



INVESTMENT COMPANY INSTITUTE

MARY S. PODESTA
SENIOR COUNSEL

October 15, 2003

Anne Cools
Review of Capital Requirements
DG Internal Market
Unit F2 Banking and Financial Conglomerates
European Commission
B-1049 Brussels
Belgium

Dear Ms. Cools:

The Investment Company Institute appreciates the opportunity to comment on the Commission's Third Consultation Paper on Capital Requirements for Credit Institutions and Investment Firms. The Institute is the national association of the US investment company industry.¹ Many of our members manage European mutual funds and pension funds through their European-based affiliates.

The Third Consultation Paper provides the basis upon which the Commission expects to issue draft proposals for a directive on new capital requirements for credit institutions and investment firms in the European Union. The proposals in the Third Consultation Paper are based on the third consultation paper issued by the Basel Committee and would be implemented in the EU under the Lamfalussy procedure. In other words, the Commission envisions that a revised EU Capital Adequacy Directive would be drafted to focus on essential principles and policies and the annexes would contain the technical implementing rules, which could be changed at a later time without amending the Directive.

As we have expressed in response to the Commission's prior consultations, we have two particular concerns with respect to the revision of the capital adequacy framework for asset managers: (1) bank-styled capital requirements are not appropriate for the asset management industry and (2) use of insurance should be permitted to offset minimum capital requirements. We were pleased that the Commission has begun to address the first issue in the Third Consultation Paper. We, however, were disappointed that the Commission reversed its position of permitting the use of insurance under all three methods of calculating capital.

¹ The Institute's membership includes 8,655 open-end investment companies ("mutual funds"), 588 closed-end investment companies, 106 exchange-traded funds, and 6 sponsors of unit investment trusts. Its mutual fund members have assets of about \$6.857 trillion, accounting for approximately 95% of total industry assets, and 90.2 million individual shareholders.

Bank-Styled Capital Requirements Are Not Appropriate for the Asset Management Industry

We continue to believe that it would be unwise to introduce into the Capital Adequacy Directive bank-style capital requirements for asset management firms. As we mentioned in our previous letters to the Commission, the businesses of banking and asset management are fundamentally different and any capital requirement imposed on institutions that engage in these diverse activities must take into consideration the separate risks involved in these businesses. Although the Commission continues to take the general view that the new capital adequacy framework should apply to all types of institutions to ensure a level playing field within Europe, the Third Consultation Paper acknowledges that in the case of asset management firms, their limited activities and risk profile indicate the need for a modified approach. As a result, the Commission proposes that asset management firms that do not trade for their own account or underwrite securities (firms with limited license) would be permitted to continue to calculate their capital requirements under the current rules (*i.e.*, firms must have a minimum capital of at least 13 weeks of expenditures).

We support the Commission's proposed approach to permit asset management companies to continue to calculate their minimum capital requirements under the current rules. We believe that this approach has the added benefit of making the capital requirements for asset managers authorized under the Investment Services Directive consistent with those imposed on asset managers authorized under the UCITS Directive. In the Third Consultation Paper, however, the Commission provides the Member States with discretion regarding whether asset management firms with limited license would be permitted to continue to calculate their capital requirements under the current rules. We respectfully urge that the Commission *require* the competent authorities of the member states to permit firms with limited license to comply only with the current expenditure-based requirement.

If, however, firms cannot rely only on the expenditure-based approach (either because they are not firms with limited licenses or Member States are permitted to prohibit firms from complying with only the expenditure-based approach), the Commission should permit these firms to not have to comply with both the expenditure-based approach and one of the three Basel-based approaches.² In other words, if a firm is required to calculate operational risk using one of the three methods, it should not also be required to comply with the expenditure-based approach. The Commission has taken a similar approach for firms authorized to use the Advanced Measurement Approach (Title II, Chapter 3, Article 113).³

² For both the Basic Indicator and Standard approaches, we continue to believe that the Commission should apply a lower calibration for asset management than, for example, for banking and trading because of the lower risks involved in asset management.

³ Similarly, we recommend that the Commission not require a firm whose parent must calculate consolidated capital based on one of the three approaches also to have to comply with the expenditure-based approach.

The Commission Should Permit the Use of Insurance for All Methods of Calculating Minimum Capital

We were disappointed that the Commission decided not to permit the use of insurance to offset capital requirements if firms use the two simpler (Basic Indicator and Standardised) approaches to calculating minimum capital. As a result, consistent with the Basel proposals, only firms using the Advanced Measurement Approaches would be able to recognize insurance in calculating capital, and maximum capital alleviation would be limited to 20%.

In not permitting insurance to offset capital charges calculated under the two simpler methods, the Commission is of the view that the potential recognition of insurance under the simpler approaches should await further development in insurance products, progress in the mapping and measurement process of insured operational risk events, and the availability of a straightforward formula. The Commission expects to revisit these issues over time.

We appreciate that developing a specific proposal or formula for permitting insurance to alleviate capital charges is a complex undertaking. We, however, are of the view that it is critical for insurance to be part of all of the methodologies for calculating minimum capital, including the current expenditure-based approach.⁴ As discussed in our submission to the Commission in April 2003 on the experience of the US asset management industry in using insurance to cover certain risks, insurance provides adequate protection and, in some respects, other advantages over a capital adequacy framework.⁵

Moreover, we believe that the technical implementation of the use of insurance could be left to comitology procedures, which could draw on the expertise of the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR) as well as private sector experts.

Commission Should Retain the Alternative for Consolidated Capital

The Institute also urges the Commission to reconsider the specific conditions under which Member States may grant waivers to investment firm groups from the requirements to consolidate capital.

As we mentioned in our letter to the Commission in January 2003, some of the specific conditions under which the alternative for consolidated capital would be

⁴ Asset managers that would be allowed to calculate capital under the current expenditure-based rules also should be permitted to use insurance to offset capital charges.

⁵ A copy of the paper, produced by ICI Mutual (a captive insurance company of the US investment company industry), is enclosed.

