Mutual Fund Directors Forum
The FORUM *for* FUND INDEPENDENT DIRECTORS

Report of the
Mutual Fund Directors Forum

Practical Guidance on Director and Officer Insurance for Fund Independent Directors

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I. Introduction and Summary

The economic crises and scandals over the last three decades resulted in increased litigation and regulation of the financial industry.[1] Directors and officers are not immune from the heightened risk of litigation and regulatory enforcement that most frequently target fund advisers and service providers of the funds directors oversee. The costs of investigations, examinations, trials, settlements, judgments, and penalties can be staggering. Therefore, when a regulatory investigation or legal proceeding is launched, a director may ask:

- Are directors' personal assets ever at stake?
- Who will cover the costs?
- What are the fund's obligations to the directors?
- Are the fund and its directors covered by insurance?
- Is the insurance coverage adequate for the entire claim?
- Who pays the costs when a director is asked to serve as a non-party witness?
- What types of insurance coverage are available to directors?
- What happens if there is a divergence of interests between fund directors and the adviser?

Indemnification and insurance are directors' main lines of defense when they or the funds they oversee are threatened with litigation or costly regulatory action. This paper[2]:

- sets forth general principles on indemnification and director and officer (D&O) and errors and omissions (E&O) insurance;
- examines areas of potential liability for directors; and
- discusses the evolving area of cybersecurity insurance.

Civil Litigation, Regulatory Action Expose Fund Independent Directors to Personal Liability

While fund directors are always at risk of being sued, historically their actual exposure to personal liability has been low.[3] Civil litigation typically targets advisers, distributors and other fund service providers, although from time to time independent directors are directly named as defendants in lawsuits.[4] Directors also have been called as witnesses in shareholder lawsuits against fund advisers that have challenged the fund board's processes in determining fund fees and board approvals of advisory contracts. Any personal liability exposure for directors most likely will be incurred through the costs of legal representation or expert assistance in preparing a defense or preparing to serve as a witness. Fund directors' exposure to litigation can arise in a number of other ways, including claims that:

- Allege breach of directors' fiduciary duties of care and loyalty to the fund and its shareholders under state law;
- Allege directors failed to fulfill their obligations to the fund and its shareholders under federal securities laws;
- Challenge the accuracy or completeness of prospectus disclosures; and
- Challenge the structure or governance of closed-end funds.

In addition to private litigation, fund directors also could be the target of federal agencies for allegedly having a role in a fund adviser's violations of the securities laws or for failures in the directors' fund oversight responsibilities.[5] Regulatory actions can leave fund advisers and affiliates with years-long, costly examinations that can end in large monetary penalties, fines and judgments. Directors will want to understand the extent to which the costs associated with these matters are covered by indemnification or insurance. Moreover, even when fund directors are not directly implicated in these investigations, fund independent directors may be required to protect the interests of the fund and shareholders by leaning on the adviser to efficiently manage the legal or regulatory proceeding.

Insurance and Indemnification Work Jointly to Protect Directors

When a director is called as a defendant, litigation witness, or is the target of a regulatory investigation, independent counsel most likely will review what the fund's charter, bylaws, indemnification agreements, and D&O insurance policy say about reimbursement and advancement of legal costs and expenses.

Indemnification allows one party to shift the burden of financial liability to another, subject to conditions of state law as well as a corporation's governing documents. In the mutual fund context, indemnification enables a director to avoid paying for legal fees, costs or other expenses out of his or her own resources. The fund pays the expenses, which may be reimbursed to the fund by the D&O insurance carrier. A fund's governing documents (or an indemnification agreement) may also contain provisions that entitle a director to receive advancement of legal expenses (which operates separately from indemnification) under specified terms and conditions. The D&O insurance policy itself contains clauses that operate, generally, to compensate the fund for the amounts paid out to indemnify the director, advance expenses or directly compensate the director for losses arising from claims not indemnified by the fund.[6]

D&O insurance pays for liabilities resulting from claims made against a fund's past, present and future directors for acts occurring in their official role, including negligence and breach of fiduciary duty. The directors' liabilities covered by the policy are paid by a third-party insurer, unlike indemnification, which is paid directly out of the fund's assets. Both indemnification and D&O insurance allow for advancement of expenses.

The joint protection of indemnification and D&O insurance has long served to protect fund directors from personal liability, but directors increasingly are seeking to obtain assurances from independent counsel that insurance coverage is adequate and D&O policy provisions are broad enough to protect them from emerging liability threats. Fund directors would be well served to understand their exposure and responsibilities – whether as third-party witnesses, defendants or simply as a co-insured with other parties in various legal disputes – and to explore the nature and adequacy of liability protections available to them. Directors may wish to work closely with fund counsel, independent counsel, an insurance lawyer, broker or consultant to understand the workings of indemnification and insurance.

II. Indemnification and Insurance are Directors' Main Lines of Defense from Incurring Personal Liability

The Basics

► **What is indemnification?** Indemnification permits a party to shift the burden of financial liability from one source to another. When a fund director faces legal expenses and liabilities arising out of his or her role as a director, indemnification transfers the financial liability from the director to the fund.

► **When do I need it?** When a director is named as a defendant or a witness in civil litigation, indemnification is the director's first level of protection, allowing reimbursement for legal expenses and the costs incurred from judgments and settlements. Indemnification may also cover a director's deposition costs, attorney fees and other expenses, even before a claim is established with the insurer.

► **How do I know that my fund indemnifies its directors?** Indemnification operates under a statutory framework governed by state law. Generally, most state laws require organizations to provide indemnification for trustees and directors and to fully indemnify the legal expenses for directors who are completely cleared of wrongdoing. Indemnification provisions are written into a fund's bylaws or charter. Funds can also enter into indemnification agreements with directors, which must be approved by the board. The SEC requires that indemnification provisions (in fund bylaws or charters, for instance) set forth reasonable and fair means for determining whether a director is entitled to indemnification.

► **Am I guaranteed indemnification?** The right to indemnification is contingent upon a director's conduct. Each state has established a minimum standard of conduct that makes a director eligible or ineligible for indemnification. Generally, statutes require that a director is either completely cleared of wrongdoing or has acted in good faith and in accordance with the belief that his or her actions were in the best interest of the corporation. Criminal acts by a director are generally presumed to be ineligible for indemnification.

► **What happens before I can receive indemnification?** In order to determine a director's eligibility for indemnification, state statutes generally require a majority vote of the directors who are not involved in the action or proceeding; or a vote by a committee designated by a majority of the uninvolved directors; or a written opinion by independent legal counsel.

► **Can I ever be denied indemnification?** Although rare, in unusual circumstances indemnification can be denied due to disputes among directors, the nature of the legal action or proceeding, and legal disputes over whether the action is indemnifiable.

