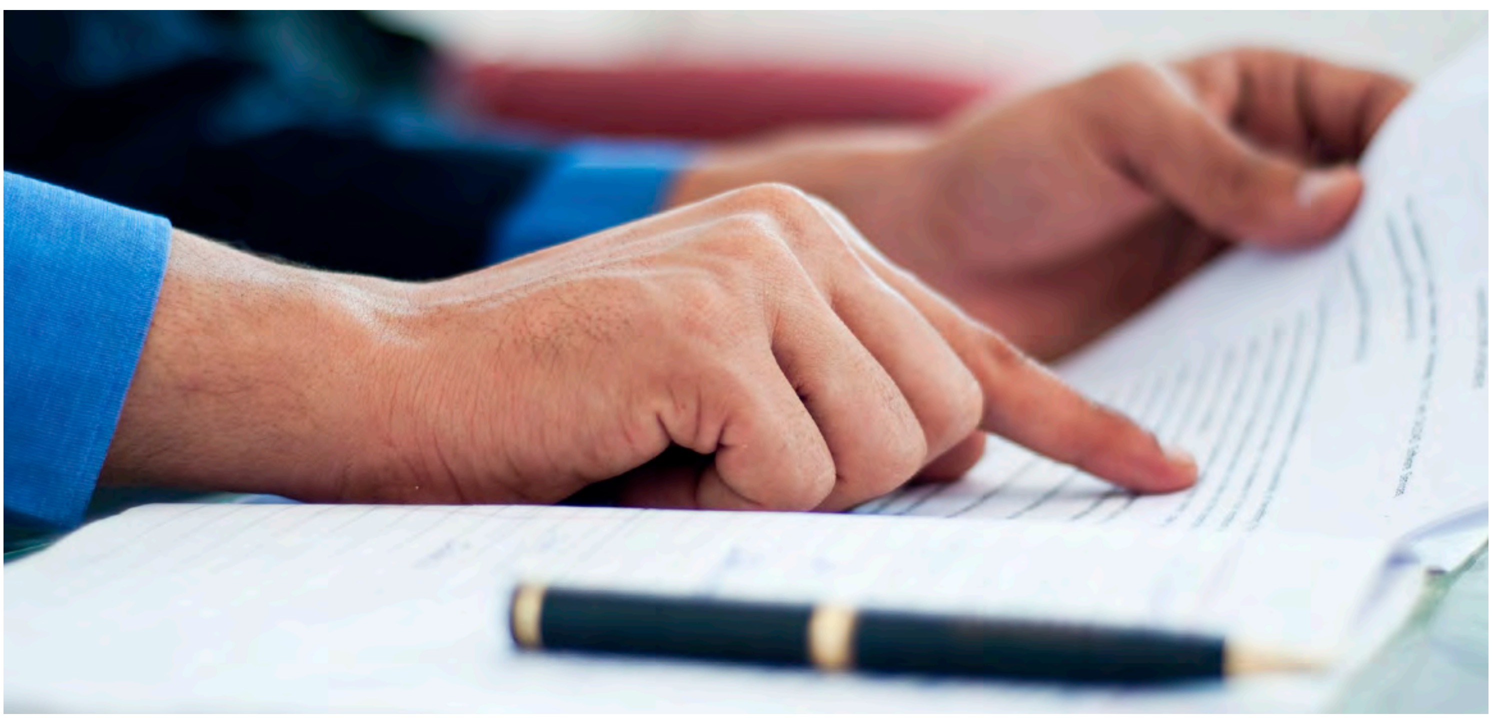
Developing a succession plan helps to mitigate risk to not only an adviser's clients but to his or her personal assets as well. An unforeseen event that puts the RIA's ongoing operations in doubt can create uncertainty unless a succession plan is in place. There are several options; among them internal succession, transfer to an heir, merger or sale with peer, and full divestiture or sale.

The documents listed below provide general considerations and guidelines for both the internal and external succession planning process. This summary should not be construed as the substitute for individualized advice from professionals (e.g., attorneys, CPAs, insurance brokers) of your choosing. Questions regarding the applicability to your specific situation should be addressed with those qualified professionals.

