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# The Alternative Investment Fund Managers Directive

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# The Alternative Investment Fund Managers Directive

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# Chapter 10
# The Liability Insurance of the AIFM

*Gregory Walker*

## 1 INTRODUCTION

This chapter is dedicated to the AIFMD's provisions relevant to the professional risk exposure and the legal liability of an AIFM and discusses measures for practical handling, including entering into an insurance contract. It is arranged as follows: Section 2 is dedicated to the identification and assessment as well as the monitoring and control of the professional liability risks of an AIFM. Section 3 treats the covering of these risks by means of equity capital, by means of a professional indemnity insurance policy or by contractually removing its related legal liabilities. Section 4 provides recommendations for AIFMs on how to optimize the use of its equity capital considering its individual risk profile and outlines the need for action of an AIFM against the background of the guideline and under consideration of its strategic and economical options. Section 5 concludes.

## 2 IDENTIFICATION AND ASSESSMENT OF THE OPERATIONAL AND THE PROFESSIONAL LIABILITY RISK OF AN AIFM

### 2.1 Operational Risk

The operational risks[1] of each AIFM are different depending on the client base,[2] the asset classes[3] and product design, as well as the resulting organizational structures and processes. AIFMs use tax efficient business models with both, on- and offshore structures, and they collaborate with outsourcing partners, which exposes them to different jurisdictions, increasing the AIFM's legal and regulatory risks.

Adding more dynamism to the above, the world of AIFMs continues to evolve: for example, an AIFM originally focusing on Venture Capital may dedicate itself to secondary buy-outs or turn to the financing of infrastructure plants. Further, a convergence between managers of hedge funds and those of private equity funds can be observed: hedge funds look to invest in non-correlated assets and may go into private equity. On the other hand, private equity houses may consider strategies typical of hedge funds. Such a convergence causes structures, processes and systems to change. It also requires new skill profiles of partners and employees: A manager of private equity funds may lack the abilities of a hedge fund manager in the trading of complex financial instruments. Likewise, the hedge fund managers may miss the discipline and rigour needed for private equity investments as well as experience with the planning and implementation of corporate transactions (e.g., M&A, IPO and MBO).[4]

To add even more complexity: the AIFM's operational risks do not exist nor evolve in isolation of other risk categories. Losses and damages from operational risks affect the business, market and credit risk and vice versa.[5] An excessive credit risk can arise due to faulty database records, for example. On the other hand, an extreme volatility of the credit risk can lead to unexpected operational events if operational resources and processes cannot cope with a related increased transactional volume. Operational risks therefore influence directly or indirectly a fund manager's liquidity, income and the equity.[6]

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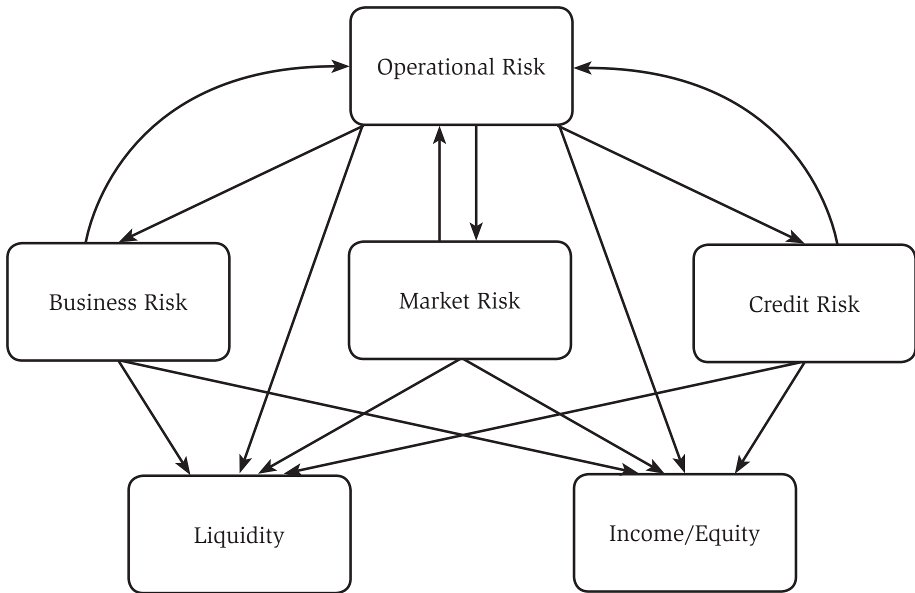
1. According to Art. 4 (1) No. 52 CRR, 'operational risk means the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events, and includes legal risk.' For further details, see also D. Zetzsche & D. Eckner, *Risk Management under AIFMD*, Ch. 14.
2. The AIFM's customer base may typically include institutional investors such as pension funds, banks and insurers, as well as independent asset managers, family offices and very wealthy private clients.
3. AIFM typically invest in assets like private equity and venture capital fund, single and fund of hedge funds, finance instruments as managed futures, real estate funds, and commodity funds as well as – in a broader sense – collective arrangements of assets such as art and antiques.
4. P. Cagan, *Operational Risk Red Flags: Lessons Learned from Ten Hedge Fund Blow-Ups*, 1(2) Journal of Securities Operations & Custody, 131–152 (2008).
5. D. Imfeld, *Operational Risk Management in Practice*, 5 (2011), http://www.garp.org/media/696026/operational_risk_management_in_practice_wp_v1_0.pdf (accessed 11 Apr. 2015).
6. See Figure 10.1.

*Figure 10.1 Direct and Indirect Impact of Operational Risk on Liquidity, Income and Equity*[7]




The operational exposure is often connected with reputational risk. Once a risk event materializes, it affects and increases other risks and causes events with a reciprocal impact. For example, reputational damage may provoke investors to pull out. This may lead to a sudden increase of transactions and, hence, affects the operational risk. On the other hand, the perception of the AIFM's brand depends on having operational risk 'under control'. Hence, the AIFM has yet another incentive to keep the operational risk as small as possible.

Briefly: the challenges in managing operational risks of an AIFM are both complex and dynamic. Operational risks and their impact on an organization and its stakeholders are often underestimated.[8]

Against this multifaceted background, the EU is implementing the AIFMD with the aim of uniformly regulating the AIFM's professional indemnity exposures and its financial consequences.

7. *Source*: Walker Risk Solution Ltd.
8. In 2003, the Capco Study claimed that 50% of all collapses of hedge funds were caused by operational risk events. The Capital Markets Company Ltd., *Understanding and Mitigating Operational Risk in Hedge Fund Investments: A Capco Whitepaper* (2003). See also Zetzsche & Eckner, *supra* n. 1, Ch. 14.

### 2.2 Professional Liability Risk

The AIFM's professional liability risk is part of the operational risk.[9] Article 10 of the AIFMD (Commission) Regulation defines the potential liability risk arising from professional negligence, for which the AIFM has to hold adequate additional own funds or a professional indemnity insurance, as following:

(1) The professional liability risks to be covered pursuant to Article 9(7) [AIFMD] shall be risks of loss or damage caused by a relevant person [[10]] through the negligent performance of activities for which the AIFM has legal responsibility.
(2) Professional liability risks as defined in paragraph 1 shall include, without being limited to, risks of:
    (a) loss of documents evidencing title of assets of the AIF;
    (b) misrepresentations or misleading statements made to the AIF or its investors;
    (c) acts, errors or omissions resulting in a breach of: (i) legal and regulatory obligations; (ii) duty of skill and care towards the AIF and its investors; (iii) fiduciary duties; (iv) obligations of confidentiality; (v) AIF rules or instruments of incorporation; (vi) terms of appointment of the AIFM by the AIF;
    (d) failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts[[11]];
    (e) improperly carried out valuation of assets or calculation of unit/share prices;
    (f) losses arising from business disruption, system failures, failure of transaction processing or process management.
(3) Coverage of professional indemnity insurance 3. Professional liability risks shall be covered at all times either through appropriate additional own funds determined in accordance with Article 14 or through appropriate determined in accordance with Article 15.