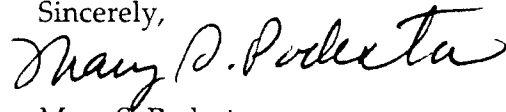
Letter to Anne Cools
October 15, 2003
Page 4 of 4

permissible are unduly restrictive. In particular, we are concerned about the condition that would require all the investment firms within a group to be authorized and supervised by the same Member State to be eligible for the waiver. This proposed condition would prevent Member States from granting waivers to groups whose holding company structure does not pose particular risks. Moreover, this particular condition, which would limit the alternative approach to only national investment firm groups, is fundamentally inconsistent with the goal of facilitating a truly pan-European market for financial services. We strongly urge the Commission to revise this condition and permit groups with affiliates authorized in more than one Member State to be eligible for this alternative.

* * *

If we can provide any other information or if you would like to discuss further any issues, please call me at (202) 326-5826 or Jennifer Choi at (202) 326-5810.

Sincerely,



Mary S. Podesta
Senior Counsel

Enclosure

Insurance in the US Market for Investment Companies and Related Entities

I. Introduction

The European Commission, in its Working Document of the Commission Services on Capital Requirements for Credit Institutions and Investment Firms, dated November 18, 2002, proposed to impose capital adequacy requirements on investment firms, but to allow, under some circumstances, insurance to alleviate those requirements. ICI Mutual Insurance Company is pleased to provide the European Commission with information on the use of insurance by US registered investment companies and their affiliated entities, including investment advisors, distributors, administrators, transfer agents, and custodians.

ICI Mutual is a captive insurance company of the US investment company industry and provides insurance products and services to approximately 70% of the US registered investment companies (often referred to herein as "funds") and affiliated entities. ICI Mutual is owned by its member insureds. As a captive insurance company, ICI Mutual focuses exclusively on the risk management challenges of the investment management industry and is uniquely qualified to comment on the role of insurance in the industry.

The formation of ICI Mutual was sponsored by the Investment Company Institute, the national association of the US investment company industry. Members of the Institute manage approximately 95% of the total assets of the US registered investment company industry, and many members, through European affiliates, also manage European UCITS, pension funds, and other investment vehicles.

II. Summary

As described below, operational risks in the asset management business are fundamentally low. As a testament to the low level of operational risk in the US investment company industry, which currently has over \$6 *trillion* in assets under management, we note that, in the 16 years since ICI Mutual's inception in 1987, ICI Mutual has paid a total of less than \$143 *million* in 136 claims. We believe that our discussion below of the key types of operational risk and our examples of insurance coverage must be viewed in the context of an extremely low level of overall risk in the US investment company industry.

From our experience of providing insurance to the US investment company industry, we believe that operational risk, defined by the Investment Services Directive 93/22/EEC as "the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, including legal risk," has been and continues to be minimized by numerous structural safeguards and that the remaining operational risk has been appropriately addressed by other means, including insurance. We believe

that, by covering key operational risks, a strong insurance regime furthers the objectives of financial stability, investor protection, and competition among financial institutions.

In the US market, investment companies and certain related entities generally have broad insurance coverage. For the sake of brevity, this paper generally refers to insurance coverage of the investment companies themselves. In general, however, the insurance policies held by US investment companies also cover various affiliated entities, which may include the investment companies' investment advisors, distributors, transfer agents, administrators, and custodians. Thus, the US investment companies' insurance would typically cover "investment firms" (as defined in Investment Services Directive 93/22/EEC) or management companies under the UCITS directive in their capacity as service providers to investment companies and may also cover them in their capacity as service providers to private advisory accounts, private investment companies, and foreign assets (non-US client assets). In addition, the US investment companies' insurance often covers many non-investment firms. This paper's discussion is limited to insurance provided to registered investment companies and to other entities by virtue of their relationship with the investment companies and does not cover other insurance that may be independently held by investment advisors or other entities.

As described in greater detail below, investment companies are required by the Investment Company Act of 1940 (1940 Act) to have a fidelity bond, issued by a reputable fidelity insurance company, against larceny and embezzlement, covering each officer and employee who has access to securities or funds of the investment company. Investment companies, along with their investment advisors and distributors, also typically have directors and officers (D&O) and errors and omissions (E&O) policies that cover the insured parties for liability to third parties resulting from negligent acts, errors, omissions, or breaches of duty committed by them, their employees acting within the scope of their employment, and their directors and officers acting in their official capacities. Many investment companies also have a unique type of E&O coverage called "costs of corrections" insurance, which covers the costs of correcting deficiencies before they lead to otherwise insurable losses. These layers of insurance are often supplemented by additional insurance, such as fiduciary liability insurance or business interruption insurance, to cover specific risks.

Like mutual fund industries in the EU and its member states, the US asset management industry benefits from a rigorous regulatory scheme that tends to minimize operational risk. In the US, registered investment companies in particular are subject to more stringent regulation than any other financial institution, which has resulted in a virtually scandal-free industry that strongly protects shareholders. Among other things, the 1940 Act requires: the close oversight and involvement in the affairs of an investment company by its board of directors (generally with a majority of directors who are independent of the investment companies or affiliated entities); daily pricing of open-end investment company portfolios; the segregation of the investment company's assets from other assets of or managed by its investment advisor; annual audits by independent accountants; and protection against fraud by employees of mutual funds. In addition, the 1940 Act prohibits or places severe restrictions on an investment company's transactions with affiliates (such as investment advisors, underwriters,

directors, officers, and significant shareholders); capital structure; and ability to leverage its investments through borrowings.

Operational risks in the asset management industry primarily derive from the following six key activities in the investment management process that are common to all fund complexes: (A) selection of securities; (B) execution of orders; (C) allocation of brokerage; (D) allocation of securities to client accounts; (E) pricing of portfolio securities; and (F) disclosure relating to investment management matters. In our experience, the most common types of claims in the investment management industry stem from the following: introduction of new investment strategies and products; communication lapses; regulatory or client limits on investments; administrative errors; and employee misconduct.

Based on our experience in the US asset management industry, we believe that insurance promotes financial stability, enhances consumer protection, and furthers competition among financial institutions. Insurance also offers a number of advantages over a capital adequacy framework.