► **Is there any action I can take after being denied indemnification?** Directors and officers have brought legal action against companies that have refused to indemnify legal costs associated with their defense. Similarly, companies have sued insurers that refused to reimburse the companies' costs in indemnifying their directors and officers.

► **Is indemnification ever prohibited by law?** The Investment Company Act of 1940 prohibits indemnification for a director who has engaged in willful misfeasance, bad faith, gross negligence, or reckless disregard of the duties involved in the conduct of his office.

- ♦ A director cannot be indemnified against liabilities arising under certain federal securities laws, such as certain violations of the Securities Act of 1933. The SEC has affirmed that indemnification against liabilities incurred while violating federal securities law is contrary to

public policy and is therefore unenforceable.[7]

♦ Certain regulatory fines and penalties are not indemnifiable. SEC administrative orders regularly prohibit parties from seeking indemnification in the paying of fines and penalties, and courts have agreed that the SEC can prohibit a defendant from seeking or accepting any payment, reimbursement, or indemnification from any third party for a penalty because the "remedial purpose" of the penalty would be diluted if it were paid by a third party.[8]

♦ Each state has its own statutory framework, however, a director generally may not be indemnified by a corporation if the act or omission of the director was committed in bad faith; was the result of active and deliberate dishonesty; the director actually received an improper personal benefit in money, property, or services; or in the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful.

A. Indemnification Is Governed by State Law, Corporate Documents, Contractual Agreements

A fund director's potential right to indemnification can arise:

- by the operation of state or common law;
- under the charter or bylaws of a corporation;
- under the terms of an insurance policy or indemnification agreement.

A director has no express right to indemnification under the federal securities laws and should discuss with independent counsel the conditions under which state law permits or requires indemnification and any related conditions to receiving indemnification.[9]

B. Indemnification in Contractual Arrangements

Many states permit corporations to enter into indemnification agreements with their directors and officers. These contractual arrangements, which must be approved by the board, can secure a director's rights to indemnification even in the event a board amends the fund bylaws or charter documents. An indemnification agreement provides several benefits, including giving fund directors a contractual right to specific procedures for indemnification and advancement of expenses, setting forth the timeframe in which a company will respond to requests for indemnification, and establishing alternative remedies if the company refuses[10] to indemnify the director or advance legal expenses regardless of whether a final adjudication or disposition has cleared the director of wrongdoing. An indemnification agreement may even provide directors protections beyond what is allowed by statute and many standard fund insurance policies. Overall, the general aim of an indemnification agreement should be to both protect the fund and give directors enough comfort to confidently serve and carry out their roles on the board. Directors may wish to discuss with independent counsel the indemnification statutes where their funds are domiciled to help determine whether an indemnification agreement would be appropriate.

Navigating an Indemnification Agreement

Indemnification agreements typically provide that directors are protected to the fullest extent permitted by law. Changes in the state's indemnification statutes are automatically incorporated into the agreement. The key provisions in an indemnification agreement are: that the fund will maintain insurance; that the director can request advancement of expenses; a procedure for determining whether the director is eligible for advancement of expenses and indemnification; and that the agreement continues after the director leaves the fund board.

C. Key Considerations in Reviewing Indemnification Agreements

Extent of indemnification protections	The obligation to indemnify directors should extend as broadly as permitted by state law. Review carefully any liabilities or expenses that are excluded from indemnification.
Exceptions from indemnification	Indemnification is most commonly withheld when a director is deemed ineligible by federal law, a determination made by a court or by a majority of directors uninvolved in the action or proceeding. Any other exceptions to eligibility should be reviewed closely with independent counsel.
Specific policies and procedures not covered by state law	It is helpful when an agreement can specify the timeline and procedures for receiving indemnification.
Dispute resolution when indemnification is withheld	Indemnification agreements should outline specific procedures for resolving disputes over indemnification rights.
Clarity on contractual issues and definitions	Indemnification agreements should be specific in their usage of terms. For instance, the definition of "expenses" and "proceedings" can bear heavily on what is and is not considered indemnifiable.

D. Advancements of Legal Fees and Expenses

While advancement of expenses and indemnification are closely related, they are not identical. Advancement operates like a credit, in that it provides a director "immediate interim relief"[10] from paying out-of-pocket expenses related to investigations and legal proceedings while indemnification involves the right to receive reimbursement for losses. A director may receive advancement of expenses before his or her expenses are deemed eligible for indemnification. Another key characteristic of advancement of expenses is that a director who is ultimately found ineligible for indemnification will be required to repay the amount advanced.

Regulatory Requirements

Most corporations are obligated under state law or their charter documents to advance the costs of a director's legal defense before the final disposition of an underlying claim pursuant to certain procedural requirements.[11] According to the SEC staff,[12] before advancing legal fees to a director, a fund's board must either: (1) obtain assurances, such as insurance or collateral or a written commitment from the director, that the advance will be repaid if the director is found to have engaged in disabling conduct; or (2) have a reasonable belief that the director is eligible for indemnification, *i.e.*, has not engaged in disabling conduct. SEC staff has stated that such reasonable belief may be formed either by a majority or a quorum of the independent, non-party directors of the fund, or based on a written opinion provided by independent legal counsel.[13]

III. Overview of Directors and Officers and Errors and Omissions Insurance

The Basics

- ► **Am I legally required to have insurance?** While there is no legal requirement for directors to obtain insurance, the SEC permits funds to purchase D&O insurance coverage to encourage the independence and effectiveness of their independent directors.
- ► **How does D&O insurance benefit me?** D&O insurance protects fund directors' personal assets against the costs of legal expenses and other potential losses incurred in fund-related litigation, regulatory investigations and enforcement actions, as well as when directors serve as non-party witnesses in litigation. D&O insurance may also provide advance payments to directors to cover expenses incurred before a final adjudication of a legal proceeding.
- ► **Should my board obtain independent director liability coverage?** D&O insurance is typically purchased under one policy for the fund, adviser, its affiliates, directors and officers to capture savings and coverage efficiencies. A joint policy offers several advantages, including ease of administrating claims and uniformity in the policy's terms. However, more fund boards are expressing interest in separate independent director liability coverage due to concerns over increasing litigation costs and depletion of policy limits under a joint policy. As discussed above, directors historically have faced relatively low risk of financial exposure to legal liability and directors should discuss with independent counsel the benefits and disadvantages of joint director liability coverage.
- ► **How much insurance do I need?** When determining the appropriate amount of coverage, directors will generally defer to independent counsel, management and insurance brokers. Directors may discover that the focus in policy negotiations is the adviser and the fund rather than independent directors mainly because directors face a lower risk of liability. Factors that help determine the amount of coverage include: industry benchmarks, peer reports, size of the fund's assets, past claims filed by the fund and its directors and officers, the types and risk profile of funds in the complex, and recent industry litigation trends.
- ► **Is the insurer obligated to launch a defense on my behalf?** D&O insurance policies do not require an insurer to defend claims brought against a director; that obligation rests with the insured person. The D&O policy merely reimburses the insured person for covered costs associated with that defense.
- ► **Will D&O insurance cover every legal liability?** Insurers may deny coverage for a variety of reasons. Disputes can arise regarding what is considered a claim or a loss under the policy and whether the insured gave proper and timely notice of a claim, among other things. In addition, joint policies also carry the risk of erosion of policy limits.
- ► **What are my responsibilities with respect to the fund's insurance?**[14] Fund independent directors are required to approve the insurance policy that covers the fund based on certain considerations.