Article 10(2) AIFMD (Commission) Regulation specifies that the defined professional liability risks are neither complete nor exhaustive. Indeed, the AIFM shall

9. Art. 9(7) AIFMD.
10. According to Art. 1(2) AIFMD (Commission) Regulation the term 'relevant persons' in relation to an AIFM means any of the following: (a) director, partner or equivalent, or manager of the AIFM; (b) an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM; (c) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM.
11. Apparently, ESMA recognized that fraud, (being an intentional act of the insured) typically is not insurable in a liability policy. Hence, it clarified that the losses linked to fraud, for which the AIFM is responsible, are only those arising from the failure by the AIFM's senior management to put in place procedures in order to prevent fraudulent acts within the AIFM's organization.

implement effective procedures in order to identify its own specific risks related to its professional liability. More precisely, within its risk management framework, the AIFM shall make use of its historical internal loss data and, where appropriate, of external data, scenario analysis and factors reflecting the business environment and internal control systems. In addition, the AIFM shall maintain financial resources adequate to its assessed risk profile.[12] This approach provides scope for discretion in the determination of AIFM's specific risks beyond the definition of the AIFMD not only for the AIFM but also for the Competent Authority.

### 2.3 The Insurability of Professional Liability Risk

Following the AIFMD's definition of professional risks and the fact that an AIFM's operations are highly complex, the CEA was concerned that there are few insurers available to cover the AIFM's risks. Hence, there could be a lack of insurance capacity, especially in smaller markets. Further, there was concern that some risks, based on the AIFMD's definition, may not be insurable at all.[13] According to the CEA, insurance underwriters apply different standards and methods in order to perform their risk assessments. This makes it virtually impossible to standardize the risks covered by professional indemnity insurance, as the Directive intends to do. The EFAMA mentioned similar concerns.[14] Hence, the AIFM industry may have felt optimistic because, after all, ESMA/2011/379 reflected the industry's concerns to a large part. Yet, their optimism should have disappeared in the meantime because the AIFMD (Commission) Regulation did not follow the recommendations of ESMA in all points, as the AIMA noted.[15] Some of the concerns regarding the insurability of the AIFM's professional liability risks do remain, as we can see below:

- The AIFMD (Commission) Regulation requires that the AIFM's professional indemnity insurance cover certain risks that in fact are D&O liability risks.[16] Taking the definition of the term 'relevant persons'[17] in connection with Article 14(1) AIFMD, directors, officers and partners of an AIFM could be held liable (towards customers or investors) for the failure to properly govern (i.e., 'establish adequate procedures') and supervise the AIFM, which is a

12. Art. 13(7) AIFMD (Commission) Regulation.
13. CEA, *CEA comments on AIFM Directive level II implementing measures for professional indemnity insurance*, (2011), http://www.insuranceeurope.eu/uploads/Modules/Publications/Level_II_implementing_measures_for_professional_indemnity_insurance.pdf (accessed 11 April 2015).
14. European Fund and Asset Management Association, *EFAMA Reply ESMA/2011/379*, 17–27 (2011), http://www.esma.europa.eu/system/files/11_4059_EFAMA_Reply_to_ESMA_Cons_AIFMD_Level_2.pdf (accessed 11 April 2015).
15. AIMA, *Analysis of divergences between EU Commission's draft regulation implementing the AIFMD and the ESMA advice* (2012).
16. The D&O liability insurance indemnifies the insured persons' loss (or the AIFM's to the extent it has indemnified that insured person) arising from a claim for wrongful acts of insured persons in their capacity as directors and officers of the AIFM.
17. According to Art. 2(d)(i) AIFMD, the term includes 'a director, partner or equivalent, or manager of the AIFM'.

typical constellation of D&O's liability. A professional indemnity insurance[18] would exclude such cover for the reason that these type of risks ought to be insured rather by a D&O liability insurance policy.[19] Because ESMA rightly argued that a single D&O-insurance policy would also not meet the Directive's requirement,[20] the only possible solution in order to include coverage for directors and officers, as the AIFMD requires, would be to issue a combined insurance policy, covering both D&O liability[21] and professional indemnity. This said, in spite of that there is no explicit restriction in the AIFMD that a qualifying PI policy must only cover professional liability risks (as set out in section 4 above) and no other risks such as fund liability, D&O liability or crime cover, the buyer of a combined policy for compliance purpose should beware. Given the current regulatory climate, the Competent Authority would expect that the cover for 'AIFMD loss' should be exclusive of any other cover provided under the policy, so that the protection for investors under the AIFMD cannot be eroded by 'non-AIFMD claims' such as fund liability, D&O liability or crime.

– The definition of the term 'relevant persons' includes service providers, being third parties, for which the AIFM is liable.[22] In other words, the AIFM's professional liability is not anymore just limited to loss from the negligent selection, commissioning and monitoring of its service provider, but it extends to negligent wrongful acts of its third-party service providers. By making the AIFM liable for culpable acts of its service provider,[23] the AIFMD introduces a kind of 'strict liability'.[24] Based on current market practice, professional indemnity insurance would not cover such liability.[25] Even if it did, then such cover would typically be 'carved back' by policy exclusions or by introducing obligations that for the insured are difficult to fulfil.
– Another challenge, which a market-standard professional indemnity insurance would be facing, results from Article 14(2)(f) AIFMD, according to which 'professional liability risks include … risks of losses arising from business

18. The professional indemnity insurance responds to the AIFM's loss from a claim from professional wrongful acts of the AIFM or an insured person for which the AIFM is legally liable.
19. See Insurance Institute of London, *Professional Indemnity Insurance* 82 (2010), for 'risks excluded because more properly covered elsewhere'.
20. A directors' liability insurance cover on its own might not replace the professional indemnity insurance prescribed by the AIFMD, see ESMA/2011/379, Annex IV (34), 375.
21. The D&O liability insurance indemnifies the insured persons' loss (or the AIFM's to the extent it has indemnified that insured person) arising from a claim for wrongful acts of insured persons in their capacity as directors and officers of the AIFM.
22. That is, 'a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM', Art. 1(2)(c) AIFM (Commission) Regulation.
23. Culpability in this special case is no precondition for liability. For a more detailed definition, see P. Lewisch, *Sorgfaltsmaßstäbe im Schadenersatz- und Strafrecht*, Österreichische Juristen-Zeitung 489 et seq. (2000).
24. EFAMA, *supra* n. 14, at 20.
25. Liability for acts of third-party service providers typically remains excluded from coverage, according to feedback from selected insurers to the author's query.

disruption, system failures, failure of transaction processing or process management'. The CEA questioned rightfully, whether professional indemnity insurance must include loss from events deemed as 'force majeure',[26] or rather only the negligent prevention of, dealing with and management of the impact of such dangers and events.[27]

To end this analysis of particular AIFMD requirements with regards to professional liability and its 'insurability' on a positive note, some of the objections by industry associations like EFAMA, AIMA, and CEA were implemented in the final version of the AIFM (Commission) Regulation:

- The Regulation clarifies in Article 14(1) that professional liability risks are only related to loss from the AIFM's negligent (i.e., not intentional) acts and omissions. This clarification is crucial, because professional indemnity insurance typically excludes intentional acts of the insured.[28] And it is particularly essential for the AIFM's prospectus liability, i.e., 'misrepresentations or misleading statements made to the AIF or its investors' which are uninsurable, if they were made intentionally.
- And, while professional risks according to the Directive include the risk of loss from improperly carried out valuations, the Directive also makes it clear that losses incurred because of a loss of value of an investment as a result of adverse market conditions must not be covered by the AIFM's additional own funds or its professional indemnity insurance.[29]

In summary, the professional liability of an AIFM as defined by the AIFMD has become very onerous. Add to this the uncertainty, on how the Competent Authority will interpret those AIFMD clauses, which we deem to be vague, unclear or ambiguous. Considering all these concerns, the AIFM will have to see whether the insurance industry can provide suitable solutions for the purpose of regulatory compliance, and if so, at what total cost (i.e., insurance premium plus additional own capital to fund the insurance deductible and any identified gaps in cover).