- Comprehensive coverage – Insurance generally covers the key types of operational risk.
- Flexibility and accuracy of approach – The insurance obtained by investment companies tends to be closely matched to their risk profiles. The insurance company's interest in the process fosters greater accuracy of insurance coverage.
- Targeted to operational risks – Whereas capital is used to support the full range of business operations of a firm, insurance is targeted at covering loss from specified events, such as negligent acts or errors in connection with investment management activities.
- Dynamic approach – Through the underwriting process, insurance needs are closely monitored both by an investment company and by its insurance companies. As a result, the scope and level of insurance are adjusted on a regular basis according to the insured company's risk profile.
- Strong incentive to manage risks – Insurance fosters a stronger commitment to risk management by providing a direct incentive to minimize areas of potential risks.
- No discrimination against low-risk firms – An insurance program rewards firms that have strong internal controls or otherwise present a low degree of risk. By contrast, a capital adequacy regime does not distinguish between levels of risk.
- Lower costs to industry and to shareholders – Premiums are extremely low compared to the total assets under management and are likely to be significantly lower than capital requirements. By freeing up capital that would otherwise be

used to satisfy capital requirements, insurance permits investment advisors to allocate their assets more efficiently and may reduce the incentive to seek greater risk.

III. Overview of Insurance for US Investment Companies and Related Entities

In the United States, registered investment companies are required to obtain fidelity bond coverage and typically obtain other types of insurance to cover operational risks. In particular, investment companies and their related entities, including their investment advisors, distributors, transfer agents, administrators, and custodians, generally obtain D&O insurance and E&O insurance. As noted above, for the sake of brevity, this paper generally refers to insurance coverage of the investment companies themselves, even though those other entities are typically covered as well. In addition, investment companies and related entities may also obtain other types of coverage to provide additional protection or address specific risks or for other purposes.

In different ways, each of the common types of insurance – fidelity bond, D&O, and E&O – covers operational risks. In particular, a fidelity bond covers larceny and embezzlement, and often other fraudulent and dishonest acts, committed by directors, officers, and employees of the insured fund and of related entities. D&O insurance generally covers the directors and officers of an insured company for claims made against them for their designated acts, errors, or omissions in operating and managing the insured fund. E&O insurance typically covers an insured entity for claims made against the entity itself (as opposed to its directors or officers) for designated acts, errors, or omissions committed by the entity itself (or by persons for whom the entity is legally responsible) in operating and managing the insured fund. Although D&O and E&O coverages are logically distinct from each other, the line between the two often blurs, as claims against the insured entity may extend to include claims against the directors and officers of the entity acting in their official capacity.

As described in greater detail below, although fidelity bonds cover certain intentional acts, insurance for investment companies is generally limited to negligent acts, errors, or omissions.

A. *Types of Insurance for Investment Companies and Related Entities*

1. *Fidelity Bond*

Under Rule 17g-1 under the 1940 Act, a registered investment company is required to provide and maintain a bond, issued by a reputable fidelity insurance company, against larceny and embezzlement, covering each officer and employee who has access to securities or funds of the investment company. The fidelity bond and the premiums to be paid must be approved by a majority of the independent directors of the investment company.

Rule 17g-1 includes a schedule based on an investment company's assets that sets forth the minimum amount of the fidelity bond. Many fidelity bonds exceed the minimum

statutory requirements as to both the amount and the extent of coverage. In general, fidelity bonds cover other items as well, including fraudulent and dishonest acts committed not only by directors, officers, and employees of the insured fund, but also by directors, officers, and employees of the fund's advisor, distributor, affiliated transfer agent, and affiliated administrator. Fidelity bonds can also cover additional risk exposures for investment company complexes, including audit expenses resulting from audits or examinations required by a governmental regulator due to fidelity loss; loss of property on premises or in transit; loss from forgery or alteration of documents, counterfeit securities, or receipt of counterfeit currency; loss resulting from payment of dividends, issuance of shares, or withdrawals based on uncollectible items of deposits of a shareholder; and loss resulting from certain voice-initiated transactions.

2. *D&O Insurance*

D&O liability coverage generally covers the directors and officers of an insured company for claims made against them for their designated acts, errors, or omissions. Unlike the fidelity bond, investment companies are not required to, but generally do, obtain D&O coverage.

D&O policies usually subdivide coverage into "company reimbursement" and "direct" coverages. Company reimbursement coverage is paid to the insured company where the company has, to the extent permitted by law, indemnified the directors and/or officers for claims made against them. Direct coverage typically covers the directors and/or officers of an insured company directly if the insured company is not legally permitted or is financially unable to indemnify them.

Direct coverage may be unavailable where coverage would violate applicable law. For example, Section 17(h) of the 1940 Act prohibits registered investment companies from indemnifying directors or officers for "disabling" conduct – that is, "willful misfeasance, bad faith gross negligence, or reckless disregard of the duties involved in the conduct of [their] office." State corporate codes often contain similar prohibitions. Policy forms often have exclusions for fraud, dishonesty, and other conduct that is similar to the prohibited conduct.

3. *E&O Insurance*

E&O insurance typically covers an insured entity for claims made against the entity itself (as opposed to its directors or officers) for designated acts, errors, or omissions committed by the entity or by persons for whose acts, errors, or omissions the entity is legally responsible. As with D&O coverage, investment companies are not required to, but generally do, obtain E&O coverage.

Listed below are examples of acts, errors, and omissions that would be covered under E&O insurance:

- *Restricted and Impermissible Investments* – Particular investments by a portfolio manager for a managed fund or account may be prohibited or exceed limits (e.g.,

percentage limits, quality limits, geographic limits) imposed by: (1) statute or regulation; (2) terms of a fund prospectus or other disclosure document; or (3) restrictions established by an advisory client or the complex itself.