I. IAR due diligence document/information checklist

In order for an SEC registered investment adviser (Adviser) to learn important background information prior to the hiring (and subsequent thereto) of a prospective individual as an adviser investment adviser representative (IAR), the following due diligence procedures should be considered:

1. If the individual is an existing registered investment adviser (or a principal thereof), obtain current Form ADV (Part 1, Parts 2A and B) and proof/confirmation of current registration status with the SEC and/or states, as applicable;
2. So as to provide preliminary and current important due diligence information, an investment adviser may consider requiring each prospective IAR to execute a Representative Questionnaire and an Investment Adviser Representative Agreement;
3. For the purpose of determining the appropriate qualifying examinations and/or state registration filings that may be required by the IAR (and/or notice filings required by the Adviser as result of becoming engaged by existing clients of the IAR), the Adviser should obtain from the IAR: (a) a list of all current clients of the IAR by state of residence; and (b) a list of all locations (i.e., city/town and state) where the IAR maintains (or plans to maintain) an office (i.e., principal branch, or otherwise) while acting on behalf of the Adviser;
4. To the extent that any IAR is/was a registered representative of a FINRA broker-dealer, obtain a current CRD report for each such person to ascertain additional information, and to confirm the information previously reported on Parts 1 A and 1 B of Form ADV pursuant to Item 1 above;
5. To the extent that any IAR is/was currently an IAR for another adviser and is in a state that requires IAR registration on the IARD system, obtain a current CRD report for each such person to ascertain additional information, and to confirm information previously reported on Parts 1 A and 1B of Form ADV pursuant to Item 1 above;
6. By obtaining the above information, an Adviser will be able to determine that the IAR or RIA is: (a) not subject to an order issued by the United States Securities and Exchange Commission (the "Commission") under Section 203(f) of the Investment Advisers Act of 1940, as amended (the "Advisers Act"); (b) has not been convicted within the previous ten years of any felony or misdemeanor involving conduct described in Section 203(e)(2)(A)-(D) of the Advisers Act; (c) has not been found by the Commission to have engaged, and has not been convicted of engaging, in any of the conduct specified in paragraphs (1) (4) or (5) of Section 203(e) of the Advisers Act; (d) is not subject to an order, judgment or



decree described in Section 203(e)(3) of the Advisers Act; and (e) is otherwise involved in any activity, proceeding, etc. that an investment adviser would determine as disqualifying the IAR from becoming associated with the Adviser;

7. Obtain a list of all outside investment-related and financial services industry activities so that an Adviser is informed of any such services, affiliations, etc., so that it can determine if those affiliations and/or services warrant enhanced ongoing due diligence or disqualification from serving as an IAR of the Adviser;
8. Obtain written verification of current examinations (i.e. Series 6, 7, 65, 66, etc.) and designations (CFP, CFA, ChFC, etc.) for each prospective IAR; and
9. E&O insurance issues (to the extent applicable). Will the Firm maintain coverage for the IAR's former activities or is a tail policy necessary? Has the IAR provided proof of coverage for any Outside Business Activity per Item 7 above (i.e., CPA, Attorney, Insurance Agent, etc.)?

All of the above should be maintained in the IAR due diligence file. In addition, the information/responses should be codified in the representations section of the Investment Adviser Representative Agreement, which agreement should be executed by the IAR prior to becoming associated with the Adviser, and should, among other requirements, require the IAR to immediately notify the Adviser of any change in his/her response to any previously provided information. As part of the Investment Adviser Representative Agreement, the IAR should acknowledge his/her duty of confidentiality and prohibition from soliciting and/or serving clients of the Adviser in the event of termination of the IAR's association with the Adviser. These obligations should be set forth in a separate Confidentiality and Restrictive Covenant Agreement to be executed by the IAR in favor of the Adviser, which agreement may exclude from the solicitation/service prohibition specific current clients of the IAR that transferred their accounts to the Adviser.