This said, most (for not to say all) of the 'AIFMD-endorsements', which insurers have brought to the market so far, do not provide coverage in the full meaning of the AIFMD. In fact, such endorsement – for the purpose marketing – often called 'AIFMD-extension' might even lure the unwary AIFM into believing that his policy were compliant with the AIFMD and – even worse – that his legal liabilities deriving from the AIFMD were fully covered.

Indeed, since the AIFMD came into force in 2013, insurance brokers required and likewise insurers readily offered to amend the AIFM's insurance solutions with a so-called AIFMD-extension. These policy endorsements would usually list the type of risks covered as well as insurance contractual obligations following the Directive

26. For a definition of the term see U. Draetta, *Force Majeure Clauses in International Trade Practice*, 5 International Business Law Journal 547 et seq. (1996); H. Konarski, *Force Majeure and Hardship Clauses in International Contractual Practice*, 4 International Business Law Journal 405 et seq. (2003).
27. AIMA, *supra* n. 15, at 9.
28. CEA, *supra* n. 13, at Art. 9, 2.
29. Recital 34 AIFMD (Commission) Regulation.

word for word. While such an approach would be a condition for the insurance policy to become compliant, it is surely not sufficient. The general conditions of a policy, for instance, may contain exclusions that limit or remove the coverage given in first place, as section 3.4 in this chapter elaborates.

### 2.4 AIFMD's Incentive for Effective Risk Management

Pressure from investors[30] as well as increasing competition amongst AIFMs is leading to a more transparent, professional approach for the identification, assessment, controlling and monitoring of operational risk.[31] Mainly larger AIFMs[32] have considered this for many years and have built an internal risk management system for operational risk.

The AIFMD's requirements with regard to the management of operational risk are based on the European Directives for other financial services providers.[33] The regulation of the financial industry – at least to some extent – seems to be 'one size fits all': what is good for banks must be good for insurers, and must be good for the fund manager. Accordingly, the AIFM shall implement 'effective internal operational risk management policies and procedures in order to identify, measure, manage and monitor appropriately operational risk including professional liability risks to which the AIFM is or could be reasonably exposed'.[34] This includes the AIFM having to set up a historical loss database to keep records of all operational failures and all professional liability risks as described in Article 14(2) AIFMD.[35]

Medium-sized AIFMs[36] often use simple office tools (e.g., Excel) to support risk management. This can make sense during the build-phase of a system to support operational risk management, by tracking events and doing the action planning and monitoring with simple tools like spreadsheets. But normally, after a few years, the proven concept should be transferred after such a piloting phase to a more efficient database-driven solution, which permits data history with an audit trail, user rights

30. For the scope of this chapter, the term 'investor' means 'institutional investor or other qualified AIF investor' and does not include any retail investor.
31. For further details, see also Zetzsche & Eckner, *supra* n. 1, Ch. 14.
32. The size of an AIFM refers to its organizational structure as well as to the assets under management. In this chapter, the differentiation by size allows determination of adequate levels of risk management. A small AIFM might manage EUR 10–500 million; a medium-sized EUR 300 million–5 billion; a larger AIFM might manage assets of EUR 3 billion to over EUR 20 billion.
33. For example, Basel II for banks, Solvency II for insurers or UCITS IV for fund managers of collective investments in transferrable securities.
34. Art. 15(1) AIFMD (Commission) Regulation.
35. See definition of risks in s. 2.1.
36. Smaller and medium-sized AIFMs – compared to larger asset managers – have very specific challenges: (1) being a small organization with few personnel; (2) they manage large fortunes from several hundred million to several billion EUR; (3) an explicit separation of responsibilities, e.g., between business decision and risk management, is in reality difficult if not impossible; and (4) often these are young organizations with creative portfolio managers. Therefore, smaller and medium-sized AIFMs need to strike the right balance between business development, risk management and controls.

management, simple workflow support, e.g., to record the status of action taken, as well as a management information dashboard highlighting the known critical areas. In addition, larger AIFMs with AuM of EUR 10 billion or more may consider the AIFMD's approach[37] being a further incentive to build an effective risk management system. With the primary objective of lessening operational risk, the AIFM can argue for a reduction in the level of additional own funds by reason of reliable, better than average loss data with regard to the professional risks as defined in the AIFMD.[38]

Within the risk management framework[39] the AIFM shall make use of its historical internal loss data and where appropriate of external data, scenario analysis and factors reflecting the business environment and internal control systems. Such requirement involves using an integrated and system-based approach to risk management. Arguments supporting an integrated approach are as follows: First, one of the most important root causes of risk management failure is the 'silo approach' to the management of market risk, credit or operational risk, as opposed to the integrated approach. Experience shows that the different risk categories often influence or even reinforce each other.[40] Second, many organizational functions[41] are simultaneously involved in risk management activities. An enterprise-wide and integrated approach would ensure that these activities coordinated. In other words, to avoid flawed business decisions due to failure in risk identification and risk assessment, organizations need a holistic view of risk management. In order to facilitate an integrated approach, financial institutions use special IT solutions to support their governance, risk management and compliance functions.[42] These solutions document and trace auditable actions of all relevant processes and control points. They collect historical loss data and link them with identified risks, as the AIFMD requires.[43] Larger AIFMs with many users might install an internally hosted solution, while medium-sized AIFMs could prefer an externally hosted solution combined with external support.[44]

Risk management is ongoing for AIFMs and their risk policies and processes require a regular, at least yearly review.[45] Therefore, the cost/benefit aspect is a key factor in implementing an IT based, integrated approach to support the AIFM's

37. Art. 16(4) AIFMD (Commission) Regulation, i.e., linking the required level of additional own funds to the estimated exposure based on historical loss data.
38. Art. 15(2) AIFMD (Commission) Regulation.
39. The requirements of an AIFM's risk management framework are described and discussed in more detail in Zetzsche & Eckner, *supra* n. 1, Ch. 14.
40. D. Imfeld, *Operational Risk Management in Practice*, 3.
41. For example, functions like the internal control system, internal audit, security and business continuity management as well as the compliance and corporate governance function.
42. So-called GRC applications; the acronym GRC stands for governance, risk management and compliance. GRC applications are database-driven IT solutions with workflow support, a complete and auditable data history, user rights management and flexible monitoring functions on departmental and corporate level. The GRC application should match and follow the maturity level of the risk management of the organization, as in practice the roll-out of an enterprise-wide risk management system may take up to three years.
43. Art. 15(2)–(5) AIFMD (Commission) Regulation.
44. D. Imfeld, *Operational Risk Management for Asset Managers*, (2011), http://www.garp.org/media/688251/20110920%20operational%20risk%20management%20for%20asset%20managers.pdf (accessed 11 April 2015).
45. Art. 15(6) AIFMD (Commission) Regulation.

enterprise-wide risk management. The ultimate objective must be to increase the risk-taking capability and to contain the total cost of risk consisting of the cost of equity, risk reduction efforts and of risk transfer options (e.g., insurance cost) and the cost of any losses incurred (net of insurance claim payments).

