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VIEWPOINT

Maximizing the Value of Your D&O/E&O Insurance

When Preparing for Regulatory Audits and Examinations

by Graig Vicidomino

The SEC has been gradually increasing its audits of financial firms, with plans to visit even more this fiscal year. For many, the paperwork, headaches and anxiety can be reduced or eliminated ahead of time—with a mock audit.

As Securities and Exchange Commission auditors pay surprise visits to a record number of fund managers, a growing number of financial firms are able to surprise them right back by saying, essentially, "We've been expecting you."

Your firm should be among them.

To be sure, choosing to have a mock audit sounds about as appealing as having a practice root canal. Specialized consultants, more often than not former SEC examiners, appear at a company's offices, demanding documents, examining records, and asking tough questions. But many firms find real comfort in knowing they are prepared in the event that government regulators do come knocking on their doors. As any trial lawyer will happily explain, there is nothing quite as comforting as having the answers to tough questions before they are asked.

But there's another strong reason to justify the hassle and expense of a mock audit: A growing number of insurance companies are offering those firms that undergo pretend audits some very real discounts on their insurance policies. It's the same logic that often earns homeowners a discount on their property insurance if they've invested in a sprinkler system or burglar alarm. Insurers have found that when a financial firm has gone through a mock audit, the costs of dealing with a real one can be much less. Moreover, the procedure can uncover potential violations and record keeping gaps that can be fixed before they become problematic, either from a regulatory or operational perspective.

Chubb was the first carrier with which we deal to introduce a premium rebate for companies that undergo mock audits. And over the past two years, several other major carriers have likewise started to offer similar discounts.

Such savings, it's worth noting, can cover a significant portion of a mock audit's cost, which typically runs between $30,000 and $100,000. Most commonly, the insurance companies offer of 10% of a policy's annual premium or 50% of the audit cost (whichever the lesser), up to a maximum of $25,000.

The focus on preparing for audits has increased over the past several years because the SEC stepped up its sweeps of financial firms. In fiscal 2012, the agency audited 8% of the nearly 12,000 registered investment advisors. And officials have said their intention is to audit 11% of firms in fiscal 2016. (Such audits typically begin with a one-week visit by agency staff to the advisor's office, followed by months of additional written inquiries and responses.)

The modest good news for advisors is that the share of firms audited referred to the agency's enforcement division is declining slightly. In 2015, 11% of audits resulted in such referrals. Still, three-quarters of the audits turned up "deficiencies," often record-keeping gaps. One-third of audits discovered "significant findings," which the agency defines as actions or omissions that harm customers or have a high potential to cause harm.

In January, the SEC's Office of Compliance Inspections and Examinations announced its priorities for examinations this year. It is going to take a close look at firms that offer electronic investment advice, those that manage money market funds, and any thought to be exploiting the elderly. But even if your firm is in none of those categories, the commission says it will also conduct examinations related broadly to individual investors, market-wide risks, and cyber-security. In other words, the list of potential targets includes nearly every company in the financial industry.

To be sure, this agenda was one of the last acts under SEC Chair Mary Jo White, who stepped down at the end of President Obama's administration. President Trump has nominated Jay Clayton, a partner at Sullivan & Cromwell, to replace White. Clayton has been outspoken in his skepticism of over-regulation, so some of the SEC's auditing zeal may lessen in coming years. But new policies take effect slowly, and audits will always be part of the agency's repertoire.

So if you haven't gone through a mock audit, these new premium discounts may be a good reason to plan one soon.

And if you have undergone this ordeal, be sure to claim any rebates you've already earned.

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