A. D&O Insurance Mainly Benefits Directors and Officers While E&O Insurance Primarily Benefits the Fund

Most funds obtain insurance policies that cover the fund's present, past and future directors and officers for claims made against them for acts occurring in their official role and such policies also cover the fund to the extent the fund indemnifies its directors and officers. Generally, when a director becomes legally obligated to pay any amount resulting from an action occurring in his or her professional role, the fund indemnifies the director's costs and the insurer then reimburses the fund, either upon culmination of or during the legal proceeding. In the very rare circumstances when the fund is unable to provide indemnification, a D&O policy can directly cover a director's legal costs and expenses.

> ***Risks covered by D&O/E&O and IDL Insurance***
>
> - Defense costs for prospectus liability lawsuits
> - Settlement costs, judgments
> - Costs for directors serving as non-party witnesses
> - Costs for formal and informal regulatory investigations
> - Adviser defense costs in certain lawsuits
> - Costs of correction of errors

Many funds also obtain errors and omissions (E&O) insurance policies for the fund, its officers and directors, and the fund's adviser. Funds and advisers may, in certain situations, maintain separate errors and omissions insurance policies for each entity. Generally, E&O insurance covers claims based on the insured's designated acts, errors, or omissions. An E&O policy may also cover fund service providers, including the adviser, distributor, transfer agent or administrator and their representatives. E&O insurance typically covers losses incurred due to mistakes in providing investment management services, such as pricing errors; inaccurately executed trades; and unauthorized moving of portfolio assets.[15]

Funds also may choose to purchase excess insurance policies for added or specialized protection (such as standalone independent director liability (IDL) and cyber security insurance). Some funds use multiple insurers instead of a single carrier to hedge against insurer insolvency although the use of multiple insurers can present administrative burdens when seeking recovery of costs.

B. Categories of D&O Insurance Coverage

Mutual fund D&O policies contain two standard insuring clauses. Side A Coverage insures the personal assets of directors and officers against losses that the fund is not legally or financially able to indemnify. Side B Coverage, also known as fund reimbursement coverage, reimburses the fund for legal expenses paid in advance or other amounts paid to indemnify directors and officers. The Side A and Side B insuring clauses are limited to the total coverage amount available under the policy. Side B coverage typically requires the insured to pay a "retention," which is an amount the policyholder, must pay before the insurer makes any reimbursement payments. Side A insurance coverage is not subject to a retention.

Categories of Coverage	
Side A	Coverage for directors' losses not subject to indemnification. Protects directors' personal property and assets if the company does not pay defense costs or indemnification.
Side B (Fund Reimbursement Coverage)	Coverage for the fund and affiliates that will provide reimbursement if the fund advances legal fees or indemnifies directors against losses. Most common.

C. Navigating a D&O Insurance Policy

D&O insurance policies feature certain standard characteristics and terms although there are significant variations among insurance carriers in how those terms are defined and applied. A policy's front page, or declarations section, normally will set out its duration (typically one year but could be up to three years); the dollar limit of liability that the policy will cover; related deductibles or retentions; definitions of terms; and exclusions from coverage. See the Glossary in the Appendix for a list of key D&O policy terms.

D. Major Terms and Definitions

Determining the **policy limit**, or maximum amount of coverage, depends on a variety of factors, and the expertise of independent and fund counsel and insurance brokers is key for such determinations. Considerations include: the size of the fund's assets; the number of insureds under the policy; and the fund's history of prior claims.

Normally, the insurance coverage process is initiated when a **claim** is communicated to the insurer. Definition of a claim can include: the filing of a legal action, a formal regulatory investigation, or a writing that makes a demand for payment or serves such a demand on an insured.[16]

The majority of D&O policies are **claims-made**, which means that coverage is triggered when a claim is made against an insured. For claims-made policies, directors should be aware of the insurer's notice requirements and other claims-reporting conditions. A claim may also be initiated by giving the insurer a **notice** of circumstance, by alerting the insurer to the happening of a fact or issue that could result in future claims or demands on the policy. **Occurrence-based** insurance policies cover events during the policy period and allow for claims to be asserted after the policy expires, an open-ended feature which leads to greater uncertainty for the insurer (and usually a higher expense for the policy owner) than a claims-made policy. Under either type of policy, giving timely notice of a claim (or potential claim) is of critical importance, since failure to do so could result in a denial of coverage.[17]

D&O policies do not cover every possible claim that may arise. Typical **exclusions** from coverage, sometimes termed "conduct exclusions," include breach of contract, claims arising from bodily injury, personal injury or property damage, dishonest, fraudulent or criminal acts, personal profit of the directors and officers, environmental violations, violations of certain statutes like ERISA (which has its own legal framework of fiduciary liability), and claims made by and against persons insured under the same policy (the so-called "**insured** vs. **insured exclusion**"). The SEC recognized in 1999 that insured vs. insured exclusions in D&O policies may provide inadequate protection to fund independent directors in disputes with other parties under a joint D&O/E&O policy, and thus effectively disallowed a joint D&O insurance policy from excluding coverage for litigation between fund independent directors and other parties under the same policy.[18]

The **self-insured retention** operates similarly to a deductible in that it is a portion of the loss the insured must pay before the insurer will distribute any proceeds. Side A insurance typically does not apply a retention. For large funds, a retention can range from $500,000 to $1 million.

E. The Director's Role in Policy Negotiations

The topic of insurance may arise once per year during fund board meetings, typically around the policy renewal, with additional questions addressed at a subsequent board meeting. However, there is an ongoing need for independent counsel to carefully review coverage terms either with newer directors or during periods of increased litigation or regulatory enforcement risk. Industry trends, such as new coverages, topics in insurance industry litigation and regulatory priorities, may also necessitate renegotiations of policy terms.