That said, especially for smaller organizations[46] (as this will frequently be the case for AIFMs), the requirement to maintain a database of historical loss data and to combine it with external data may not reflect their reality. In fact, the great majority of small and medium-sized AIFMs have hardly ever been confronted with a claim to indemnify an investor's loss due to operational failures. Hence, both historical internal and external loss data – if available – can barely be statistically significant, hardly applicable and likely not even relevant. The AIFMD (Commission) Regulation is missing the guiding principle suggested in ESMA/2011/379,[47] where 'the AIFM should, appropriate to the size and organization of the AIFM and the nature, scale and complexity of its business, establish and maintain a separate operational risk management'.[48]

## 3 FUNDING, INSURING OR CONTRACTING OUT OF THE PROFESSIONAL LIABILITY RISK

In practice, the investors are often those who ultimately bear the losses of and damage to the assets arising from the professional negligence of the AIFM. Principally, the claims for indemnification are paid out of the income or the equity of the AIFM, but its own funds might not be sufficient to cover these claims. In that case – as a last resort – the investor might consider claiming against the directors and officers of the AIFM, e.g., by alleging a failure of oversight. While directors and officers are legally liable with their personal assets for negligent wrongful acts in carrying out their duties, such claims are often complex and fraught with uncertainty. Some institutional investors, practising due diligence, require the AIFM to buy adequate liability insurance.[49] The financial crisis of 2008 evidenced that some investors suffered loss following operational negligence by the AIFM,[50] which the equity of the AIFM was not sufficient to cover. In addition, the AIFMs' professional indemnity or D&O liability insurance policies had insufficient cover, or the insurance terms and conditions did not permit the insurer to pay for the loss of the investors by indemnifying the fund manager in full or in part. The AIFMD therefore considers the AIFM's additional own funds or its professional indemnity insurance as important means to safeguard the investors' interests:

> It is necessary to provide for the application of minimum capital requirements to ensure the continuity and the regularity of the management of AIFs provided by an AIFM and to cover the potential exposure of AIFMs to professional liability

46. See Zetzsche & Eckner, *supra* n. 1, Ch. 14.
47. ESMA/2011/379, 35, Box 6, No. 1.
48. AIMA, *supra* n. 15, at 10.
49. The liability insurance of an AIFM may include both the professional indemnity insurance and the D&O liability insurance.
50. For example investor's losses arising out from the Ponzi scheme of the Madoff Funds or from the collapse of Lehman Brothers Holdings.

in respect of all their activities, including the management of AIFs under a delegated mandate. AIFMs should be free to choose whether to cover potential risks of professional liability by additional own funds or by an appropriate professional indemnity insurance.[51]

### 3.1 Quantitative Requirements Regarding Additional Own Funds

The AIFMD defines the level of additional own funds to cover the professional liability risks. If the AIFM chooses to cover its liability by additional own funds, it shall determine the amount being equal to at least 0.01 % of the value of the portfolios of AIFs managed. The value of these portfolios shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, with derivative instruments being valued at their market value.[52]

ESMA, with the purpose to promote common supervisory approaches and practices in the application of the AIFMD and its implementing measures, does regularly assess questions and provides responses to questions the general public and competent authorities in relation to the practical application of the AIFMD. Concerning 'additional own funds', ESMA specified in a document released in March 2015[53] that, when calculating the additional own funds, AIFM can exclude investments by AIFs in other AIFs they manage. To the contrary they should not exclude them from the calculation of additional own funds for the covering of potential liability risks arising from professional negligence as such investments increase the operational risk.

Using the variable level of AuM as an indicator of the AIFM's exposure is consistent with the UCITS framework.[54] It is based on the assumption that the AIFM's exposure is directly linked to the AuM. Further, an AIFM shall establish yearly, and monitor on an ongoing basis, the value of the AIF's portfolios managed. Where, before the annual recalculation, the value increases significantly,[55] the AIFM shall recalculate and adjust the additional own funds accordingly.[56]

The local Competent Authority may allow the AIFM to reduce the requirement of additional own funds to be not less than 0.008 % of the value of the portfolios managed. However, the authority needs to be satisfied that the AIFM provides sufficient additional own funds to appropriately cover professional liability risks. The AIFM has to prove the adequacy based on its recorded historical loss data over a period of at least three years prior to the assessment. On the other hand, the Competent Authority may request the AIFM to have additional own funds higher than the amount referred to above if it is not satisfied with the level of protection.[57] As for the banking and insurance industry, only very large AIFMs may be in a position to demonstrate their specific level of professional liability exposure on the basis of

51. Recital 23 AIFMD.
52. Art. 16(2) AIFMD (Commission) Regulation.
53. www.esma.europa.eu/system/files/2015-630_qa_aifmd_march_update.pdf (accessed 11 April 2015).
54. Art. 7(1)(a)(i) UCITSD.
55. The AIFMD (Commission) Regulation does not specify what 'significant increase' means.
56. Art. 16(3) AIFMD (Commission) Regulation.
57. Art. 16(4) and (5) AIFMD (Commission) Regulation.

statistically significant data on losses from operational risk. Hence, in practice this provision will not find extensive application. Further, an AIFM managing EUR 10 billion of assets may keep in mind that the largest possible reduction of additional own funds – by way of well-documented and favourable loss data – amounts to only EUR 200,000. AIFMs of less valuable assets would save an accordingly lower amount.

### 3.2 Quantitative Requirements Regarding the Professional Indemnity Insurance

If the AIFM chooses to cover its liability for professional liability risks by way of an insurance policy,[58] the sum insured to cover such risks is determined by the value of the portfolios of AIFs managed[59] and the AIFM's individual risk profile. The sum insured shall be at least equal to 0.7% of the value of the portfolios of AIFs managed to cover a single claim, and 0.9% of the portfolios' value to cover all claims made in a single year, it being the aggregated sum insured.[60]

The AIFMD further stipulates, that any excess[61] shall be fully covered by own funds.[62] In theory, this could provide some flexibility[63] to the AIFM to fund the professional liability risks by a combination of own funds and insurance. The first portion of a loss will be paid out of own funds to the level of the agreed excess. The insurance policy would then cover that portion of loss above that first level.

### 3.3 Risk Finance versus Risk Transfer

Because the coverage through an insurance contract is supposed to be less certain than cover for risk by the AIFM's equity, different percentages apply to the two instruments.[64] In fact, based on a rate of 0.9% of managed assets, the sum insured equals ninety times the amount of additional own funds (i.e., 0.01%).

Whether a factor of ninety is justified and how these factors will work out in a practical context should have raised at least some questions.[65] A straightforward

58. The AIFMD uses the term 'professional indemnity insurance'. However, as the AIFMD's definition of professional liability risks and hence the term 'professional indemnity insurance' does not follow the insurance market practice (as explained in 2.2 above), the author prefers to use the terms 'insurance contract', 'liability insurance', 'professional indemnity insurance' or 'D&O liability insurance' specifically in the broader or narrower context as needed.
59. The calculation of AuM follows the same formula and rules as described in 3.1 above.
60. Art. 17(3) and (4) AIFMD (Commission) Regulation.
61. By applying an 'excess', i.e., the first portion of each loss, to be carried by the insured, the insurer motivates the policyholder to prevent loss. Above the excess, the insured is liable to pay loss in the full amount of the sum insured. A similar term with a slightly different concept is the term 'deductible', which is an insured retained amount being part of the total sum insured. See also Insurance Institute of London, *supra* n. 19, at 87.
62. Art. 17(2)(d) AIFMD (Commission) Regulation.
63. Recital 38 AIFMD (Commission) Regulation.
64. Recital 36 AIFMD (Commission) Regulation.
65. The author assumes that there was either an error in the technical transmission of ESMA's recommendation or a misunderstanding in the calculation of the additional own

example based on numbers from below table can demonstrate that the two factors are not well aligned:

Take for instance an AIFM with EUR 1 billion AuM. He has two options:

– Provide EUR 100,000 of additional own funds. Assuming a capital cost of 15% per annum and applying it to the total AuM, the 'own capital'-option will cost him EUR 15,000.
– Buy an insurance policy with a sum insured of EUR 9 million. Assuming a premium rate of 0.4%, the 'insurance'-option will cost the AIFM annually EUR 36,000.

