



INTERNAL RISK MANAGEMENT

As hedge funds look to recover from the substantial losses that resulted from the global financial crisis, the need for adequate protection against potential claims from disgruntled investors is becoming increasingly evident. *HFMWeek* talks to three industry experts about the growing demand for fund insurance as a method of risk management

HFMWeek: With many insurance providers increasingly reluctant to insure hedge funds, how can a fund still gain coverage?

Sanford Crystal (SC): Insurance companies have always viewed hedge funds as a riskier class of business, and the current environment has only contributed to this view. Recently, underwriters have shown even greater caution regarding hedge funds and have significantly increased the extent of their underwriting. Moreover, carriers are looking to reduce the capacity provided on a single risk type and restrict coverage terms while also increasing premium levels.

That said, coverage is available, and the impact of market conditions can be mitigated by differentiating the risk from the overall industry. Insurance carriers have been very responsive to our negotiations, not treating all funds the same. In this market, it is critical for the insurance broker to understand the 'hot button' issues underwriters have and how to position clients with underwriters to best address these issues.

Lorraine Adlam (LA): While the appetite of some insurers has reduced, cover is still available, albeit at a price. The key to obtaining good coverage at affordable costs is working with your broker to provide current and high-quality information that will differentiate your business from others. Face-to-face meetings with insurers can also be beneficial. In the case of distressed funds, discussions with insurers are tougher, a larger number of potential markets need to be approached and negotiations take longer to conclude – in these situations, the more lead time available, the greater likelihood of a better outcome.

Barrie Tingley (BT): Despite the real reduction of market capacity and appetite for managers' and funds' business since the start of 2009, professional risks coverage is still available to hedge funds. However, whether or not a manager or fund is able to purchase cover, as well as the scope and price of coverage, will depend on a number of risk profile factors. Some of the key factors include:

- Complexity of investment strategies, use of leverage and portfolio valuation policies;
- how conflicts of interest and fair treatment of investors are managed;



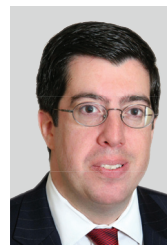
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BARRIE TINGLEY

is insurance director at ASF Financial, a leading independent specialist provider of financial services to the hedge fund sector. Working closely with managers and fund boards, ASF provides insurance solutions to mitigate against operational, regulatory and legal exposures.



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is the head of Frank Crystal & Company's Financial Insurance Services group, which handles all lines of insurance for the firm's financial institution clients. He is a frequent speaker on the topic of insurance for hedge funds.

- quality of the key service providers and fund documentation;
- type of investors, their geographical location and frequency/quality of investor dialogue;
- legacy management and operational business matters.

Going forward, we can expect insurers to consider other factors, including how a manager or fund responds to new regulator and investor requirements. For example, the alignment of management fees and liquidity terms with an investor's own investment strategies, and whether there is a greater reliance on non-conflicted third parties for operational and administrative functions and stronger in-house operations and controls to verify this.

HFMWeek: How has the fallout from the Madoff scandal impacted the demand for fund insurance over the past 12 months? Are some fund managers taking out insurance for the first time?

LA: We are certainly seeing demand from fund managers who have not purchased cover before, and also an increased appreciation of the value of insurance from existing buyers. This trend is not just being driven by Madoff fallout – there is a correlation between economic downturn and professional indemnity and directors' and officers' liability (D&O) claims, particularly for financial institutions. Following a period of low loss activity, insurers are now experiencing unprecedented volumes of claims from asset managers. Investor disquiet around

issues such as prospectus disclosures, valuations, the operation of gates, fund restructurings and liquidations, together with regulatory interest, are all demonstrating that insurance has a significant role to play in managing operational and litigation risk.

BT: The events of the past year have highlighted the importance of the use of professional risk insurance as part of managers' overall risk management strategy. A year of financial disasters culminating with Madoff has led many managers and their directors to become more concerned and focused on the scope of their coverage, adequacy of limits and how they can mitigate against market-wide scaling back of cover and premium increases.

SC: Institutional investors have always wanted the funds they invest with to carry insurance; they are just more adamant about it today given the events of last year – both in terms of results and the various scandals. Investors now have more leverage with many funds to push the issue of insurance; whereas in years past they may not have been in such a position. Moreover, as institutional investors and funds of hedge funds revamp their own internal due diligence processes, we are seeing a continued increase in insurance purchasing.

LA: We have not experienced an investor-driven push for management liability insurance. While a due diligence questionnaire (DDQ) will ask whether insurance is pur-



The economic crisis has also seen an increase in demand from managers attempting to purchase insurance cover for the first time, as managers and directors alike become more anxious at the prospect of litigation.

SC: The Madoff scandal is only one element of many events in 2008, and the resultant credit crisis, that have increased demand for insurance. While the Madoff scandal increased investor awareness about funds carrying insurance, the credit crisis and the resulting litigation and regulatory environment has had a greater impact on hedge funds looking for insurance coverage.

We have seen numerous cases in the past 12 months of fund managers implementing insurance for the first time. In some instances, this was to satisfy investor demand, but more often it was the result of an increased focus on the fund's risk and exposures and how to best address them.

HFMWeek: As the fund industry becomes more institutionalised, has the push for insurance been increasingly investor-driven?

BT: The continued institutionalisation of the sector and managers' desire to attract more 'sticky' investment mandates remains another driving factor behind the increase in demand. Pension funds have for some time now been seen as setting the standards of professionalism for risk management and sound corporate governance of managers and fund directors. However, as the relationship between managers and their investors becomes less formal with more asset allocation from other types of institutional investors, the demand for professional risk insurance is increasingly derived from insurance provisions included within investment mandates.

chased, this seems generally to be no more than a 'tick box' exercise. We see little, if any, quantitative or qualitative analysis by investors of the cover being purchased by managers and funds. In contrast, there is strong appetite from investors for insurance products covering fraud. While the market for this has all but dried up post Madoff, this could change in the future.

