AKO FINANCIAL SERVICES

ALERT

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Insurance for Hedge Funds

By R. Mark Keenan

Hedge Fund managers are the epitome of perfection and therefore need no insurance. Right?

No matter how well run your hedge firm is, you are exposed to serious liability risks given the current regulatory environment, volatile market conditions, and the public concern regarding corporate governance.

Just wait until the next market downturn occurs to see how insulated you are.

Who sues Hedge Funds? Try: Investors, Limited Partners, Competitors, Regulatory Agencies, Companies in which the hedge fund has invested, etc.

What Are Your Liability Risks

The risks faced by a Hedge Fund include:

1. **Misrepresentation** — These involve claims that the fund misrepresented the investment risks, its performance or financial condition.
2. **Fiduciary Breaches** — If your fund acts as an administrator, or investment advisor or service provider for a pension, employee benefit, group life or medical expense plan, there could be claims that there were violations of ERISA (Employee Retirement Income Security Act of 1974) or common law fiduciary obligations.
3. **Oversight Failures** — This involves claims based upon the alleged failure to supervise outside service providers.
4. **Negligence** — incorrect sales executions, mismanagement, inadvertent failure to follow investor instructions, etc.
5. **Fidelity or Crime** — the rogue employee who steals from the "till."
6. **Employment Practices** — sexual harassment, wrongful termination, failure to promote and the like.

> *"A knowledgeable buyer can beat many of these new exclusions..."*

What Types of Insurance?

Hedge Funds need certain key insurance lines to protect against such risks including (among others):

1. D&O (Director & Officer) or General Partnership Insurance to protect the decision makers.

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who's who

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2. Professional Liability (E&O) Insurance — to protect the fund and the managers.
3. Fiduciary and Trustee Insurance.
4. Crime/Fidelity Insurance.
5. Investment Advisor Insurance
6. Employment Practices Insurance.
7. Key Man Life Insurance — in case the Fund is highly dependent upon the expertise of one or several key men or women.

How Much?

Ask your insurance broker. Insurance companies will often require a minimum of $150 million Assets Under Management (AUM) and sell a $1 million policy at that level (with a $100K retention). We have also seen an investment fund with $10 billion AUM purchase more than $60 million in coverage. However, loss history and potential future problems are a better indication of future claims than total assets.

The Market is Tightening

Underwriters are becoming more stringent regarding the capital they are willing to commit, the retentions they require, the funds they are willing to insure and the breadth of coverage they are willing to sell.

- Insurance companies are limiting regulatory investigation coverage.
- Insurance companies are widening the exclusions for personal profit and wrongful acts. Under older policies, the exclusions would not kick in until there was a "final adjudication" of fault. The current policies use a more nebulous "in fact" standard. Stick with the old one.
- Insurance companies are narrowing the severability language of their policies (which protects innocent officers from the wrongful conduct of other officers).
- Insurance companies are also issuing specific additional exclusions:
  - Fair market valuation
  - Selective disclosure
  - Market timing
  - Front running
  - Conflict of Interest
  - Laddering
  - Late trading
  - Failure to maintain insurance

Review your existing insurance, then call your lawyer, broker or other expert to assist you in making decisions about your coverage. The limitations listed above can be expanded through negotiation and the added exclusions can be limited. A knowledgeable buyer can beat many of these new exclusions and policy restrictions.