Hence, especially for smaller and medium-sized AIFM, the insurance option will hardly be the instrument of choice.

*Table 10.1 Own Funds versus Purchasing Liability Insurance: Annual Cost*[66]

| | *Additional Own Capital* | | *Professional Indemnity Insurance According to AIFMD* | | |
|---|---|---|---|---|---|
| AuM (EUR million) | Additional Capital (0.01% of AuM) | Cost of Capital p.a. (EUR) | Sum Insured (0.9% of AuM) | Premium Rate | Cost of Insurance p.a. (EUR) |
| 50 | 5,000 | 750 | 450,000 | 1.60% | 7,200 |
| 100 | 10,000 | 1,500 | 900,000 | 1.00% | 9,000 |
| 250 | 25,000 | 3,750 | 2,250,000 | 0.75% | 16,875 |
| 500 | 50,000 | 7,500 | 4,500,000 | 0.50% | 22,500 |
| 1,000 | 100,000 | 15,000 | 9,000,000 | 0.40% | 36,000 |
| 2,500 | 250,000 | 37,500 | 22,500,000 | 0.30% | 67,500 |
| 5,000 | 500,000 | 75,000 | 45,000,000 | 0.25% | 112,500 |

Not only the higher cost of the insurance solution, but also the fact that any excess (deductible or retention) needs to be fully funded by own capital will deter an AIFM from choosing the insurance option to fund operational risks following the AIFMD regulation. In practice, the level of excess is somewhere in between 1% and 5% of

funds. However, ESMA/2011/379 already contained arithmetically flawed examples of the calculation of additional own funds, see ESMA/2011/379, 33, No. 15, where factor of 0.0001 (i.e., 0.01%) is required to calculate the amount of own funds. On the other hand, to calculate the insurance in combination with own funds based on an example of AuM of EUR 1 billion, ESMA/2011/379 states that additional funds of EUR 1 million are required, arithmetically, this is based on a factor of 0.001 (0.1%), see ESMA/2011/379, 37, No. 26(i).

66. *Source*: Walker Risk Solution Ltd.

the sum insured. However, the parties to an insurance contract are free to agree on any level of excess.[67]

Taking the above-used example of an AIFM that manages AuM of EUR 1 billion, the excess amount, which an insurer typically requires for a policy with an insured sum of EUR 9 million, is EUR 100,000 (i.e., 1%, rounded). Hence the amount of the excess (i.e., EUR 100,000) is equal to the amount of originally required additional own funds (i.e., EUR 100,000 without insurance). No doubt, there is little reason for the AIFM to opt for insurance, if it still has to provide additional own funds to cover the excess.

*Table 10.2 Own Funds versus Purchasing Liability Insurance: Funding the Deductible*[68]

| | *Additional Own Capital* | *Professional Indemnity Insurance According to AIFMD* | |
|---|---|---|---|
| AuM (EUR million) | Additional Capital (0.01% of AuM) | Sum Insured (0.9% of AuM) | Deductible (Approx. 1% of Sum Insured, Rounded) |
| 50 | 5,000 | 450,000 | 10,000 |
| 100 | 10,000 | 900,000 | 10,000 |
| 250 | 25,000 | 2,250,000 | 25,000 |
| 500 | 50,000 | 4,500,000 | 50,000 |
| 1,000 | 100,000 | 9,000,000 | 100,000 |
| 2,500 | 250,000 | 22,500,000 | 250,000 |
| 5,000 | 500,000 | 45,000,000 | 500,000 |

Given the provisions in the AIFMD (Commission) Regulation, the percentages used to determine the amount of own funds and the amount of professional indemnity insurance definitely need revision. If not, the AIFMD provides little incentive to cover the professional liability risks by way of insurance.[69]

67. Premium discounts for uninsured excess larger than 10% of the sum insured may not compensate sufficiently the insured's increased exposure.
68. *Source*: Walker Risk Solution Ltd.
69. Another preference for supplying own funds rather than insurance cover is based on the fact that ESMA/2011/379 setting the minimum sum insured to EUR 2 million and the maximum to EUR 20 million, has not been considered in the AIFMD (Commission) Regulation, see also AIMA, *supra* n. 15, at 11. As a consequence, the potential advantage for larger AIFM with managed assets above EUR 2.5 billion to buy insurance rather than supplying own funds has been removed.

That said, in the opinion of the EVCA:[70]

> professional indemnity insurance should be a far better policy instrument to meet the risks to investors from professional negligence than additional own funds. Requiring additional own funds reduces the ability of the owners of the AIFM (typically the senior management of the AIFM) to invest in the AIF. This has traditionally been a key mechanism, insisted on by private equity and venture capital AIF investors, for aligning the interests of investors and AIFM.

The advantage of an ‘insurance solution’ over ‘own funds’ to cover professional liability is not only due to the fact, that it would be far less costly to provide larger amounts of protection, but also that such protection is guaranteed by a third party. Considering that the overall circumstances, which come along with an investor’s loss, may negatively affect the credit risk of an AIFM – from an institutional investor’s viewpoint – insurance is clearly a better option compared to the AIFM’s own capital. The AIFM will have to consider the institutional investor’s perspective of getting much higher amount of protection by way of insurance and balance that argument against the lower cost of the ‘own funds’ option. The table below demonstrates the financial advantage, which the insurance solution can provide to the (institutional) investor.

*Table 10.3 Own Funds versus Purchasing Liability Insurance: Investor’s Protection*[71]

| | *Additional Own Capital* | *Professional Indemnity Insurance According to AIFMD* | *Additional Advantage of the Insurance Solution for Investors* |
|---|---|---|---|
| AuM (EUR million) | Additional Capital (0.01% of AuM) | Sum Insured (0.9% of AuM) | |
| 50 | 5,000 | 450,000 | 445,000 |
| 100 | 10,000 | 900,000 | 890,000 |
| 250 | 25,000 | 2,250,000 | 2,225,000 |
| 500 | 50,000 | 4,500,000 | 4,450,000 |
| 1,000 | 100,000 | 9,000,000 | 8,900,000 |
| 2,500 | 250,000 | 22,500,000 | 22,2500,000 |
| 5,000 | 500,000 | 45,000,000 | 44,500,000 |

Certainly, an insurance policy does not equal a pay cheque. All insurance policies come with contractual risks. Moreover, in the event of a dispute with the insurer there is a considerable litigation risk.

70. EVCA, *Response to ESMA’s draft technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive* (2011), http://www.esma.europa.eu/node/49288 (accessed 11 Apr. 2015).
71. *Source*: Walker Risk Solution Ltd.

As for the contractual risks of insurance, there are not only the notorious exclusions, but also certain definition of terms used in the policy that may limit the scope of coverage. Finally, yet importantly, an insurance policy stipulates duties and obligations in its general provisions that the insured has to fulfil before the insurer could pay an otherwise insured claim. In spite of the contractual risks of a policy, insurance has become an efficient means of risk transfer to offset some of the risks in commercial dealings with counter parties.