Directors also may wish to review with independent counsel the considerations that inform the structure of the D&O policy and to identify the questions that should be addressed to fund counsel or the insurer. Boards may take differing approaches in this process. For instance, a board may assign a committee or just one director to work with fund counsel on renewals, current trends and general issues. When selecting an insurer, it is especially important to consider the insurer's knowledge of and commitment to the mutual fund industry and the insurer's claims-paying reputation and historical record.

F. Considerations for Approval and Renewal, Appropriate Amount of Coverage

When approving or renewing a D&O policy, directors may wish to consider:

- Whether the insurer is focused solely on the investment management industry or is a larger, more diversified insurer that offers D&O insurance to a range of industries;
- the financial strength and credit rating of the insurance carrier, for example ratings from A.M. Best;
- the insurer's knowledge of the mutual fund industry and reputation (in responding to policy claims, history of denying coverage, for example);
- whether the insurer is dependent upon reinsurers to collect funds required to pay claims and, if so, whether the reinsurers are highly rated or have provided collateral to the insurer;
- the costs of coverage and competitive rates, and how the insurer's policy provisions compare to others in the market;
- whether the policy will cover multiple parties (including the fund, advisers, other service providers, and the directors)
- the scope of the coverage, such as whether the policy will cover informal SEC investigations or data breaches;
- recent actions against fund directors and the penalty or settlement amounts;
- the risk profile of the funds; and
- the funds' assets under management.

Beginning the renewal process early will allow the insurance broker adequate time to negotiate with a variety of carriers and to lessen the chance that coverage enhancements will be denied without time to explore other options.

When determining the appropriate amount of coverage, directors will generally defer to independent counsel, management and insurance brokers but may still wish to consider industry benchmarks, past claims filed by the current fund and its directors and officers, the types of funds under management in the complex, and recent industry litigation trends. Peer reports provided by insurers, insurance brokers and consultants provide helpful comparisons of insurance coverage limits among mutual fund complexes. An annual review of prospectuses and other fund documents can help the adviser and counsel identify potential risks emerging in the markets. Directors may also consider whether any covered entity under

the joint policy has already claimed losses in the coverage period. Directors may also discuss with independent counsel whether a joint policy with the adviser and service providers or a standalone policy covering only the directors and officers is appropriate.

G. Common Challenges with D&O Insurance Negotiations

Definition of a Claim

One of the most important negotiating terms in a D&O policy is what constitutes a claim. That determination will trigger the insured person's obligation to timely report the event under the policy's notice requirements before coverage commences. Some D&O policies' definition of a claim include formal lawsuits, investigations and administrative proceedings. Other policies define claim to mean solely a written demand seeking monetary damages, and may exclude regulatory investigations.

Common Examples of a Claim

- Issuance of a subpoena
- Service of a complaint or criminal indictment
- Shareholder derivative demand
- Discovery of a violation of securities laws
- Commencement of an investigation

Regulatory Requests and Informal Investigations

A more nuanced issue can arise with informal regulatory requests, which sometimes are not viewed as an investigation and may be ineligible for coverage. Some D&O policies explicitly require that a formal investigation charge or order be launched or issued before a claim can be established. Insurers can have varying approaches to regulatory requests and formal investigations – and the policyholder will need to carefully review the D&O policy language to determine what actions a regulatory authority must take before a claim commences.[19]

Joint Policies, Allocation Agreements, Erosion of Policy Limits

It is common and more cost effective for funds to purchase an aggregated insurance policy that covers each fund in a complex, all fund directors and officers as well as the adviser and its affiliates. A joint policy can also cover multiple fund complexes and advisers under a common parent company. Such joint policies are permitted subject to certain conditions under the 1940 Act.[20] A joint policy offers several advantages, including ease of administrating claims and uniformity in the policy's terms. However, the defense, settlement, or judgment costs for all of the parties can quickly add up, possibly depleting the joint policy's limit of liability. This risk typically affects fund directors more directly than other co-insureds because the fund and the adviser are more likely to first tap into and erode coverage limits.[21] Fund directors have sometimes addressed this concern by seeking out a separate policy[22] or exploring a priority of payments clause in the D&O policy. Any such options should be carefully weighed and discussed with independent counsel.

Some fund boards and advisers have entered into allocation agreements, while some D&O policies require the insureds to agree to use their best efforts to determine a fair and proper allocation of amounts to be paid. An allocation agreement can, among other things, dedicate a minimum amount of coverage to each party and set the criteria by which the premiums will be allocated among the parties. An allocation agreement usually contains a provision that prioritizes the funds as first to receive insurance proceeds before the adviser or any affiliates. Directors may wish to discuss with independent counsel how to appropriately allocate premium amounts. For example, an insurer may recommend assigning 50 percent of the premium to an insured group of funds and 50 percent of the premium to the fund service providers then further adjust within these allocations to other covered parties depending on the specific factors at hand.

Other ways directors can address policy erosion risk:[23]

- ► Reserved limits: A layer of the total policy limit is reserved for independent directors.
- ► Internal agreements: Agreement among the insureds guaranteeing the directors a certain minimum of coverage.
- ► Priority of payment provisions: An addition, or endorsement, to the insurance policy that could direct that in the event of a loss the directors will be the first to receive insurance proceeds.
- ► Standalone policy: Directors may also obtain an IDL policy, which provides a dedicated, separate coverage limit for directors only.

Definition of a Loss; SEC Findings, Settlements, Disgorgements

Insurers sometimes exclude certain fines, penalties and statutory damages from the definition of loss, and legal disputes have arisen over related denials of coverage. In one recent case, a court disagreed with an insurer that sought to deny coverage for an SEC settlement because the payment was labeled as "disgorgement."[24] Another highly disputed issue arises in the context of SEC settlement agreements that end with no admission of wrongdoing by the policyholder. An insurer may attempt to deny coverage if an SEC administrative order finds that a policyholder engaged in fraudulent conduct even though the policyholder neither admitted nor denied wrongdoing.[25] The choice of insurer and proper negotiation of terms can be key to avoiding such disputes.

Special Issues – Fund Mergers, Liquidation

If a fund is acquired by another fund, directors may find that they no longer have the same insurer or amount of coverage. While D&O insurance typically covers the past, present and future directors of a fund, a question arises on coverage when a fund no longer exists. While the acquired fund, its directors and affiliates are likely to be covered under the acquirer's insurance policy, an insurer may hesitate to provide coverage for wrongful acts committed before the acquisition. To prepare for such scenarios, funds may purchase "tail coverage" for past directors of the acquired fund to cover any pre-acquisition claims. Similarly, a fund may purchase a separate policy for subsequent acts during the fund liquidation process.