- *Inaccurate Execution of Trade Orders* – Trades may be inaccurately executed (e.g., incorrect security, incorrect number of shares, purchases instead of sales (or vice versa)) as a result of system errors or errors by traders or other portfolio management personnel.
- *Pricing Errors* – Errors in pricing portfolio securities may lead to losses in purchases or sales of fund securities as a result of inaccurate NAV calculations.
- *Sales Practice Violations* – If the distributor of a fund's shares has committed sales practice violations, such as sales of shares to investors for whom such shares are not suitable, losses may be incurred.
- *Unauthorized Trading* – Losses can result when trades are not authorized by appropriate portfolio management personnel.
- *Inaccurate Recording of Trades* – If executed trades are not recorded correctly, net asset values/account values will not be accurate and the portfolio manager will not have accurate information about positions held in client accounts, which may lead to further errors.
- *Inaccurate/Incomplete Disclosure* – Inaccurate/incomplete disclosure of matters specifically required (e.g., in fund prospectuses or in the investment advisor's Form ADV).
- *Failure to Disclose* – Failure to disclose other material facts to clients/fund directors.

4. *Costs of Corrections Coverage*

ICI Mutual pioneered, and is the largest provider of, a unique type of E&O coverage called "costs of corrections" coverage. This provides coverage for loss, cost, or expense incurred by an insured entity, pursuant to the insurer's consent, to correct situations that, if not corrected, would automatically result in future losses otherwise insurable under the policy.

"Costs of corrections" coverage does not require a claim to have been made against the insured before coverage can be sought. However, the insured must be legally liable for the losses. In other words, the insured does not have to be sued or to have a demand made against it or a regulatory investigation brought before coverage is available. This type of coverage permits – and encourages – an insured to correct a problem before a lawsuit is brought. Many investment companies consider this coverage to be critical to a complete insurance program. Indeed, approximately 40% of the amounts paid by ICI Mutual involve claims for costs of corrections.

Over the years, ICI Mutual has paid a number of claims under the “costs of corrections” coverage. These have included claims for the following:

- Errors in effecting foreign currency exchange transactions;
- Violations of investment restrictions;
- Errors in pricing and calculating net asset value;
- Errors in processing 401(k) plan contributions;
- Errors in purchases and sales of foreign securities;
- Incorrect processing of wire order transactions for purchases and redemptions of fund securities;
- Errors with respect to the purchases or sales of fund shares;
- Errors in rebalancing a fund’s portfolio;
- Overpurchases of shares of a portfolio security; and
- Violations of regulatory restrictions.

5. *Fiduciary Liability Coverage*

Fiduciary liability coverage may provide coverage for certain claims made against insured entities (and, in some cases, individuals) in their capacity as fiduciaries to pension or other employee benefit plans. Such claims could include, for example, allegations that a fiduciary has failed to discharge his, her, or its duties or to act prudently within the meaning of the Employee Retirement Income Security Act of 1974 (ERISA).

B. *Scope of Coverage*

D&O and E&O policies typically cover claims for virtually all negligent acts, errors, and omissions by the insured entity or by directors, officers, and other persons for whose acts, errors, or omissions the entity is legally responsible. Although, as noted below, intentional conduct is excluded from coverage under D&O and E&O policies, as are certain other categories of claims, most losses that occur are covered.

Under the terms of most insurance policies, claims generally include lawsuits filed against the insured. In addition, under some policies, claims may also include threats of lawsuits filed against the insured or proceedings brought against the insured by a regulatory agency (e.g., the Securities and Exchange Commission or the Internal Revenue Service). Furthermore, as described above, coverage may be available under a “costs of corrections” policy even when no claim has been filed or threatened against the insured party.

Losses covered include the amounts that the insured is legally obligated to pay, including damages, judgments, settlements, and costs of defense, but does not generally include fines, penalties, punitive damages, or two-thirds of treble damage awards.

In addition, there are a number of standard exclusions generally applicable to D&O and E&O policies. Among those exclusions are the following:

- *Intentional conduct* – Most D&O/E&O policies have exclusions for the fraudulent, dishonest, or criminal acts of an insured, and deliberate or intentional violations of law are frequently excluded; some of these losses may, however, be covered by a fidelity bond.
- *Personal torts* – Most D&O/E&O policies exclude losses arising out of bodily injury, sickness, emotional distress, libel, slander, wrongful termination, or discrimination. Some may remove the exclusion for wrongful termination and/or discrimination.
- *Profit or advantage* – Many policies have exclusions for losses attributable to an insured gaining any profit or advantage to which it was not entitled.
- *Insured v. insured* – Policies often exclude claims brought by one insured against another insured (to avoid collusion among insured). This exclusion often has an exception for derivative claims made by shareholders and claims made by any insured against another if the failure to make such claim would result in liability for such failure.

C. Underwriting Process

In determining whether to provide coverage to an investment company and its related entities, ICI Mutual undertakes a rigorous and comprehensive review of the proposed insureds. This review is essentially the same for new policies as it is for policies that are being renewed (almost exclusively on an annual basis). Described below are some of the underwriting factors that ICI Mutual considers:

- *Proposed Insured Identification* – ICI Mutual considers the entities that are to be covered under the policy. For example, ICI Mutual examines the number, type (open-end or closed-end), investment strategy (bond, equity, money market, international, etc.), and assets of registered and unregistered investment companies. In addition, other service providers, including the investment advisor, underwriter, administrator, transfer agent, or custodian, are examined for the risk that they may present to the policy, even if any of those entities are not insured under the policy.
- *Loss History Analysis* – ICI Mutual assesses the nature and resolution (or expected resolution) of pending and prior claims and reviews the loss potential of known circumstances.

