

The Professional Liability Risks of the Fund Manager According to the AIFM Directive and the revised CISA

This paper is dedicated to the regulations of the Swiss CISA as well as the corresponding European guidelines relevant to the professional risk and the legal liability exposure of an Alternative Investment Fund Manager (AIFM). It discusses measures for practical handling.

The regulatory background of the AIFM's risk management function is outlined in part 1. Part 2 dedicates to the identification and assessment of the AIFM's professional liability risks. Part 3 discusses means to monitor and control these risks. In part 4 we look at to which level these risks need to be covered by way of equity capital or by way of a professional indemnity policy. Part 5 looks at the AIFM's exposure beyond the minimum coverage and how to protect against.

1. Regulatory Background

As of March 2013, the revised Swiss Collective Investment Schemes Act (CISA) and its ordinance (CISO) came into force. The main reason for the revision was the Alternative Investment Fund Managers Directive (AIFMD)¹ issued by the European Union (EU).

According to the new Swiss regulation "managing an investment fund" broadly means performing portfolio **and** risk management. This definition does not conform to that in the AIFMD, which requires that the asset manager exercises either portfolio management or risk management. As such the AIFMD provides more room to allow substantial delegation of the risk management function. Having said that, the liability of the AIFM for failing in its risk management is demarcated, and the exposure to claims for indemnification of investor's losses due to such failure will - no doubt - be rising. It should be kept in mind that one of the main objectives of the legislator is the protection of the investor.

2. Operational Risks and Professional Liability

The operational risks, of an AIFM are different depending on the client base², the asset classes³ and product design⁴, as well as the resulting organizational structures and processes. AIFM's use tax efficient business models with both, on- and offshore structures, and they collaborate with outsourcing partners, which expose them to different jurisdictions, increasing the AIFM's specific legal and regulatory risks.

Against the multifaceted sources of exposures, the Swiss CISA does not outline the negligent operational and professional errors or omissions for which a fund manager could be held liable.

In contrast, the AIFMD aims to uniformly regulate the AIFM's professional indemnity exposures. Professional liability risks are risks of loss or damage caused by a relevant person⁵ through the negligent performance of activities for which the AIFM has legal responsibility.

Professional liability risk include 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: legal and regulatory obligations, duty of skill and care towards the AIF and its investors, fiduciary duties; obligations of confidentiality, AIF rules or instruments of incorporation, 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; (e) improperly carried out valuation of assets and calculation of unit/share prices; and (f) losses arising from business disruption, system failures, failure of transaction processing or process management.

The regulation's detailed definition of professional liability risks, however, is neither meant to be complete nor exhaustive. Indeed, the AIFM shall implement effective procedures in order to identify its own specific risks related to its professional liability.

¹ The AIFMD regulates activities of Alternative Investment Fund Managers (AIFM) operating in the EU, i.e., any EU or non-EU AIFM managing and/or marketing any EU or non-EU Alternative Investment Fund (AIF) to qualified investors in the EU. An AIF is any non-UCITS fund, both EU and non-EU domiciled, explicitly including hedge funds, private equity funds and real estate funds.

² The AIFM's customer base may typically include institutional investors like 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, in finance instruments like managed futures and other hedging strategies, in infrastructure, real estate, and in commodities as well as - in a broader sense - into collective arrangements of assets like wine, art or antiques.

⁴ E.g. single funds or funds of funds.

⁵ According to the AIFMD, the term 'relevant persons' includes: (i) a director, partner or equivalent, or manager of the AIFM; (ii) an employee of the AIFM; (iii) a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement.

3. Management of Operational Risks

The Swiss regulatory approach to managing operational risks is brief: The regulated asset manager has to provide a risk management function, an internal control system as well as a compliance function that covers all of its business activities. The risk management function must be organised in such a way, that it can identify, assess, control and monitor all relevant risks. The regulated asset manager separates risk management function, an internal control system as well as a compliance function from other operational functions, namely from portfolio management.

The AIFMD's requirements are comparable to this point: 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 fund manager is or could be reasonably exposed'.

The directive then goes further and requires that the AIFM shall set up a historical loss database, in which any operational failures, loss and damage experience and any professional liability risks shall be recorded. Where appropriate the AIFM shall make use of external data, scenario analysis and factors reflecting the business environment and internal control systems. This AIFMD-requirement mirrors the standards for banks and insurers. In order to facilitate such an approach, some larger financial institutions use special IT-solutions to support their governance, risk management and compliance functions⁶.

Larger AIFMs with assets under management of € 10 billion or more may have already implemented an IT-system to support risk management. Smaller and mid-size AIFMs often start using simple office tools (e.g. Excel) to support risk management. But, after a few years, it is recommended to transfer the proven concept to a database-driven solution, which permits data history with audit trail, user rights management, simple work-flow support, as well as management reporting. Depending on the size and complexity, a fund

manager might opt for an internally or an externally administered solution⁷.