Directors as Witnesses or Defendants; Section 36(b) and Other Private Litigation

Indemnification and D&O Insurance Cover Many, Not All, Regulatory Investigations

While it is rare for a fund independent director to be singled out in a regulatory action or civil litigation, some recent regulatory actions have specifically targeted fund directors focusing on board processes around advisory contract approvals and proper valuation of securities.[26] Funds may indemnify directors' expenses incurred in regulatory investigations and may provide advancement of expenses when directors are subpoenaed or are direct targets of regulators. D&O insurance coverage for an investigation can often turn on whether the type of regulatory investigation is included in the policy's definition of a claim.[27] Therefore, directors should understand whether their policy includes coverage for regulatory examinations and investigations (formal and informal).

Fee Litigation: D&O Insurance, Indemnification May Cover Costs Incurred in Witness Role

Lawsuits filed under Section 36(b) of the 1940 Act allows shareholders to sue based on a breach of fiduciary duty based on the fees charged to shareholders. These lawsuits typically allege that an adviser charged excessive fees for managing the fund or retained a disproportionately large amount of fees for a sub-advised fund. The industry has seen an increasing number of claims under Section 36(b)[28] in recent years despite plaintiffs' overall failure to prevail in the courts.[29] Few excessive fee cases specifically target directors of funds,[30] thus a director's financial exposure in this area primarily arises from an obligation to serve as a witness. Preparation for appearance as a witness can be expensive, with attorney and other fees quickly adding up. Depending on applicable state law and the fund's governing documents, indemnification and advancement of expenses may be available to directors for expenses incurred even as a non-party witness.[31] Additionally, some insurers offer policies designed specifically for fund independent directors or Side A difference-in-condition policies that cover requests to provide testimony as a non-party witness in a civil proceeding. Directors may wish to consult with their independent counsel to ensure that fund documents and their indemnification agreements cover such costs.

Questions to Ask Fund and Independent Counsel Regarding D&O Insurance

How are fund directors typically covered against personal liability for official actions?

What are the conduct exclusions that could limit coverage?

Does the policy require a final judgment adverse to a director before the exclusions are triggered? Further, how does the insurer view SEC settlements in which there is no admission of wrongdoing?

Does the policy include a severability clause? Is the severability clause broadly written?

What are the conditions under which the insurer may deny coverage?

Are multiple insurers or a single insurer more appropriate for our business?

Does the policy contain a provision protecting against legal expenses related to a sub-adviser's lawsuit, cyber breaches, other third-party provider risks (e.g., high-frequency trading), and other recent trends in litigation?

Will the policy force directors to settle at the direction of the insurer against their wishes?

Can a director hire his or her own counsel and who will cover the cost of a director's counsel?

Does the policy require that directors first seek advancement of funds directly from the fund? If so, when and under what circumstances can directors seek funds directly from the insurer?

Are informal regulatory requests eligible for coverage? Is there coverage for internal investigations or for shareholder derivative suits?

Is notice required to be given to the insurer where there is a "threat" of litigation (i.e., no formal action has yet commenced)?

What happens if the D&O policy does not cover past directors of a fund?

Does the D&O policy "true up" during the policy period – i.e., when multiple matters arise during the same policy period, does the policy revert to its original coverage after a payout or is the coverage for subsequent matters reduced by the amount paid out for a previous claim?

What losses are excluded from coverage? (Are fines, penalties and punitive damages excluded?)

What to Expect When You or Your Fund is Sued

► Notify the insurer promptly. Most insurance policies require notification when the insured (a director, counsel, fund officer, for instance) receives notice that a lawsuit, regulatory investigation, or other claim is made, or if the insured person becomes aware of a loss or liability that may be eligible for insurance coverage.

► The insurer will provide what is commonly referred to as a "reservation of rights" letter, which will explain the policy provisions, the insured's rights and obligations, and responsibility to provide information regarding the matter to the insurer.

► The insured person or the insurer itself will select counsel who will represent the insured in the claim.

► The insurer will investigate and monitor the claim. After its investigation, the insurer will provide its assessment of necessary coverage and what it will provide.

IV. Cyber Risk Coverage: An Evolving Landscape

Cybersecurity has quickly become one of the top business and operational priorities for asset management firms. A cybersecurity breach is not only financially costly; a breach can damage a firm's physical infrastructure and reputation, and expose private customer data and proprietary firm information. For regulated investment companies, a cyberattack can expose a fund to compliance failures, regulatory fines and penalties. The SEC is highly focused on cybersecurity threats and the Division of Investment Management has issued guidance[32] urging funds to periodically assess their vulnerabilities and security controls, create a strategy designed to prevent, detect, and respond to cybersecurity threats, and to implement their strategy through policies and procedures and training. The Division of Investment Management has also asked firms to consider whether any insurance coverage related to cybersecurity risk is necessary or appropriate with respect to the fund and adviser.[33]

Mutual fund boards have increasingly become involved in overseeing advisers' cybersecurity activities as part of their mandated oversight of compliance policies and procedures of the fund.[34] Directors should thus be aware of the primary areas in a fund's operations that are relevant to cybersecurity preparedness, such as safeguarding client information and records, protecting the fund's records and financial reporting systems, business continuity plans, and custody of fund assets. Directors may also wish to consider and discuss with counsel their exposure to cybercrime while in possession of confidential board materials.

Data Security (Breach) Coverage Most Common Policy for Funds

The cyber security insurance market is maturing, and an increase in actuarial data is steadily informing the structuring of insurance products. Cyber security insurance can protect against liabilities, including crisis response costs, restoration of physical and digital assets, legal costs, as well as liabilities to third parties and losses of customers' personally identifiable information.

Currently, standalone cyber policies for funds are relatively rare. The fund's adviser and service providers (which may include the funds as additional insureds under their policies) may also have cyber insurance policies. For mutual funds, the most common type of cyber insurance product offered is a breach response policy, meaning coverage for damages incurred after a cyber breach has occurred. Such insurance policies may provide direct coverage for loss/breach of data; loss of personally identifiable information, non-public data and non-electronic data; business interruption and remediation costs; reputational harm expenses; extortion or ransom costs, and coverage for fines and regulatory penalties. Coverage may also extend to third-party liability costs, including privacy breaches and regulatory penalties.

In choosing an insurer, brokers and fund counsel can help to determine the scope of coverage and assess and negotiate the policy exclusions. Some key coverage considerations are: the estimated cost of risk the policyholder can expect to incur (which could depend on the amount of highly sensitive data in the company's possession) and the policyholder's contractual obligations to its clients. Like traditional D&O policies, working out the definitions of key terms, such as "loss," determining the specific events that trigger a claim as well as the policy exclusions, and whether coverage extends retroactively to the actual date of the cyber incident (as opposed to date of discovery), is essential in the negotiating stage. As more states, such as New York, move toward adopting cyber security regulations, directors may wish to keep in mind the relevant cyber security statutory requirements as they review D&O policies.