- *Regulatory Inspections Analysis* – ICI Mutual reviews inspections by a regulatory authority, such as the SEC, the NASD, or the NYSE. ICI Mutual reviews regulatory comments and the management’s response to those comments.
- *Funds Analysis* – With respect to investment companies covered under the policy, ICI Mutual undertakes a detailed review of their boards of directors or trustees; internal controls; investment strategies; valuation procedures; fees (especially the so-called 12b-1 fees paid by funds to distributors of fund shares); performance; in case of closed-end funds, discounts to net asset value and proxy votes; the expertise and experience of advisors, sub-advisors, outside counsel, and other service providers. A review of the sufficiency of internal controls is one of the most important considerations in underwriting a fund group.
- *Investment Advisor Analysis* – ICI Mutual reviews the regulatory filings of investment advisors. As part of this review, ICI Mutual reviews disciplinary actions against advisors or their personnel, seeks to identify interests (if any) in client transactions, and reviews the experience of management. ICI Mutual considers the financial condition of investment advisors and also scrutinizes the compliance operations of advisors, both in terms of the personnel and of the compliance policies and procedures (including, among other things, those related to trading, privacy, management of investment guidelines and restrictions, preparation of fund disclosure and regulatory filings, brokerage allocation, codes of ethics, advertising, oversight of sub-advisors (if any), corporate actions, hiring (background checks of employees), computer security, phone and electronic transactions, and disaster recovery). In addition, ICI Mutual considers other services provided by investment advisors, including management of private advisory accounts and services provided to employee benefit plans (which subject advisors to the stringent regulatory provisions of ERISA).
- *Analysis of Other Service Providers* – ICI Mutual undertakes a similar review of other service providers, examining their regulatory filings, disciplinary history, experience, policies and procedures, and potential exposures.
- *Other Factors* – There is also a review of other factors, including the reputation of the fund complex and key employees and the investment management style.

D. Levels of Insurance

In general, the larger the insured, the more likely it is to purchase higher limits of liability. However, the level of insurance, as well as the deductible level, chosen by investment companies and related entities depends in large part upon their assessment of the likely risks, their tolerance for those risks, and their internal controls.

Entities insured by ICI Mutual have an average of approximately \$1 million of insurance coverage per \$3 billion in assets under management, which include assets held by both registered and private investment companies, private advisory accounts, and foreign assets (non-US client assets). The average size of a policy issued by ICI Mutual is

approximately \$20 million. In addition, the average deductible for ICI Mutual's insured is slightly over \$250,000.

E. Premium Levels

Premiums for investment company insurance are extremely low relative to overall assets under management, averaging, among ICI Mutual's insureds, less than \$8 of premium per \$1 million of assets under management (including private assets, unregistered fund assets, and foreign assets).

In general, premiums paid by investment companies have some degree of correlation with the amount of coverage. However, the correlation is not perfect, as the premium levels depend to a large extent on the levels of risk and on the deductibles. A pure dependence on premiums as a proxy for the level of coverage would be inaccurate and would tend to penalize investment companies that present a smaller risk of loss (*e.g.*, because of stronger internal controls).

F. Claim Resolution Process

An important consideration in evaluating insurance of investment companies is how claims are handled by the insurance company. Described below are the five basic steps in processing an insurance claim with ICI Mutual.

- *Prompt Notice of Potential Claims* – Insured are obligated to provide ICI Mutual with prompt notice of a potential claim. This obligation is typically triggered when: a lawsuit, SEC or SRO investigation, or other claim is brought against the insured, for which coverage may be available under the policy; the insured discovers an unrealized liability requiring corrective action, for which coverage may be available under the policy; or the insured discovers a loss, for which coverage may be available under the policy. ICI Mutual encourages its insureds to provide notice on all potential claims, even if it appears that the underlying matter will involve a loss below the applicable deductible, in order to avoid any possible prejudice to the insureds' ability to recover as a result of late notification. ICI Mutual does not prescribe a particular format for providing notice of a potential claim.
- *Acknowledgment of Notice and Provision of "Reservation of Rights" Letter* – ICI Mutual reviews each notice of a potential claim and engages the services of outside counsel to monitor and analyze the claim. At that point, the insured will be provided with a "reservation of rights" letter that seeks to identify and explain provisions of the policy that may, on the basis of information then known about the potential claim, limit or preclude insurance coverage for the potential claim. The letter also reminds the insured to receive ICI Mutual's consent before incurring any liability, committing to paying any costs of corrections, making any settlements, or releasing any third parties from liability. The "reservation of rights" letter is only a preliminary statement of likely coverage based on available information and does not constitute the final word on coverage.

- *Monitoring the Matter Underlying the Claim* – In the case of shareholder litigation or a regulatory investigation, the notice of a potential claim may come months or years before a final determination or settlement. ICI Mutual monitors the lawsuit or investigation, as well as the legal and related fees incurred by the insured. Regardless of the nature of the claim, ongoing communication between ICI Mutual and the insured is critical.
- *Factual Investigation of the Underlying Matter* – ICI Mutual conducts its own factual investigation of the underlying matter. This investigation serves both a specific purpose and a broad purpose. The specific purpose is to gain an understanding of the relevant facts and circumstances in order to fairly evaluate whether coverage is available and, if so, in what amount. The broad purpose is to add to ICI Mutual’s institutional knowledge of when, how, and why losses of particular types are sustained by fund complexes. As described in greater detail below, ICI Mutual draws on its experience to assist fund complexes in avoiding losses in the future. As a result, these factual investigations help to enhance insurance’s role in managing operational risk.
- *Final Resolution of the Claim* – ICI Mutual advises its insured of its conclusions regarding coverage of the claim. The insured then has the opportunity to raise any factual or legal issues regarding the level of coverage. The final step is that ICI Mutual provides its final resolution and, if appropriate, payment of the claim.

G. *Payments of Claims*

Since inception, ICI Mutual has received more than 750 claims, of which over 100 are still active, and has paid out approximately \$143 million in 136 claims (with nearly \$27 million of that amount devoted to legal fees and expenses). In sum, ICI Mutual has paid out on over 20% of the closed claims. The percentage of paid claims is deceptively low due to several factors. The vast majority of unpaid claims were below the applicable deductibles. In addition, the applicable policies may have contained specific exclusions (such as for losses insured by another valid policy or for losses arising from an insured’s activities as a broker-dealer in securities other than fund shares) that precluded coverage of many claims. Finally, ICI Mutual counts as a “claim” every notification that it receives from an insured about a potential claim, whether or not such notification results in an actual claim filed.