This said, along with the increase of due diligence requirements, the pressure from institutional investors will likely convince the AIFM to purchase a professional indemnity insurance.

### 3.4 Capital Impact of the Exclusions in an Insurance Policy

Principally, professional indemnity policies designed for AIFMs do fulfil their promise. After all, the legal liability to reimburse a third party's loss from negligent wrongful acts and omissions of the insured is at the core of such policy. However, that does not mean that every professional indemnity insurance satisfies all the requirements of the AIFMD. The key to understand, whether it does or not, needs to be found in the fine print of such policy.

It is noteworthy, that the AIFMD has not specifically addressed the 'exclusions' of the professional indemnity insurance. The British FCA recognized this potential gap.[72] Accordingly, British AIFMs have to demonstrate that adequate own funds are available to reimburse losses to the investor, for which they are legally liable, even in case a 'business line exclusion' in the insurance contract applied.

The FCA, however, did not explain what a 'business line exclusion' is. AIMA assumes that the FCA wants applicants to provide details in respect of (1) 'non-standard' exclusions contained in the PI policy; and (2) any 'standard' exclusions. AIMA goes on in its guidance note[73] in that all exclusions, which the general conditions of a liability policy typically contain, should be deemed 'standard' exclusions. In other words, only those exclusions that are specific to the exposure of an AIFM and that are added to a policy by endorsement should be deemed 'non-standard'.

Table 10.4 lists a number of insurance exclusions that PI policies typically contain. The indication whether a particular exclusion has an impact on the capital of an AIFM means that the AIFM may need to hold extra capital to cover investor claims for indemnification based on legal liability, which the insurance policy does not cover due to any such exclusions.

72. For AIFMs, which elect to use a PI Policy to cover their professional liability risks under the AIFMD, the FCA's AIFM Variation of Permission Application Form contains a request for details of the PI Policy's 'business line exclusions' (question 5.7). www.fca.org.uk/static/fca/documents/aifmd-vop.doc (accessed 19 June 2015).

73. AIMA, *Guidance Note* (2013), www.aima.org.

*Table 10.4 Policy Exclusions with AIFMD-Relevant Capital Impact*[74]

| *PI Insurance Policy Exclusions* | *Capital Impact* | *Comment*[75] |
|---|---|---|
| Contractual liability exclusion | Yes/No | |
| Insured versus Insured exclusion | Yes/No | Carefully review carve-back clauses |
| Insolvency exclusion | Yes/No | |
| Illegal acts exclusion | No | OK, if only proven acts are excluded |
| Retroactive date exclusion | Yes | OK, if backdated to inception of firm |
| Prior notified acts exclusion | Yes/No | |
| Prior knowledge exclusion | No | |
| US SEC-exclusion | Yes | Should be removed |
| Corporate acts exclusion | Yes | |
| Bodily injury / property damage | No | Yes, if worded as absolute exclusion |
| Nuclear | No | |
| Pollution | No | |
| War | No | |
| Terrorism | No | |
| Mechanical breakdown exclusion | Yes | Should be removed |
| Fines and penalties exclusion | No | |
| Punitive damages exclusion | No | |
| Fees or commissions exclusion | Yes | |
| US Jurisdiction/territory exclusion | Yes | Should be removed |

For the coverage of the AIFM's liability, it does not really matter much whether an exclusion is deemed to be 'standard' or 'non-standard': The less exclusions an insurance policy contains, the broader and more straightforward its coverage becomes. If some exclusions cannot be removed at all, the AIFM should at least consider negotiating with its insurer – with the assistance of its insurance broker or its legal counsel – to limit the exclusions in their scope or to include a 'carve back' for situations that are pertinent to an AIFM's loss scenario. To highlight only three potential traps:

– Most professional indemnity insurances contain a director or officer's liability exclusion and/or wrong doing-exclusion, each of which could affect the coverage granted under the AIFMD-extension for the investor's loss arising

74. *Source*: Miller Insurance Services LLP, Key note speech at a Luther law firm conference (September 2013) and Walker Risk Solution Ltd.
75. The AIFM should consult his legal adviser or insurance broker before taking action based on these comments.

out of failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts.

- Most professional indemnity insurances contain certain exclusions related to system failures (e.g., mechanical breakdown exclusion), which could affect the coverage granted under the AIFMD-extension for the investor's loss arising from business disruption, systems failures, failure of transaction processing and process management of the AIFM.
- Probably the trickiest 'standard' exclusion is the *insured v. insured-exclusion*, which again almost all liability insurance policies contain. The purpose of such exclusion is to avoid coverage for claims that are not initiated by a third party. However, if the insurance policy of the AIFM includes the AIF as an insured entity (e.g., for the purpose to extend coverage to its directors), such exclusion would prevent the insurer from also paying in the situation of a claim made by the fund only and without the investor's initiative.

It is therefore essential to negotiate with the insurer the scope of each exclusion in view of the relevant claims scenarios of the AIFM, the AIFs and its directors. To reduce the scope of an exclusion, specific words like 'alleging, arising out of, based upon or attributable to or in any way involving, directly or indirectly', which introduce the exclusion, should be avoided where possible.

### 3.5 AIFMD Contractual Requirements of the Insurance Policy

If the AIFM opts for insurance cover instead of providing additional own funds, it has to conclude and maintain an insurance policy that satisfies the AIFMD's insurance contractual requirements.[76]

While the AIFMD did not address the exclusions of a policy, it specified some other relevant contractual requirements regarding the insurance policy. Amongst other, the contract shall have an initial term of at least one year have a notice period for cancellation of ninety days.[77] It must cover all risks as outlined in Article 14(1) and (2) AIFMD. The contract needs reviewing at least once a year and to be adapted if there are changes which affect compliance of the policy with the requirements. The insurer has to be authorized to provide for professional indemnity insurance, and is subject to prudential regulation and ongoing supervision in accordance with European law.

The CEA criticized the limited freedom of contract between the AIFM and the insurer. In this aspect, however, ESMA maintained its position. It considered the investors' protection higher than the AIFM's own interest, and was concerned that – in case of a claim – unregulated insurance arrangements might not apply in the intended way and that an investor's claims might not be covered.[78]

76. Art. 17(2) AIFMD (Commission) Regulation.
77. ESMA/2011/379 did not contain any recommendation for a ninety-day cancellation clause.
78. ESMA/2011/379, 257.

### 3.6 Non-insurance Contractual Transfer and Financing of Risks

Contract law allows contracting parties to transfer or finance risk in different ways besides through insurance. Two parties may agree, for instance, that one party will reimburse the other for loss. Another contractual arrangement entails one party waiving its rights to sue the other party for a negligent wrongful act or omission, for which the remedy is usually monetary damages.

Non-insurance risk transfers techniques include incorporation, contracting for services, guaranty agreements, waivers and exculpatory clauses, limitations of liability or disclaimer of warranty. Whereas techniques of non-insurance risk financing includes the hold harmless agreement or a risk transfer to the transferee's insurers. The latter of which, for instance, can be accomplished by endorsing the policy of the transferee with additional named insured (e.g., a subcontracting service provider)

The legal principle underlying non-insurance risk transfer allows certain freedoms and imposes certain limitations. Contracting parties have the freedom of contract, which promotes commerce and facilitates business transactions. The limitations are important too because they protect the public by preventing parties from engaging in unacceptable behaviour.