V. Conclusion

The insurance market for fund directors has not changed much in the last decade and the overall risk of personal liability for fund independent directors remains low. Technological innovation and trends in the financial services industry have increased the threat of cybercrime along with enforcement by regulators. In addition, plaintiffs' lawyers have continued to file and sometimes litigate cases under Section 36(b) of the 1940 Act, despite their lack of success in the trial courts. Indemnification and insurance protect fund independent directors from incurring personal liability, and directors should be aware that they enjoy greater protection when their fund governing documents adopt provisions providing advancement of expenses and indemnification to the fullest extent permitted by the law. Fund directors should continue to monitor and ask questions about their indemnification rights and D&O and cyber insurance coverage, along with obtaining sound counsel to navigate the current litigation environment while protecting themselves from personal liability.

Additional Resources:

Report of the Mutual Fund Directors Forum:

- Role of the Mutual Fund Director in the Oversight of the Risk Management Function
  http://www.mfdf.org/images/Newsroom/RiskPaperFinal2017.pdf
- Board Oversight of Cybersecurity
  http://mfdf.org/images/Newsroom/Cybersecurity.pdf

Appendix

Director and Officer Insurance Glossary of Terms

This glossary is meant to be a guide and provides only general definitions and descriptions of terms found in D&O insurance policies. Terms and their actual definitions will vary by insurer.

Advanced defense costs: A provision in a D&O insurance policy obligating the insurer to pay defense and indemnity costs as they are incurred. Such provisions eliminate the need for the insured to pay these costs prior to receiving reimbursement from the insurer.

Advancement of expenses: Under state law or fund charter documents, most funds are obligated to pay the costs of a director's legal defense before the final disposition of an underlying claim, subject to certain conditions.

Allocation agreement: Allocation agreements require parties covered under a single insurance policy to agree to use their best efforts to determine a fair and proper allocation of all insurance proceeds and may set forth pre-determined amounts to be received by each insured party.

Claims-made policy: An insurance policy in which coverage is triggered when a claim is made against the insured during the policy period, regardless of when the wrongful act took place. D&O policies are claims-made policies.

D&O insurance: A type of liability insurance that covers claims made against directors and officers related to their designated acts, errors, or omissions while serving on a board of directors and/or as an officer. Distinctive features of D&O policies are that they: (1) are written on a claims-made basis, (2) usually contain no explicit duty to defend, and (3) cover monetary damages but exclude bodily injury and property damage.

D.I.C. (Difference in conditions policy): A provision sometimes found in an excess insurance policy, which is designed to drop down within a layered insurance program to fill coverage gaps. D.I.C. coverage is designed to broaden coverage by providing additional limits of coverage for specific occurrences, or for acts or events that are excluded from traditional D&O policies, or to supplement the existing policy.

Declarations page: The front page (or pages) of a policy that specifies the named insured, address, policy period, location of premises, policy limits, and other key information that varies from insured to insured. The declarations page is also known as the information page

Derivative lawsuit: A derivative suit is one brought on behalf of the fund, and not an individual or class of shareholders. Any recovery in a derivative suit would benefit the fund itself as opposed to the shareholders who bring the action.

Direct lawsuit: A direct action is one in which a shareholder sues to enforce rights arising from individual share ownership.

E&O insurance: E&O insurance provides coverage to the fund or insured service provider for claims made against them for designated acts, errors or omissions of the fund or its representatives, including employees, directors and officers, in the performance of their professional duties.

Endorsement: A separately negotiated clause (sometimes referred to as a rider) to the insurance policy that either changes or adds to policy provisions. Endorsements can be used to, among other things, broaden or limit the scope of coverage, clarify the application of coverage, and add other parties as insureds.

Entity-only coverage: A type of direct coverage under a D&O policy for the fund.

Exclusion: A provision in a D&O policy referring to circumstances not covered by the policy. Typical exclusions from coverage include breach of contract, claims arising from bodily injury, personal injury or property damage, dishonest, fraudulent or criminal acts, personal profit of the directors and officers, environmental violations and violations of certain statutes like ERISA (which has its own legal framework of fiduciary liability).

IDL (Independent Director Liability) insurance: IDL insurance is a stand-alone liability insurance coverage that provides protection solely to fund independent directors. It is designed to supplement fund indemnification and D&O insurance coverage. ICI Mutual estimated in 2017 that approximately 50-60 percent of fund groups purchase some form of IDL insurance.

Indemnification: Indemnification is an agreement of one party to assume financial responsibility for the liability of another party. In D&O policies that are written on an indemnification basis, the insurer reimburses the fund for costs already paid by the fund to indemnify directors and officers.

Investigative cost coverage: Insurance coverage for costs relating to informal investigations where documents or interviews are sought from a company's executives, but where there is no actually alleged wrongful act by or involving such individual.

Joint policy: An insuring agreement that covers the funds, adviser, affiliated service providers, directors and officers. Unlike a "funds-only" policy, which covers all funds within a fund complex together with the directors and officers of those funds, a joint policy also covers affiliated advisers and/or other affiliated service providers (together with the affiliated providers' own directors and officers).

Limit of liability: The maximum amount that an insurer will potentially pay under an insurance policy in the event of a covered loss; also called a policy limit. For D&O insurance, this amount would generally include defense costs, settlements and judgments. The retention or deductible is not included or added to the limit of liability.

Loss: The basis of a claim for damages under the terms of a D&O policy. Inclusions in the definition of loss vary by insurer and may exclude fines, regulatory penalties and punitive damages.

Notice of facts or circumstances: The discretionary reporting of facts or circumstances that, while not claims, are reasonably believed to potentially result in claims. Providing an insurer with such notice of facts and circumstances is that if these facts and circumstances result in a claim, that claim will be covered by the earlier policy under which the notice of facts and circumstances was given.

Occurrence-based policy: A policy covering claims that arise out of events that took place during

the policy period, regardless of when the claims are made. The claim does not need to be reported during the policy period.

Policy: A written contract of insurance between the insurer and the policyholder. It is typically composed of a declarations page, policy form, and endorsements or riders.

Premium: The dollar amount an insurer charges to provide the coverage described in the policy or bond.

Priority of payments provision: A provision found within D&O policies that sets forth the order in which policy proceeds will be paid out to the various insureds under the policy. It can be an addition, or endorsement, to an insurance policy that could direct that, in the event of a loss, the directors will be the first to receive insurance proceeds. Generally, a priority of payments provision states that claims are paid for persons before parties (entities) and non-indemnifiable claims prior to indemnifiable claims.

Reimbursement policies: Insurance policies in which the insured must first pay losses out-of-pocket and then seek reimbursement for any covered loss from the insurer, as opposed to policies in which the insurer is required to pay losses on behalf of an insured.