II. Documents to be considered during an internal RIA transition process

1. **Investment adviser representative questionnaire**. Initial document to be completed by the IAR candidate prior to his/her becoming an employee of/associated with the Company, pursuant to which the IAR candidate shall answer various background questions regarding his/her relevant experience, designations, disciplinary history, potential conflicts of interests, etc., so as to allow the Company to perform initial due diligence on the IAR candidate;
2. **Restrictive covenant agreement**. Critical initial document (preferably to be executed upon commencement of the investment adviser representative's [IAR] employment/association with the Company), pursuant to which the IAR shall agree (among other covenants and restrictions), that upon termination of his employment/association with the Company, to maintain all Company information confidential, not to render services to Company's clients, or induce any Company employees to leave the Company's employ, etc.;
3. **Investment adviser representative agreement**. Also to be executed by the IAR (preferably to be executed upon commencement of the IAR's employment/association with the Company), pursuant to which the IAR acknowledges the terms and conditions of his employment/association with the Company;
4. **Purchase agreement**. To be executed between the Company and the IAR, setting forth the terms and conditions of the IAR's prospective purchase of a Company ownership interest (i.e., as a shareholder, member, or partner); and
5. **Shareholder/operating agreement**. To be executed by the Company and each of its owners, setting forth, among other substantive provisions, the terms and conditions for the disposition of each owner's ownership interest upon the occurrence of various events, including death, disability, statutory disqualification, employment termination, etc.;
6. **Insurance-related documents**. Pursuant to which insurance would be purchased (the amount of which would be routinely evaluated) by the Company (or its owners) on the lives of the Company's owners, the proceeds of which insurance policies would be used by the Company (or its owners) to fund the purchase of the ownership interest from the deceased owner's estate;
7. **E&O insurance issues**. Will the Firm's current coverage be sufficient to cover the pending new representative's business activities?
8. **Regulatory filings**. (a) the filing of individual IAR registration documents with each state requiring the Company to do so (generally required by each state — with certain exceptions — in which the IAR maintains a place of business); and (b) amending of the Company's lard filing to disclose new owners.

III. Documents to be considered during an external RIA transition process

1. **Confidentiality agreements**. Should be executed prior to the Letter of Intent stage, if the parties intend to exchange information and/or documentation about the other prior to entering into a Letter of Intent. The Purpose of this document is to protect each party's proprietary interest in and to its confidential information and documents, and to provide for the immediate return thereof (including any copies) in the event that a transaction does not proceed forward within a specified period of time. (e.g. 90 days);
2. **Letter of intent**. Prelude to commencement of the Agreement of Sale preparation stage. The Letter of Intent should set forth the basic terms and understandings of the parties, which should include the initial understanding as to the basic terms of the prospective transaction,

including payment terms, due diligence review, continued employment, restrictive covenants, etc. Although the Letter of Intent will usually be drafted by legal counsel, the parties should attempt to arrive at the basic terms thereof independent of legal counsel's direct involvement, including a preliminary Due Diligence Schedule. Must also contain a confidentiality provision as discussed above;

3. **Purchase agreement**. A comprehensive document to be executed between the seller and buyer, setting forth the terms and conditions of the purchase of the investment advisory entity, including, but not limited to, representations and warranties, purchase price and payment terms, remedies in the event of violation, continued employment of key personnel, restrictive covenants, indemnification, etc.

   One of the most critical sections of this documents is to indicate what happens in the event that the purchase and/or transition does not go as planned due to various events, including, but not limited to, failure to have certain clients transfer/maintain accounts (i.e. purchase price set-oft), breach of material representations or warranties (i.e. recapture of business, further set-off of purchase price or repayment of monies previously paid, etc.);

4. **Shareholder/operating agreement**. Document to be executed by the surviving advisory firm and each of its owners, setting forth, among other substantive provisions, the terms and conditions for the disposition of each owner's ownership interest upon the occurrence of various events, including death, disability, statutory disqualification, employment termination, etc;

5. **Restrictive covenant agreements**. Critical document, pursuant to which the principals and associated persons of the selling firm agree (among other covenants and restrictions), that upon commencement of their employment/association with the acquiring firm, to maintain all buyer's information confidential, not to render services to buyer's clients (including those clients that he/she previously serviced when employed by or associated with the seller), or induce any of buyer's employees to leave the buyer's employ, etc. It is critical for the selling firm to already have these agreements in place prior the Letter of Intent stage (preferably always upon commencement of employment or association with the firm) so that the seller does not run the risk of clients leaving the firm during the transition process with employees or associates who are not subject to any such restrictions;

6. **Regulatory issues and filings**. Including, but not limited to: (a) amending of the Company's ADV filings as required; (b) the filing/maintaining/withdrawal of Notice filings with each state requiring the Company to do so; (c) the filing/maintaining/withdrawal of individual IAR registration documents with each state requiring the Company to do so; (d) announcement to clients; (e) obtaining client approvals (Negative Consent letters); (f) assignment under the Advisers Act (change of management or control); (g) Advisory Agreements (assignment vs. execution of new agreement); (h) withdrawal of Seller's registration (pros and cons); (i) books and records retention; and U) maintaining/supplementing E & O insurance;

7. **E&O insurance issues**. Will the Buyer maintain coverage for the Seller and its representatives' prior acts or is a tail policy necessary?