It is difficult to provide any meaningful data about the length of time for the payment of claims. The length of time from the filing of a claim to its ultimate payment may be affected by a number of factors, including the following: the duration (months or even years) of litigation or regulatory investigations to which many claims relate; the need to develop sufficient information about a claim; and the responsiveness of the insured to ICI Mutual. As a testament to ICI Mutual’s even-handed treatment of its insureds in a claim situation, it should be noted that no insured has ever left ICI Mutual because it was unhappy with ICI Mutual’s claims handling or payment.

IV. Operational Risks Faced by Investment Companies and Related Entities

A. Key Investment Management Activities and Related Risks

Investment company complexes structure their investment management processes differently, depending on their size, investment style and philosophy, resources, and other factors. Nonetheless, the following six key activities in the investment management process are common to all complexes: (A) selection of securities; (B) execution of orders; (C) allocation of brokerage; (D) allocation of securities to client accounts; (E) pricing of portfolio securities; and (F) disclosure relating to investment management matters. Potential operational risks exist with respect to all of those activities, and insurance would typically cover all of the operational risks described below.

1. Selection of Securities

Selecting securities for client accounts is, of course, the heart of the investment management process. The portfolio manager, with assistance from financial analysts and others, typically researches and evaluates securities that are potential purchase or sale candidates. Any securities selected must be permitted investments and must comply with any relevant investment guidelines or restrictions applicable to the client account.

Poor investment performance, by itself, is not a basis for private or regulatory actions against complexes or portfolio managers, provided that adequate risk disclosure has been made to investors and the account has been managed in accordance with applicable guidelines. Rather, a recent study by ICI Mutual on Investment Management Compliance Risks (Compliance Risk Study) suggests that the most common sources of risk in this area have involved (1) impermissible investments, (2) failure to comply with applicable limits imposed on otherwise permissible investments, (3) failure to fully analyze the risk parameters of new strategies or products, and (4) employee misconduct. In each case, insurance would usually cover resulting losses.

2. Execution of Orders

Once a portfolio manager has decided which securities to buy or sell, the purchase or sale order must be executed. Execution typically involves two steps (1) the portfolio manager transmits the order internally to the trading desk, and (2) the trader arranges for execution of the order with a broker-dealer.

Good faith miscommunications and other errors can occur at a number of points during the order execution process. Some sources of risk in this area have involved (1) inaccurate execution of trade orders, and (2) unauthorized trading. These losses would generally be covered by insurance.

3. *Brokerage Allocation*

In allocating brokerage, the primary goal for investment company complexes is to obtain best execution. In determining whether any particular broker-dealer will provide best execution, a complex may consider a variety of factors, including the quality of brokerage services, the receipt of brokerage and research services, and the sale of fund shares/client referrals by the broker-dealer (subject to compliance with applicable disclosure and other requirements).

Sources of risk in this area occur when brokerage is allocated under circumstances suggesting that the complex or an employee, rather than obtaining best execution for clients, is seeking its own advantage.

4. *Allocation of Securities to Client Accounts*

Complexes frequently have an opportunity to purchase a security that may be appropriate for more than one client account. When a limited amount of a security is available at a given time, it must be allocated to client accounts in a fair and equitable manner.

One source of risk in this area has involved securities being allocated in a manner that favors certain clients or groups of clients. The risk is particularly significant if the complex has an economic interest in the favored accounts (*e.g.*, an in-house pension plan, accounts that pay a performance fee) or a business interest in increasing the favored account's investment returns (*e.g.*, the client is a source of referrals). Again, these losses would often be covered by insurance.

5. *Pricing of Portfolio Securities*

Once securities have been allocated to client accounts, they must be valued or "priced" properly (typically daily for open-end investment companies), and the prices must be accurately recorded in the complex's books and records for purposes of calculating net asset values/account values. The SEC staff has focused particular attention on the need for sound valuation procedures for mutual funds.

Net asset values or account values may be misstated because portfolio securities are incorrectly priced as a result of administrative oversights or errors, coupled with failures of back-up procedures. In addition, funds may receive inaccurate prices of portfolio securities from pricing services. Portfolio securities also may be incorrectly priced because of reckless or intentional misconduct by portfolio management personnel. The Compliance Risk Study suggests that the sources of risk in this area have involved (1) administrative errors in recording the details of trades (*e.g.*, amounts, CUSIP numbers, etc.), and (2) intentional misconduct by portfolio management personnel, who may be motivated to engage in such misconduct to obtain favorable performance for the account, to preserve their employment, or for other reasons. Losses of these types are generally covered by insurance.

6. *Disclosure*

Various provisions of the securities laws regulate disclosure about investment management in prospectuses, Form ADVs, advisory contracts, shareholder reports, and marketing materials used by complexes.

Complexes and/or individual personnel are exposed to potential liability when they fail to make full and fair disclosure as required by law and regulation. Errors may include inaccurate or incomplete disclosure of matters specifically required to be disclosed or the failure to disclose other material facts. Losses resulting from these errors are typically covered by insurance.

Over the years, shareholders have filed a number of actions against mutual funds and their investment advisors alleging, among other things, inadequate risk disclosure. Allegations of inadequate disclosure also frequently accompany allegations of errors in the other investment management areas described above. Even when successfully defended or settled, these types of actions can involve losses to fund complexes. Indeed, more than one-third of all amounts paid by ICI Mutual on insurance claims have involved allegations of false or misleading disclosure.

B. Common Causes of Investment Management Losses

Approximately two-thirds of insurance losses (approximately \$80 million) paid by ICI Mutual related to errors in investment management compliance. Other losses have stemmed from issues related to sales practices; underwriting; shareholding voting and proxy questions; advisory contracts; share registration; and other matters. Described below are the most common causes of investment management losses in our experience. However, we emphasize that losses in the investment company industry are relatively rare and are extremely low relative to overall assets under management.

