

INVESTMENT ADVISOR SERIES

# **Proper Insurance Coverage Should Not Be An Afterthought In The Plan Sponsor's RFP Process**

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Presented by

North American Professional Liability Insurance Agency, LLC (NAPLIA)

## Introduction

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Why should plan sponsors care if their Advisors, Record Keepers, Third Party Administrators (TPA's) and other consultants have Errors and Omissions (E & O) insurance? Because, mistakes happen and plans may require indemnification from their investment professionals. Insurance is one significant way to ensure indemnification. Once a breach occurs, it is too late to question if the proper insurance coverage is in place.

Until recently, most plan sponsors were satisfied with a certificate of insurance showing effective dates with limits and deductibles. At most, some plan sponsors asked to be certificate holders. Today plan sponsors should require much more, including a full copy of the policy form with all endorsements or, if possible, a statement from an independent third party insurance broker that has reviewed the investment professional's E & O coverage and can confirm their policy provides affirmative ERISA fiduciary coverage. In addition, the name of the carrier and their A.M. Best rating (a measure of financial strength) should be provided.

Proper insurance should be used in the vetting process for the RFP. If all things are equal among two qualified advisors bidding in the RFP process, than a plan sponsor should select the advisor with the best evidence of affirmative fiduciary coverage and dishonesty bonding.

In addition, investment advisors will often use other professionals to handle certain functions related to the ERISA plan. The plan sponsor should require evidence of insurance from these entities, when known, even if there is not a direct relationship.

Plan sponsors may not always have the expertise to evaluate an insurance contract in order to determine proper coverage. At this point, bringing an insurance expert into the RFP process to assist in the evaluation of adequate insurance coverage is recommended.

## What types of insurance protection should plan sponsors require?

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### 1. Errors & Omissions (aka. E&O, Professional Liability) Insurance with affirmative fiduciary coverage

An Errors & Omissions policy protects advisors and consultants against losses due to any actual or alleged negligent act, error or omission committed in the scope of their professional duties. Affirmative fiduciary coverage ensures that the policy extends to the professional's duties as a fiduciary under ERISA. Fiduciary coverage under the investment professionals E & O policy is considered "third party" as the advisor does NOT have a direct relationship to the plan, but rather is providing services to the plan. However, the advisor may still be considered a fiduciary to the plan.

#### First Party Fiduciary Insurance

"First party" fiduciary insurance is a policy purchased by the plan sponsors to cover mistakes made directly by the plan sponsors. It protects the functional fiduciaries of the plan (either appointed, or by function) for allegations of breach of their fiduciary duties.

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### 2. Investment Advisor ERISA Bond and/or Employee Dishonesty Bond (aka. Theft coverage, fidelity bond)

Bonding for the investment professional comes in two parts; ERISA Bonds and Employee Dishonesty Bonds. The first part is ERISA bonding under section 412. ERISA requires an advisor that has any discretionary authority over plan assets or *handles* any plan assets to be bonded<sup>1</sup>. This is required even if the advisor does not custodian any of the funds. ERISA requires the investment advisor to provide a bond equal to 10% of plan assets up to \$500,000 (\$1MM if the plan has company stock). This is the minimum bond required, however plan sponsors may also request more if there are significant assets at stake.

Most Investment Advisor ERISA Bonds are written on a blanket basis. The policy covers all plans serviced by the advisor and each plan is listed on the application at the start of the year. Any new plans added during the course of the policy period are automatically included and should be listed on the renewal application. Investment Advisor ERISA Bonds meet specific ERISA requirements such as having no deductible.

In addition to ERISA bonds, companies may have other assets invested with an advisor outside of their 401K plan. In this scenario, companies should insist that the investment professional carry an **Employee Dishonesty Bond** that specifically covers funds of clients against theft by the advisor or their employees.

## Fiduciary Duty

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Plan sponsors have a fiduciary duty to plan participants to protect plan assets. Failure to ensure that advisors have the proper E & O insurance and bonding could be a breach of fiduciary duty by the named fiduciaries.

Plan sponsors should carry their own fiduciary insurance to cover potential mistakes in their 401K plan as well as other health and welfare employee benefits. (see sidebar [First Party Fiduciary Insurance](#)) In a study of companies with fewer than 100 employees, it is predicted that 12% will have a claim that could be covered under a first party fiduciary policy<sup>2</sup>.

Companies often have employees that may not be named as fiduciaries in the plan documents, but perform duties related to ERISA. These employees are considered functional fiduciaries. See “Resources: Who is a Fiduciary under ERISA”. Companies should purchase a policy that provides coverage for both named fiduciaries and functional fiduciaries.

## Conclusion

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In conclusion, both first party and third party fiduciary claims are on the rise. The Financial Industry Regulatory Authority (FINRA) reported the number of arbitrations filed against investment professionals increased 43% from 2008 to 2009. Breach of fiduciary duty represented 59% of all complaints.<sup>3</sup>

Plan sponsors need to understand the basics of insurance and bonding. And, they need to build questions and standards into the RFP process to properly evaluate investment professionals.

## Contact

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They welcome your thoughts and comments.

### **Plans Subject to ERISA**

Plans subject to ERISA are not limited to Pension/401k plans. In fact, 50% of ERISA related claims arise from Health & Welfare related plans. Plans subject to ERISA:

#### **Pension Plans**

Profit Sharing  
Thrift & Savings (401k)  
Employee Stock Ownership (ESOP)  
Tax Reform Act Stock Ownership Plans (TRASOP)

#### **Welfare Plans**

Life Insurance  
Hospital-surgical-medical  
Dental & vision care  
Accident Insurance  
Disability Insurance  
Scholarship plans (funded)  
Supplemental unemployment  
Prepaid legal services  
Some severance pay plans

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## Plan sponsors checklist for proper insurance:

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- Evidence of affirmative fiduciary insurance coverage in E & O insurance policy
- Evidence of ERISA bonding on a blanket basis
- Evidence of employee dishonesty coverage that protects the company's funds from theft by the investment professional and their employees.
- If possible the plan sponsor should look for independent limits unique to the individual investment professional as opposed to shared limits with the broker dealer
- Plan sponsors should always carry their own first party fiduciary insurance

## Resources

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Frequently Asked Questions (FAQs) regarding ERISA and Fiduciary Liability -  
<http://www.fiduciaryinsurance.com/Resources/faqs.htm>

Who is a Fiduciary under ERISA?  
<http://www.fiduciaryinsurance.com/Resources/fiduciary.htm>

## Footnotes

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- 1 Section 412 of Title I of the Employee Retirement Income Security Act of 1974 (ERISA), subject to certain exceptions, requires that every fiduciary of an employee benefit plan and every person who handles funds or other property of such a plan shall be covered by a fidelity bond that meets the requirements of section 412 of ERISA and the Department of Labor's implementing regulations.
- 2 Towers Watson, 2008 report
- 3 Linda Fienberg, FINRA Dispute Resolution and EVP/Chief Hearing Officer. 2008 – 4,982, 2009 – 7,137