Rescission: A declaration by an insurer that the policy was never in effect, the result being that coverage for a claim is denied. Rescission is an extreme and rare remedy which typically occurs when the signer of an application for D&O liability coverage had knowledge of a potential claim and intentionally concealed such knowledge, and when the application for coverage contains information that is materially false.

Retention: A retention operates similarly to a deductible in that it is a portion of a loss incurred which the insured must pay himself or herself before the insurer will make any policy payments.

Side A insurance: Side A coverage insures the personal assets of directors and officers against losses that the fund is not legally or financially able to indemnify.

Side B insurance: Side B coverage, also known as fund reimbursement coverage, reimburses the fund for legal expenses paid in advance or other amounts paid to indemnify directors and officers. Side B policies usually include a retention which is paid by the insured.

Side C insurance: Side C coverage, or entity coverage, covers the insured entity against losses arising typically from securities lawsuits launched against publicly traded companies that also name the directors and officers.

Side D insurance: Side D coverage insures a company against costs incurred in internal investigations or in response to a shareholder derivative claim.

Tail coverage: A provision found within a claims-made policy that permits an insured to report claims that are made against the insured after a policy has expired or has been cancelled, if the wrongful act that gave rise to the claim took place during the period covered by the policy. Tail coverage requires that the insured pay an additional premium.

Wrongful act: Actions or events that trigger insurance coverage, including (though not limited to) errors, negligent acts or omissions, breaches of duty, misleading statements and misstatements that take place within the course of providing or performing professional services. The definition generally excludes acts considered to be intentional such as fraudulent, dishonest or criminal acts.

Sources: International Risk Management Institute, Inc. Insurance Glossary, D&O Dictionary by Francis Kean, May 2012, Willis Limited (now Willis Towers Watson).

Endnotes

1 According to Cornerstone Research, plaintiffs filed a record 270 new federal class action securities cases in 2016. This figure was 44 percent greater than both the total filings in 2015 and the historical yearly average of 188 filings observed between 1997 and 2015.

2 This report has been reviewed by the Forum's Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect. The Forum's current membership includes over 968 independent directors, representing 121 fund groups. Each member selects a representative to serve on the Steering Committee. Nothing contained in this report is intended to serve as legal advice. Each fund board should seek the advice of counsel for issues related to its individual circumstances.

3 See Black et al. 58 Stan. L. Rev. 1055, Outside Director Liability at 1062: "[D]espite the litigious environment in which public companies function, outside director liability is, and will in all likelihood remain, a rare occurrence, particularly for companies with state-of-the-art D&O insurance.

4 Independent directors were named in the mutual funds market timing scandal of the early 2000's but were later dismissed from the litigation. *See* In re Mut. Funds inv. Litig., 437 F. Supp. 2d 444 (D. Md. Filed Apr. 9, 2004) More recently fund independent directors were named as defendants in lawsuits alleging breach of fiduciary duty and other state law claims and in prospectus disclosure lawsuits. The plaintiffs were either unsuccessful in these lawsuits or the lawsuits were settled before trial. *See* Northstar Fin. Advisors Inc. v. Schwab Investments, 779 F.3d 1036 (9th Cir. 2015); In re Third Avenue Management LLC Securities Litigation, U.S. District Court, Southern District of New York, Civil Action No. 1:16-cv-02758-PKC.

5 SEC enforcement actions typically target directors under Rule 38a-a1 of the 1940 Act, which requires a fund's board, including a majority of its independent directors, to approve the compliance policies and procedures of the fund and the fund's service providers on the basis of the board finding that the policies and procedures are reasonably designed to prevent violation of the federal securities laws. The SEC has also brought charges against mutual fund directors where the directors had a specific responsibility, *e.g.* valuation of portfolio securities. *See* In the Matter of J. Kenneth Alderman, CPA, et al., Administrative Proceeding No. 3-15127 (June 13, 2013).

6 Direct coverage for expenses not indemnified by the fund is rare in the mutual fund industry where fund bankruptcies are unusual and indemnification is almost always available to directors and officers.

7 Item 512 of Regulation S-K, 17 C.F.R. §229.512, requires that a fund prospectus include the following language: "Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers, or persons controlling the registrant, the registrants has been informed that in the opinion of the SEC such indemnification is against public policy as expressed in the Act and is therefore unenforceable."

8 *SEC v. Conaway*, 697 F. Supp. 2d 733 (E.D. Mich. 2010), in which a court ordered that the penalty be doubled if the defendant received reimbursement from any third party. *See also* consent order in *SEC v. Falcone, et al.*, at §3 Found at: https://www.sec.gov/litigation/litreleases/2013/consent-pr2013-159.pdf

9 *Eichenholtz v. Brennan, 52 F.3d 478, 483 (3rd Cir. 1995)*. Holding that there is no express right to indemnification under the 1933 or 1934 Acts. And no implied right to indemnification under the federal securities laws.

10 Homestores Inv. v. Tafeen, 888 A.2d, 204, 212 (Del. 2005)

11 Generally, a corporation must obtain from a director: an undertaking to repay the fees advanced if it is ultimately found that indemnification was inappropriate and the director must affirm a good faith belief that his or her conduct comported with the minimum standard required for indemnification. Model Bus. Corp. Act. § 8.53(b) (2005) The Model Business Corporation Act is a hypothetical statutory framework followed by many states, which may modify the MBCA provisions and enact them as statutes.

12 *See* "SEC Interpretation: Matters Concerning Independent Directors of Investment Companies." Release No. IC-24083 October 14, 1999. Available at: https://www.sec.gov/rules/interp/ic-24083.htm

13 *Id.*

14 The 1940 Act requires funds to obtain coverage, or a fidelity bond, against "larceny and embezzlement" that covers all fund officers and employees who may have access to fund assets. Fidelity bonding is a type of insurance that covers the employees of a fund's investment advisers, administrators, and principal underwriters, but not the directors. A typical claim would involve an employee theft or other "first-party" claim pursuant to which the insurance proceeds are paid directly to the policyholder, the adviser, for example, as opposed to a third party. A fund may obtain a joint fidelity bond with other affiliates, including the adviser, underwriter, and other funds managed by the adviser. The 1940 Act prescribes the minimum amount of fidelity bond coverage required, based on the fund's assets. Fund independent directors' responsibility with respect to fidelity bonds is to at least annually approve the form and amount of the fidelity bond based on specified considerations.

15 Policyholder's Guide to the Law of Insurance Coverage Peter J. Kalis, Thomas M. Reiter, James R. Segerdahl. Volume 1, Published by Wolters Kluwer §12-11, 2001.