Contributed by Thomas D. Giachetti, Esq., Chairman, Securities Practice Group, Stark & Stark Attorneys at Law.

For more information on succession planning, read: http://www.investmentnews.com/gallery/20140729/FREE/729009999/PH?issuedate=20140730&sid=GAMECHANGE&utm_source=SpecialReport-20140730&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text

Alternative dispute resolution (ADR)

Everyone's best interest

Over the past twelve to eighteen months, Markel Cambridge Alliance has been asked more frequently what we think about having an arbitration clause in client contracts. It is our response that it is always in everyone's best interest.

Speaking from an insurance professional's point of view, it is good to have options to solving legal disputes. It is even better to have options that are fair, efficient and not costly drains on resources. Traditional legal remedies used to solve disputes drain resources; they are expensive and consume large amounts of time. Money may or may not be an issue to you, but time typically is. Time is the one resource we have been trying to manipulate from the beginning of existence. We want more. We want to be more efficient users of time. A drawn out legal matter is not efficient and not in your best interest.

(Continued on page 6)

(Continued from page 5) **Alternative dispute resolution**

Alternative dispute resolution (ADR) consists of two main categories – arbitration and mediation. Both have their advantages and disadvantages. Only you can decide which is best for you. If you Google "Advantages to ADR" or "Disadvantages to ADR" you'll have plenty of reading, but please choose your sources of information wisely. A good place to start is the American Arbitration Association www.adr.org.

Certain large legal matters are best left to traditional legal solutions where a jury of your peers is beneficial. But for medium to small matters ADRs are ideal. The arbitration panel selection process is fair and it makes sense. One side chooses a panelist, the other side chooses a panelist, and the two panelists choose the third panelist. So choosing the arbitrator is choosing the judge and jury in one body. Not to diminish the value of juries, but for sophisticated discussions on financial matters, it is more efficient to have three educated and experienced arbitrators deciding the facts of a securities matter and/or a fiduciary's duty case. More time can be focused on what happened or what didn't happen, rather than drudging through the details of "what is a fiduciary" and "are the standards the same as for a registered rep?"

A handful of regulators are taking offense to the ADR clauses. From what we've seen, the issue stems from mandatory versus optional. Statements from different regulators state a mandatory arbitration clause may not be in the clients' best interest. We have our opinions, but we've learned not to fight city hall. If the clause is optional, then it appears acceptable. The following is an example of a before-and-after arbitration clause Markel recently reviewed while analyzing a risk.

Example of before-and-after arbitration clauses

Original clause before auditing
Arbitration: Subject to the conditions and exceptions noted below in the event of any controversy, dispute, or claim arising from or relating to this Agreement, both parties agree to submit the dispute to arbitration pursuant to the Commercial Rules of the American Arbitration Association. The prevailing party shall be entitled to reasonable attorneys' fees, cost, and expenses. The Client understands that this Agreement to arbitrate does not constitute a waiver of its right to seek redress in court where a waiver would be void under applicable federal or state securities laws.

Revised arbitration clause after the auditor's comments
Arbitration: Subject to the conditions and exceptions noted below in the event of any controversy, dispute, or claim arising from or relating to this Agreement, arbitration is recommended as being in the best interests of both parties due to the significantly lower costs involved. The arbitration is suggested pursuant to the Commercial Rules of the American Arbitration Association. The prevailing party shall be entitled to reasonable attorneys' fees, cost, and expenses. The Client understands that this Agreement to arbitrate does not constitute a waiver of its right to seek redress in court where a waiver would be void under applicable federal or state securities laws.

In life and in our chosen professions we are always making decisions and using some sort of cost-benefit analysis. A bad case is a bad case no matter where it is heard, and likewise for a good case … the question is how much extra money and extra time do you want to spend for the same outcome?

If you have a safety or risk management question or a suggestion for a topic, please contact Travis Pearson at tpearson@markelcorp.com.