The British FCA[79] provided an example of how an AIFM has to seek such balance. Accordingly, it noted in their 'Letter to the CFO' '[…] that some firms – mostly hedge fund managers – relied on clauses in their contracts with customers to remove the liability for the costs of errors and omissions other than in the case of gross negligence.' The FSA goes on and warns, 'We found that some firms used these clauses to justify not reporting errors to customers and to avoid systematically collecting information about the costs of errors incurred by customers. These firms had not considered whether repeatedly making the same or similar errors might in itself amount to gross negligence.'[80]

Amongst other, this addresses a flaw inherent within liability insurance policies that they require legal liability to be present to trigger the coverage when, in fact, such liability for negligence may not exist due to the contractual terms agreed with the investor. In consideration of this, an AIFM's insurance policy may need amending, to make clear that it covers claims for covered acts, errors or omissions of the AIFM notwithstanding that the clauses in the investment management agreement, offering memorandum or other contract between the investment manager and the fund may seek to avoid or limit such legal liability. On the other side, the investment management agreement may want to stipulate that the AIFM's liability to indemnify insurable loss would be limited to the actual proceeds from its insurance cover.

This said, drivers are not only regulatory but also come from the investor. There is an increased focus by investors relating to the responsibility of the fund manager for 'negligent' trade errors in particular and therefore similar interest from insured investment fund managers regarding how their professional indemnity insurance would respond.

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79. End of 2012, the British regulatory body previously known as the Financial Services Authority (FSA) is renamed as the Financial Conduct Authority FCA.
80. UK Financial Services Authority, Conflicts of interest between asset managers and their customers: Identifying and mitigating the risks 15 (2012).

In conclusion, the AIFM's risk management professional must carefully weigh the advantages and disadvantages of non-insurance risk transfer and finance in view of increased pressure to protect the investors. He subsequently needs to ensure that the professional insurance policy meets the AIFMD's negligence standard (e.g., including gross negligent acts or omission) but also considers a lighter negligence standard, which might have been agreed with the investor, and that it pays a claim made by the AIF in absence of a formal investor's claim.

## 4 RECOMMENDATIONS FOR THE AIFM

### 4.1 Recommendations Based on the AIFMD's Requirements

According to the AIFMD (Commission) Regulation, an AIFM's shall implement and maintain the measures for the management of operational risk including its professional liability exposure. With regards to the funding of these risks, an AIFM may likely opt to cover its professional liability risks by means of equity, which provides for more flexibility and less cost than by means of insurance.

### 4.2 Insurance Recommendations beyond the Regulatory Requirements

An AIFM not yet perceiving a need for professional indemnity insurance may continue to stay without.[81] On the other hand, an AIFM that already buys professional indemnity insurance as part of his risk management strategy can get the benefit of the insurance whilst using own additional funds for compliance.

Professional indemnity and D&O liability insurance both have a place in the risk management strategy of most medium-sized or larger AIFMs. The primary reason is not the protection of investors, even though they might benefit from it. It is rather in the own interests of the AIFM's directors and officers protecting their personal assets in case of claims by investors.[82] Certain types of insurance might include payment of the cost of investigation into the directors' and officers' affairs. This can be useful because, especially in case of overseas authorities being involved, investigation costs can amount to high six-digit figures. Particularly, for smaller organizations it is difficult to assess the risk of civil demands, regulatory or criminal investigations and to provide for adequate provisions. The exchange of such risk for a defined annual premium might be more straightforward.

There is often a misunderstanding as to which type of liability insurance covers what type of claim. As such, it is possible to buy both professional indemnity insurance and D&O liability insurance separately and on an 'off the shelf' basis. The danger with this approach is that in the event of a claim or investigation, the

81. A UK-based survey indicates that 88% of survey participants currently buy PI insurance – a number that has risen from 82% in 2011 and from 65% in 2010, according to Barronsmead Partners LLP, *2014 Professional Indemnity Insurance AIFMD Benchmarking Survey for Hedge Funds* (2014).
82. Even if an indemnification agreement in a service contract with the AIFM can protect the directors and officers to a certain extent, such clause may be invalid in case of gross negligence, which is often alleged in investors' claims.

insured may find insurers arguing among themselves as to which (if either) of the two policies will respond. Thus, both insurance covers should be well coordinated to avoid gaps or duplicate coverage.[83] To respond to these particular needs, the insurance industry has developed specialized insurance cover for the AIFMs of private equity funds and for hedge funds. Such insurance can effectively protect the equity of the AIFM, and ultimately also the personal assets of its directors and officers. For an AIFM it is nevertheless crucial to build a sound understanding with directors, officers and partners about the connection between its D&O liability insurance and the indemnification clauses in the LP Agreement or similar contractual documents.

The relevant factors that an AIFM may consider when purchasing liability insurance are illustrated in Figure 10.2.

*Figure 10.2 AIFM's Considerations with Regard to Purchasing Liability Insurance*[84]

83. For some years, the insurance market has offered composite insurance policies for AIFMs that combine cover for professional and D&O liability. Coverage gaps and disputes for loss allocation between the two policies can be avoided. Further, having one aggregate sum insured combined for the two risks rather than two policies with each one sum insured, the insurance cost can be reduced. Other coverage extensions such as the fidelity insurance can be optionally included.
84. *Source*: Walker Risk Solution Ltd.

For most directors and officers of an AIFM, when buying or renewing an insurance policy, the key elements are the limit insured and its price. While the limit insured has some bearing in the event of a claim, the price certainly has less. However, equally important for the insured, but more challenging to assess, are the terms and conditions of the policy, the insurer's understanding of the insured's risk and his capability to offer tailored cover, the ability and willingness of the insurer to pay claims, as well as the impartial advice, service quality and competence of the insurance broker.

First, the easy part: The AIFM's sum insured does not follow a linear curve based on AuM as the AIFMD suggests. It depends on the AIFM's risk profile on the one hand, and the risk-bearing capability on the other hand. As an indication for a medium-sized funds manager, the level of the sum insured amounts to 1%–3% of managed assets. Smaller AIFMs should consider 2%–5%.

The insurance costs are only a small percentage of the sum insured and should relate to AuM in a digressive curve. Premiums begin currently at EUR 10,000 annually for a limit of EUR 9 million and are accordingly higher for larger structures of AIFMs and a higher amount of the insured limit.

*Table 10.5 Combined D&O Liability and Professional Indemnity Insurance*[85]

| | *Holistic Insurance Solution Covering the AIFM'S Exposure to D&O and PI Liability (Combined) Considering 'Best Market Standard'* | | | | |
|---|---|---|---|---|---|
| AuM (EUR million) | Sum Insured | As % of AuM | Chosen Deducible | Premium Rate | Cost of Insurance |
| 50 | 2,000,000 | 4.00% | 25,000 | 1.10% | 22,000 |
| 100 | 5,000,000 | 5.00% | 50,000 | 0.90% | 45,000 |
| 250 | 10,000,000 | 4.00% | 100,000 | 0.75% | 75,000 |
| 500 | 15,000,000 | 3.00% | 150,000 | 0.60% | 90,000 |
| 1,000 | 20,000,000 | 2.00% | 250,000 | 0.50% | 100,000 |
| 2,500 | 30,000,000 | 1.20% | 500,000 | 0.40% | 120,000 |
| 5,000 | 50,000,000 | 1.00% | 500,000 | 0.35% | 175,000 |

The AIFM is supposed to negotiate the voluntary insurance arrangements with its insurer. However, the freedom of contract requires that the buyer becomes competent with regard to its liability exposure and other operational risks, the insurance proposal and the insurance contract's terms and conditions, as well as the applicable insurance contract laws.[86]

85. *Source*: Walker Risk Solution Ltd.
86. The CEA comments: 'While the role of insurers is to provide insurance protection under specific circumstances outlined within their policies, it is not normally within the insurer's role to advise on how much insurance a business should buy. […] AIFMs are more likely to understand the risks they face and the needs of their customers, as well as the nature

With complex contracts, the devil is in the detail. Exclusions in the standard policies of insurers might restrict coverage where the AIFM would expect and need it most. For example, if the policy covers both the AIFM and the AIF, claims brought by the AIF against the AIFM (or vice versa) should not be excluded from coverage.[87] An AIFM has to expect claims made by the investors as well as by the fund.[88] A comprehensive insurance solution should therefore provide cover for claims made by the fund, by investors, and by other third parties. Another example refers to the modalities of concluding the insurance contract and specifically to the 'no claims declaration' in the proposal form. As the AIFM's liability policies are generally based on the claims-made principle, both the wording of the 'no claims declaration', and the mechanics of the retroactive cover are crucial in the event of a claim.[89] Further, it is essential that the insurance policy cover the geographical and legal structure of the AIFM and its AIF correctly. Global insurance programmes might be considered 'non-admitted insurance' in some jurisdictions and not offer the desired protection. That said, a specialist's review of the insurance contract prior to signing is strongly advised.