1. New Investment Strategies and Products

The introduction of new investment strategies and products can be a source of new lawsuits or other claims. In some cases – such as claims arising from the use of new derivative instruments in the 1990s – the risk parameters of new strategies or products may not be fully appreciated by the industry at large. In other cases – such as claims involving a line of business new to a particular complex – the risk of new strategies or products, or the regulatory constraints applicable to them, may not be fully analyzed or understood by the individual complex or by key individuals within the complex. Examples of these types of losses include claims triggered by the failure of the instruments or techniques to perform as anticipated, or as disclosed in prospectuses or other public documents.

2. Communication Lapses

Communication lapses between portfolio managers and the individuals with whom they interact on a daily basis, such as traders and legal and compliance staff, may lead to investment management losses. Examples of these losses include investing in certain

derivative instruments, notwithstanding a statement in the prospectus that the fund had “no current intention” of making such investments.

3. *Regulatory or Client Limits on Investments*

A portfolio manager’s investment decisions typically are subject to constraints that are separate and apart from investment judgments. These constraints may be imposed by federal, state, or local law or regulation, the terms of disclosure documents or client advisory agreements, or other sources. Investment management losses may arise from a failure to consider and/or appreciate these constraints fully before investing. Examples of these types of losses include transactions that violate legal limits or client constraints.

4. *Administrative Errors*

Investment decisions often must be made and documented under severe time constraints. Simple administrative oversights by portfolio management personnel in decision-making and documentation underlie many claims reported to ICI Mutual. Examples of these types of losses include inadvertent mistakes in acting on a tender offer and calculation errors in rebalancing a fund portfolio to mirror a model index.

5. *Employee Misconduct*

The investment management industry has been relatively scandal-free. Nonetheless, there have been claims in which a portfolio manager or other individual with significant responsibilities has engaged in reckless or intentional misconduct. Senior management is particularly at risk in these cases for “failure to supervise” charges, particularly if it appears that meaningful oversight might have prevented the misconduct. The SEC expects supervisors to respond vigorously to any indication of possible wrongdoing. Examples include the misallocation of profitable trades among clients or excessive trading by an employee that resulted in regulatory investigations.

V. Management of Operational Risk by Investment Companies and Related Entities

A. *Regulatory and Structural Minimization of Risk*

From a regulatory and corporate governance standpoint, numerous safeguards exist to minimize operational risk to investment companies and related companies. Although an extensive discussion of those safeguards is beyond the scope of this paper, we have summarized below some of the key regulatory and structural features of investment companies that mitigate risk.

US investment companies are subject to stringent regulation – indeed, more stringent than that applicable to any other US financial institution. At least in part as a result of this regulatory scheme, the industry has been virtually scandal-free for over sixty years and has an excellent record of investor protection.

Among other things, the 1940 Act requires:

- close oversight and involvement in the affairs of an investment company by its board of directors (generally with a majority of directors who are independent of the investment companies or affiliated entities);
- approval of advisory and underwriting contracts by independent directors;
- frequent (usually daily) pricing of investment company portfolios;
- the segregation of the investment company's asset from other assets of or managed by its investment advisor;
- annual audits by independent public accountants; and
- protection against fraud by employees of mutual funds.

In addition, the 1940 Act prohibits or places severe restrictions on the activities of investment companies, including:

- their transactions with affiliates (such as investment advisors, underwriters, directors, officers, and significant shareholders);
- their capital structure, limiting their ability to issue multiple classes of stock; and
- their ability to leverage investments through borrowings.

In general, investment company complexes have responded to the stringent regulation – and the threat of SEC enforcement proceedings or shareholder litigation – by establishing comprehensive policies and procedures about virtually every aspect of the investment management process. Combined with the close oversight by the boards of directors, these policies and procedures form a strong system of internal controls. While operational risk is not, and cannot be, eliminated, the regulatory and structural framework ensures that it will be minimized.

B. Role of Insurance

In our experience, insurance, particularly E&O and D&O coverage, is reliable, affordable, flexible, and comprehensive and constitutes an important component of an investment company's risk management program. As such, it serves a number of functions, including the following:

- Protecting shareholders
- Protecting investment companies and related entities
- Enhancing operational efficiency

- Promoting risk management

We believe that, in the US experience, insurance has proven to be a highly effective means of managing operational risk in the investment management industry.

- *Reliability of the Insurance Cover* – Our experience in US markets supports our belief that insurance provides a highly reliable means of managing operational risk. This reliability is ensured by the following:
 - Tight regulation of insurance companies – Insurance companies are subject to state regulation. ICI Mutual, for example, is regulated by the State of Vermont and is subject to periodic inspections.
 - High ratings of insurance companies in the investment management field – There are a number of highly regarded rating services, including A.M. Best Company and Standard & Poor's, that grade insurance companies on a number of different factors, such as their claims-paying ability, level of capitalization, and operating performance. For example, ICI Mutual has an "A" (excellent) rating from A.M. Best Company. Certain regulatory schemes in the United States (e.g., banking) may require that regulated entities use insurance companies with a certain minimum rating level. Most insureds consider ratings to be meaningful when purchasing insurance.
 - Cancellation policies – As described in greater detail below, we believe that the existence of an insurance company, such as ICI Mutual, that is dedicated exclusively to the needs of the investment management industry has been a significant factor in ensuring the availability of adequate coverage of operational risk. ICI Mutual was formed, in part, to ensure stable coverage for investment companies.
 - Timeliness of claims processing and payments – ICI Mutual has consistently provided its insureds with expeditious processing of claims and, where appropriate, payment on those claims. ICI Mutual's status as a captive insurance company ensures a high level of reliability in processing – and paying – claims. As noted above, the vast majority of claims not paid by ICI Mutual result from losses that are below the applicable deductibles or that are specifically excluded from coverage under the applicable policies. In addition, ICI Mutual counts as a "claim" a notification from an insured that a claim is possible, even if no claim is ultimately submitted to ICI Mutual. The fairness of ICI Mutual's claim resolution process is shown by the insureds' continued use of ICI Mutual long after their insurance claims are resolved.
- *Formula for Recognition of Insurance* – The development of a formula for alleviating capital requirements with insurance is beyond the scope of this paper and may, in any event, be difficult to devise *a priori*. However, we believe that

any such formula should not merely permit, but encourage, institutions to alleviate capital requirements with insurance because of the advantages that an insurance framework has over a capital adequacy framework. Moreover, any such formula should be designed to provide institutions with a greater incentive to strengthen their risk management programs and to maintain comprehensive insurance.