16 "Introduction to Directors and Officers Liability Insurance." By Martin J. O'Leary. Available at: http://apps.americanbar.org/abastore/products/books/abstracts/5190402chapter1_abs.pdf

17 A federal district court recently ruled that an insurer did not owe coverage under a D&O liability insurance policy where the policyholder failed to give timely notice of a suit arising from a loan default. The decision is *Zahoruiko v. Federal Ins. Co.*, Civil Action No. 3:15-cv-474 (VLB)., February 28, 2017

18 *See* Rule 17d-1(d)(7)(iii) of the 1940 Act.

19 A U.S. District Court in Colorado recently held that a D&O policy did not allow for coverage for the insured company's expenses incurred in responding to an informal SEC investigation targeting its directors and officers. According to the judge's opinion, the investigative documents that the SEC had presented to the insured company did not involve an actual or alleged wrongful act and thus did not create a duty for the insurer to indemnify the attorney's fees and costs incurred before the insured parties were issued a Wells Notice. MusclePharm Corp. v. Liberty Insurance Underwriters Inc., (Case No. 1:15-cv-00555) August 4, 2016.

20 Rule 17d-1(d)(7) of the 1940 Act permits joint policies provided that: (i) the fund's participation in the policy is in the best interests of the investment company; (ii) the proposed premium for the policy to be allocated to the fund, based upon its proportionate share of the sum of the premiums that would have been paid if such insurance coverage were purchased separately by the insured parties, is fair and reasonable to the fund; (iii) the policy does not exclude coverage for bona fide claims made against any disinterested director, or against the fund if it is a co-defendant in the claim with the disinterested director, by another person insured under the joint liability insurance policy; (iv) the board of directors of the fund, including a majority of the disinterested directors, determine no less frequently than annually that the standards described herein have been satisfied; and (v) the board satisfies fund governance standards of the 1940 Act.

21 "When a Fund is Sued: An Independent Director's Guide to Fund Litigation - Part 1." By Rob Helm. The Investment Lawyer July 2010.

22 Independent director liability (IDL) insurance provides standalone coverage for fund directors over and above the liability protections of the traditional D&O policy and indemnification. IDL insurance can be structured to cover non-indemnifiable losses of directors only or both non-indemnifiable and indemnifiable losses. It is important to note that purchasing IDL insurance is a business judgment decision. ICI Mutual estimated in 2017 that about 50-60% of its fund groups have purchased IDL polices for their independent directors.

23 "Mutual Fund D&O/E&O Insurance. A Guide for Insureds ICI Mutual 2009. Part IV, Issues Specific to Independent Directors." " Available at: http://www.icimutual.com/independent-directors

24 In J.P. Morgan Securities, Inc. v. Vigilant Insurance Co., a court rejected the insurer's motion to dismiss a claim by the plaintiff seeking coverage for a settlement payment made pursuant to an SEC settlement agreement, in which the payment was described as "disgorgement" in the agreement. The New York Court of Appeals concluded that the "disgorgement" label was not controlling, agreeing with the plaintiff's position that the "payment, although labeled disgorgement by the SEC, did not actually represent disgorgement of its own profits," but rather represented the improper profits acquired by third-party hedge fund customers. The 10-year litigation dispute with the insurer also resulted in the court concluding in 2016 that: "[T]he insurers fail to demonstrate that the SEC and NYSE regulatory investigations did not constitute a claim under the policies." *See* J.P. Morgan Sec. Inc. v. Vigilant Ins. Co., 2017 N.Y. Slip Op. 27127, 11 (N.Y. Sup. Ct. 2017)

25 Id. *See* also: Bear Stearns Didn't Need Insurer's OK for Settlement: Judge. Found at: https://www.law360.com/articles/820540/bear-stearns-didn-t-need-insurers-ok-for-settlement-judge

26 *See In the Matter of Commonwealth Capital Management, et al.*, SEC Rel. No. IC-31678 (June 17, 2015); *In the Matter of Kornitzer Capital Management, et al.*, SEC Rel. No IC-31560 (Apr. 21, 2015); *In the Matter of Northern Lights Compliance Services, et al.*, SEC Rel. No. IC-30502 (May 2, 2013); *In the Matter of J. Kenneth Alderman, et al.*, SEC Rel. No. IC-30557 (June 13, 2013).

27 In this matter, an Illinois court ruled for an insurer, agreeing that only a "formal" SEC investigation could meet the "claim" definition in the particular circumstances: "Prior to the issuance of a formal investigative order, an SEC investigation is considered preliminary, and no process is issued or testimony compelled." *See* National Stock Exchange v. Federal Insurance Co., 2007 WL 1030293 (N.D. Ill., 2007) and Office Dep. V. Nat. Union Fire Ins. Co. of Pittsburgh, 734 F. Supp.2d 1304 (S.D. Fla. 2010)

28 *See* "ICI Mutual, Claims Trends: A Review Of Claims Activity In The Mutual Fund Industry" at 2–3 (2016). Available at: *http://www.icimutual.com/claims-trends*

29 In August 2016, the first Section 36(b) lawsuit in six years to proceed to trial culminated in a 25-day trial after which a New Jersey district court ruled in favor of defendant firm AXA Equitable Life Insurance Company and its wholly-owned subsidiary, AXA Equitable Funds Management Group, LLC, concluding that the adviser did not receive excessive compensation for managing and administering certain of its mutual funds. In February 2017, A US District Court for the District of New Jersey ruled in favor of the Hartford Investment Financial Services Group and Hartford Funds Management in a lawsuit filed by shareholders in six sub-advised mutual funds.(Kasilag v. Hartford Inv. Fin. Servs., LLC, No. 1:11-cv-01083 (D.N.J.)) The court concluded that the plaintiffs did not carry their burden of proof in proving the fees were excessive in relation to the services rendered. Another Section 36(b) suit filed against Russell Investments was terminated without entry of judgment on February 28, 2017 and other cases filed against firms such as Prudential, SEI and Harris Associates were terminated or dismissed in late 2016 and early 2017.

30 Section 36(b)(3) of the 1940 Act states: "No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments…"

31 Directors' and Officers' Liability: Current Law, Recent Developments, Emerging Issues § 7:4.1(A) (3rd Edition) by Barry M Kaplan, Gregory L Watts (2016). Citing Heffernan v. Pac. Dunlop GNB Corp., 965 F.2d 369, 375 (7th Cir. 1992) "(interpreting Delaware law on indemnification to include lawsuits against the director by reason of his or her role, position or status). The key here is a "nexus" between the officer's or director's activity and the matter for which indemnification is sought."

32 IM Guidance Update April 2015, No. 2015-02. Available at: https://www.sec.gov/investment/im-guidance-2015-02.pdf

33 *Id.*

34 *See* "Board Oversight of Cybersecurity, Report of the Mutual Fund Directors Forum." Available at http://mfdf.org/images/Newsroom/Cybersecurity.pdf.

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