For the determination of the contract's terms and conditions as well as for the pricing of the policy, the insurers consider – besides the amount of AuM – other factors such as the following:

– the type and structure of the investors' base (e.g., proportion of institutional investors versus high net worth individuals, distribution of domestic versus international or US-based investors);
– the structure of the AIFM and the managed AIFs;
– the investment focus;
– the experience of the investment advisors, the fund manager and the fund administrator;
– the capability of the AIFM to make own provisions; and
– other AIFM-specific risks, such as the number of outside director mandates, whether 'managed accounts' are offered to privileged clients, or whether a AIF is a single fund, a fund of funds, or a combination of both;
– the claims experience of the insureds.

The cost of insurance further depends on the desired sum insured, the level of excess, and the specific coverage extensions required, including the carve-back or elimination of certain exclusions. Solutions are often tailored to the AIFM's risk profile, which makes it difficult to compare premium rates with peers. Differences in the pricing of insurance offers for the same risk can nevertheless be significant. In general, however, the cost of a well-designed insurance programme should be significantly lower than the cost of equity to provide for such exposure, even when taking into account the

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of the market in which they operate. Various AIFMs will further better understand the demands brought upon them by their regulators and supervisors.' See CEA, *supra* n. 13, at 3.

87. Professional indemnity insurance contracts usually contain an 'Insured vs. Insured' clause, which excludes such claims from cover.
88. Nigel Sanders, *Claims against Custodians, Investment Managers and Investment Advisors* (2009), http://www.ogier.com (accessed 11 Apr. 2015).
89. See also Insurance Institute of London, *supra* n. 19, at 87.

inherent uncertainty of an insurance contract. The reason for this is that, according to Solvency II, insurers have to back the accepted risk with less own equity due to better risk diversification at the insurers' level.

Beyond liability risks, the AIFM might consider in their risk management framework the potential financial consequences of fraud[90] or the loss of key persons in portfolio companies or the AIFM. Other exposures for AIFMs of private equity arise from corporate finance transactions: legal litigation exposures and counterparty risks from breach of contractual warranties and representations can be insured. Sometimes an M&A deal is not closed and the target might claim for lost financing opportunities or for breach of confidentiality agreements. Investments abroad can cause significant loss related to credit risk or political risk from confiscation and the like. Dangers like these materialize only rarely. However, if they do, the ability of the AIFM to protect its investments, settle justified claims by investors and successfully defend against unjustified demands might be greatly impaired. The EVCA recommends its members to align their insurance requirements regularly with the own risk profile.[91] The objective is to protect the AIFM, the AIF and ultimately the investors from unexpected and significant loss.

The range of insurance offers for AIFMs is limited and only selected insurers and few brokers exist with relevant experience. On the other side, the AIFM's need for advice is usually high. Sometimes, the AIFM decides to bear a risk and not to insure. From the AIFM's perspective, it is about optimizing the risk-based deployment of capital.

### 4.3 Need for an Action Plan

Every AIFM must assess the need for action in the area of its risk and insurance management individually and plan accordingly. Depending on the situation, an AIFM may consider the following measures:

(1) Integrate the management of operational risks into the framework of enterprise-wide risk management. Avoid a 'silo-approach' in risk management. Larger AIFMs might consider facilitating their risk management with a database-driven, auditable IT solution.
(2) Document the historical loss data as part of the operational risk management.
(3) Calculate the amount of additional own funds and of professional indemnity insurance required to cover risks according to the AIFMD. Consider the cost of the available options. For cost-effective compliance with the AIFMD, the AIFM may prefer the 'additional own funds'-option.

90. Fraudulent schemes of employees with or without assistance by third parties often operate undetected for many years and can cause potentially high losses. The damage to reputation can lead to the AIFM ceasing to operate. Criminal prosecutions as well as civil and regulatory actions have a direct impact on the AIFM's operation. Special insurance can mitigate loss to the AIFM caused by employee fraud.
91. EVCA, *Handbook 2011: The Professional Standards for Private Equity and Venture Capital* 35–36 (2011), www.evca.eu/about-evca/professional-standards/ (accessed 11 Apr. 2015).

(4) Build a sound understanding with directors, officers and partners with regard to the connection between the indemnification clauses in the LP Agreement or similar contractual documents and the D&O liability insurance.
(5) Ensure that actual liability insurance adequately covers the operational and professional liability risks (including but not limited to the risks identified in the AIFMD) and that it correctly reflects the geographical and legal structure of the AIFM and its AIFs. Ensure that the directors' & officers' liability and professional indemnity policy is in line with the regulatory requirements.
(6) Review whether insurance can cost-effectively optimize the risk-based allocation of own capital (part of enterprise-wide risk management strategy). Determine how capital and insurance costs can be allocated to the AIF structure to provide for cost transparency.
(7) Discuss with the Competent Authority to what degree 'voluntary' liability insurance covering professional risk can be taken into account in strengthening the own capital.
(8) Review its risk profile, its risk management policy, and that policy's compliance with the requisite requirements, at least once a year and in the event of any change, which affects the policy's compliance with those requirements. For example, if there is a significant increase in the AIFM's AuM which might affect compliance with the prescribed limits of liability.
(9) Review the insurance policy four month prior to its renewal date and compare it with its previously assessed risk profile and the risk management policy.

## 5 CONCLUSION

The AIFMD and the AIFMD (Commission) Regulation regulated the AIFM's operational risk and its related professional liability risks. The management of these risks, now on the European Supervisory Authorities' radar, has become a matter of compliance by AIFMs. In a first step, the AIFM will individually have to analyse the impact of the new requirements on its organization with respect to the management of the professional liability risks and close any gaps. In a second step, the AIFM shall establish the level of the additional own funds required to cover the professional liability risks and provide for its funding. According to the AIFMD (Commission) Regulation, the coverage of the professional liability risks by means of additional own funds may be more economical and more flexible than by means of a liability insurance regulated by the AIFMD.

The reasons for voluntary liability insurance, beyond the AIFMD's requirements, however remain. Not only do investors need to be shielded from losses arising from professional negligence, but also the directors, officers and partners of the AIFM require protection of their personal assets and that of their AIFM structure from claims for indemnification of the investors. A solution combining professional and D&O liability insurance can eliminate the AIFM's risk of potentially high costs for the defence and the settlement of liability claims including the cost of regulatory or even criminal investigations. It is, however, essential to adapt the insurance solution individually to the risk profile and the risk-bearing capability of an AIFM. As a result, the AIFM can reduce its cost of capital and increase its risk-taking capacity.