HFMWeek: In terms of service provision, how do you ensure that different fund strategies have the appropriate coverage?

SC: Different investment strategies face different risk exposures. For example, all investment funds have exposure from investors and regulators, but a distressed debt fund that takes an active role in restructuring a company in which it has invested faces additional exposure compared to a passive long/short equity fund. When negotiating and placing insurance on behalf of a fund, it is critical that the broker understands the fund's strategy in order to ensure that the coverage addresses the relevant exposures.

In addition to ensuring appropriate coverage, it is also necessary that the broker has a clear understanding of the differences in strategies and related risks in order to effectively negotiate with insurance underwriters. We have seen numerous instances in which underwriters have had misconceptions about the risks involved in a particular strategy or product. In such situations, the only way to effectively negotiate on behalf of the client is to understand the strategy being used and to dispel such misconceptions.

BT: The more complex and leveraged the strategy, the higher insurers will perceive the risk of failure, and the severity of the resulting consequences, to be. As such, different

strategies will impact the terms, conditions and pricing of coverage that insurers are willing to offer. It is important, therefore, for all parties to the insurance contract that the insurer has a sound understanding of the investment strategy they are covering and that managers are given the opportunity to meet with their insurers to address any areas of misunderstanding or concern.

LA: Management liability policies usually provide broad cover for liabilities arising out of allegations of wrongful acts in the delivery of investment management services, regardless of the type of investment strategy. While it is important that policies are specifically tailored to address individual fund and manager structures, in general, the nature of the investment strategy will not influence the cover. It will, however, be a variable in the underwriter's pricing model; for example, a collateralised loan obligation (CLO) fund business will carry a higher premium than one following an equity/fixed interest strategy.

HFMWeek: In light of the economic downturn and the fact that some hedge funds did not warn investors about the possibility of redemption gates, how important is some form of prospectus liability for a fund?

LA: Specific prospectus liability policies are typically purchased by companies making a public offering of securities, to protect the parties responsible for the prospectus from allegations that it includes untrue or misleading information. They are provided for a three- or six-year term at a one-off premium. Hedge funds tend not to purchase these policies because fund-raising is usually private rather than public. Most D&O policies exclude claims arising from a public offering of securities, but with private fund-raising this exclusion will not trigger. This means that D&O

ernance, how important is directors' and officers' liability insurance?

BT: The concept of directors' fiduciary duties is at the heart of the relationship between investment managers, hedge funds and hedge fund investors. As such, it could be conceded that you need look no further than this to consider the importance of adequate D&O liability insurance for fund directors who, in the most extreme cases, could face unlimited personal liability. The prospect of heightened regulation in both Europe and the US highlights the need for adequate D&O cover to be in place in order to protect directors (and, in turn, fund assets) from the increased exposures produced by tightening controls. This could not only see an increase in demand for D&O cover, but may also lead to higher levels of cover being purchased, or a change in how directors require cover to be purchased – or, as is more likely, all three.

SC: Given the significant increase in both litigation and regulatory scrutiny, D&O insurance is critical to protect not only the individual directors and officers, but also the fund and its assets. However, aside from the risk environment, I also believe that the events of the past year will lead to greater pressure to have more independent boards of directors. In order to entice people to serve on a board, funds must provide them with appropriate D&O insurance.

LA: I personally would not sit on any board without the comfort of D&O liability insurance. The duties of directors are onerous and increasing, and the costs of defending even spurious claims can be high. We have made recoveries under D&O policies for our alternative asset management clients in connection with claims from investors, regulators and employees. We are also seeing much greater attention being paid to D&O cover by independent directors on fund boards.

HFMWeek: With US funds facing the prospect of compulsory registration with the Securities and Exchange Commission (SEC), how will this increased regulation affect their need for insurance cover?

BT: The legislation recently proposed by the Obama administration will lead to a greater focus from regulators and investors on corporate governance, which consequently will become a more critical issue for managers and funds. As coverage for regulatory exposures forms a key part of a professional risk policy, we expect this to increase the demand for coverage from SEC-regulated managers. However, in the UK, some insurers are unable, through the terms of their own reinsurance treaties, to provide cover for SEC-regulated business and the proposed regulatory reforms may see the number of UK insurers able to provide cover reduce further.

LA: We would not expect the SEC to mandate the purchase of insurance by hedge funds or managers and SEC fines would not be insurable. However, the costs of defending an SEC investigation could be substantial and a management liability would provide reimbursement of such costs.

SC: I am not sure such regulation will create a need for insurance, as insurance will not be a requirement for registration; however, it will certainly increase the demand for insurance.

When the SEC originally required hedge funds to register, about five years ago, we saw a significant increase in the number of hedge funds securing insurance. This increase was driven by the perceived increase in exposure that would come from registration. I would expect to see a similar trend should registration become required again. ■

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policies will cover allegations of misleading or inadequate prospectus disclosures against fund directors. In addition, fund manager professional indemnity policies will address the exposures of fund managers to such claims. That said, if current allegations of inadequate warnings about redemption gates result in actual damages awards in favour of investors, it is conceivable that this type of cover offering a ring-fenced indemnity could be of interest to hedge funds in the future.

SC: Allegations of misrepresentations or failure to adequately disclose risks in the offering document are almost always part of investors' litigation. As such, a proper policy for hedge funds must respond to such allegations. This coverage should be part of any D&O liability and professional liability policy for hedge funds.

HFMWeek: Given the increased focus on corporate gov-