- *Incentive Structure of the Capital Adequacy Framework* – We believe that, in the US investment management industry, there are strong incentives for investment companies and related entities to maintain sufficient insurance, although the exact coverage that a particular entity will choose depends on the entity's tolerance for risk. Even more important, however, the US insurance regime provides strong incentives to strengthen risk monitoring and management systems for operational risk.
 - *Moral Hazard Issue* – We do not believe that insurance presents a stronger moral hazard in the investment management industry than it does for any other class of insureds. In particular, we believe that the threat of SEC enforcement proceedings, the possibility of large non-monetary (e.g., reputational) losses, the general exclusion for losses resulting from intentional conduct, and other potential losses related to operational risk mitigate any moral hazard problem presented by D&O and E&O coverage.
 - *The Impact of Underwriting Standards on Operational Standards* – In our experience, underwriting standards raise operational standards. As a condition to obtaining certain types of coverage or to obtaining more favorable rates for some coverage, investment companies may be required to improve their internal controls or procedures or to take certain other steps. As described in greater detail above, ICI Mutual closely scrutinizes its insureds in the underwriting process, both for new policies and for policy renewals. As a result of this scrutiny in the underwriting process, ICI Mutual has effectively imposed stronger standards on the investment company industry in a number of areas, including voice-initiated shareholder transactions, the acceptance of third-party checks as payment for investment company shares, computer-to-computer transactions, the security of investment company computer systems, and the errors in processing corporate action requests from portfolio companies. This threat of non-coverage provides an incentive to strengthen internal controls and thus to maintain sufficient coverage.
 - *The Educational Role of the Underwriting Process* – ICI Mutual has found that the underwriting process can serve an educational function for insureds. For example, if an insured uses new strategies or products, it may not have fully analyzed or appreciated the risks associated with those strategies or products. The underwriting process may assist that entity in focusing on those risks.

- *Risk Management Programs* – Insurance companies have a strong financial incentive to actively promote efforts by their insureds to strengthen their risk management programs and help their insureds better manage their risk. For example, ICI Mutual has a formalized risk management program to help fund groups improve their ability to prevent potential losses and claims. As part of this effort, ICI Mutual conducts industry studies that focus on specific risk areas and advise insureds on how to minimize those risks. In addition, ICI Mutual routinely conducts educational presentations on risk management to the boards of insured funds and to their legal and compliance staffs. ICI Mutual also works with individual insureds on managing their risks.
- *Impact of Industry Studies* – Industry studies on particular types of risk may lead to fewer claims. For example, in 2001, ICI Mutual published a major study on *Managing Risk in Processing Corporate Actions*, which was provided to all of ICI Mutual's insureds. Prior to the publication of the study, there had been more than \$12 million in losses reported to ICI Mutual in a five-year period resulting from errors made by advisors in processing tender and exchange offers and similar types of requests from issuers of portfolio securities. After the publication of the study, which focused on techniques that fund complexes may use to manage such risks, there were no new corporate action request claims.
- *Sensitivity to Industry Needs* – As service providers to the asset management industry, insurance companies, especially captive insurance companies, need to be – and are – sensitive to the specific needs of the industry and thus tailor their insurance to those needs. In addition, ICI Mutual provides innovative coverage to the industry, such as the costs of corrections coverage. This better serves the industry and the ultimate shareholders.
- *Transferring Risks from Banking and Investment Firms Sectors to the Insurance Sector* – Insurance operates on the concept of transferring risk from one entity or group of entities to another. Indeed, without a proper transference of risk, premiums could not be considered a business expense in the US. Therefore, the insurance provided by ICI Mutual and other insurance companies is intended to transfer risk from the investment company industry to the insurance industry. The insurance industry, however, accepts only those risks that it believes that it is able to accept profitably. There is little evidence that this transfer of risk has posed a problem in the US system. This is true in part because the level of risk has been relatively small, as is demonstrated by the extremely small ratio of insurance premiums to assets under management and the even smaller ratio of claims paid to assets under management. In addition, we believe that the risks facing the investment management business are not systemic, but generally arise on a sporadic, fund-by-fund basis. As a result, it is, in our view, extremely unlikely that an event or series of events related to operational risk would result in losses that the insurance industry would be unable to absorb.

- *Additional Benefits of a Captive Insurance Company* – Although, as described above, insurance companies in general provide significant benefits to the asset management industry, a captive insurance company was formed in the US to meet the demand for a more stable and predictable insurance marketplace. As a captive insurance company, ICI Mutual provides several benefits, including greater reliability in payment of claims and a greater sensitivity to industry needs and concerns. In addition, because of ICI Mutual's unique position in the investment company industry and strong focus on risk-based pricing, the premiums charged by ICI Mutual are less affected by market or other exogenous factors, despite a weak economy, a hardened reinsurance market, and a trend of rising claims, and thus exert a moderating influence on premiums charged by other insurance companies. This moderating influence on premiums brings stability and predictability to the marketplace, allowing investment companies and related entities to plan more effectively and to operate more efficiently. A stable, predictable insurance marketplace in Europe can be met either through the existing insurance industry or through the creation of a captive insurance company.

C. Conclusion

- The risks in the asset management industry are extremely low and primarily arise from the investment management process itself. Losses in the asset management industry have historically been insignificant in comparison to the total assets under management.
- Insurance is extraordinarily cost-effective. Insurance premiums constitute a minute percentage – less than a thousandth of one percent – of insured assets.
- Insurance provides a comprehensive means to address the risks in the industry, which protects all of the industry participants, including shareholders. As described above, insurance provides coverage for virtually every key operational risk faced by investment companies.
- Insurance provides the significant benefit of creating a strong financial incentive for asset management firms to improve their internal controls and risk management programs.
- Insurance companies, through the underwriting process, risk analysis studies, and strong risk management programs, play an instrumental role in reducing operational risk in the asset management industry.