4. Risk Retention vs. Risk Transfer

The AIFM basically has two options when covering his liability risks: (1) it can retain the risk, i.e. covering risks with own funds or (2) it can transfer the risk to another party, i.e. by way of insurance.

The Swiss CISA and the European AIFMD provide for both options: potential exposures are to be covered with additional own funds or with professional liability insurance.

However, the AIFMD defines the minimum level of coverage again in rather a detailed way.

- In case the AIFM chooses to cover its liability by additional own funds, it shall determine the amount being at least equal to 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, whereby derivative instruments shall be valued at their market value.
- In case the AIFM chooses to cover its liability for professional liability risks by way of an insurance policy, the sum insured to cover such risks is determined by the value of the portfolios of AIFs managed 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. 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. Hence, the sum insured (i.e. 0.9% of assets under management) equals ninety times the amount of additional own funds (i.e. 0.01%).

Given these factors, the Directive provides little incentive to the AIFM to opt for "risk transfer", because the cost of insurance cover is by far higher than the cost of

⁶ So called GRC-applications; the acronym GRC stands for Governance – Risk Management – 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.

⁷ Claus Huber und Dr. Daniel Imfeld, Asset Management: ORM – Erfolgsfaktoren und Stolpersteine, 9.2012, diebank (www.die-bank.de)

the additional equity⁸. Yet, the European Private Equity and Venture Capital Association EVCA considers that “[...] 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 new regulations regarding quantitative level of coverage may even send a wrong signal to the AIFM: It has to be seen whether the legal minimum amount of additional equity or the required sum insured is high enough to cover the significantly increased liability exposure. Most likely not: Investors typically consider claiming for indemnification when losses exceed 10% or more of the investment. Additional funds amounting to 0.01% of Assets under Management will barely pay for the own legal (defence) cost. Liability risks have two cost dimensions: the cost for investigating and defending a claim plus the amount of damages to be paid in the event of a warranted claim. A prudent AIFM will take this into account when arranging his own professional liability insurance.

5. How Can the AIFM Protect Against the Increased Liability Created by the Regulation

Professional indemnity and directors’ and officers’ liability insurance have a firm place in the risk management of most mid-sized or larger AIFMs. The primary reason is not the protection of investors, even though they might benefit from it likewise. It is rather in the own interest of the AIFM’s directors and officers protecting their personal assets in case of claims by the investors⁹. For smaller organisations it is particularly difficult to assess the risk of civil demands, regulatory or criminal investigations and to provide for adequate provisions. The transfer of such risk for an agreed cost is considered to be more straightforward.

For most AIFM, when buying or renewing an insurance policy, the key element is the limit insured and its price. While the limit insured has some bearing in the event of a claim, the price certainly has less. 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, and the ability of the insurer to pay claims. Once insured, it is crucial for an AIFM 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.

Beyond liability risks, the AIFM might consider the potential financial consequences of fraud. Fraudulent schemes of own 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 persecutions as well as civil and regulatory actions have a direct impact on the AIFM’s operation. Insurance can mitigate the AIFM’s loss caused by employee fraud. This in turn reduces the AIFM’s exposure to a professional liability claim for failure to prevent such fraud in first place.

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 against. Sometimes an M&A deal does not get closed and the target might claim for lost financing opportunities or for breach of confidentiality agreements. The event of key employee departures can create significant losses to the fund and its manager. Investments abroad can cause significant loss related to credit risk or political risk from confiscation and the likes. Dangers like these may materialise only in rare occasions. 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.

Accordingly, the European Private Equity and Venture Capital Association (EVCA) recommends its members to align their insurance requirements regularly with the own risk profile. The objective is to reduce the cost of capital and increase the risk taking-capacity of the

⁸ Assume an AIFM has € 1 billion assets under management. Either the AIFM shall provide € 100,000 of additional own funds (i.e. 0.01% of managed assets) at an opportunity cost of approximately € 15,000 per year, or it shall buy an insurance policy with a sum insured of € 9 million (i.e. 0.9% of managed assets) at an insurance premium of approximately € 150,000 or more per year. In addition the insurer would ask for a minimal excess of at least one per cent of the sum insured, the excess would amount to € 90,000.

⁹ 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 often is alleged in investor’s claims.

AIFM by protecting the AIFM, the AIF and ultimately the investors from unexpected and significant loss.

6. Conclusion

The new Swiss and EU regulations outline the AIFM's duty to implement and maintain effective measures for the management of operational risks. No doubt, the fund manager's professional risks and the legal liability exposure towards clients and other stakeholders will increase.

The regulation specifies minimum financial coverage of these risks. At the legal minimum, the AIFM might opt to cover its professional liability risks by means of equity capital, which provides for more flexibility at a lower cost than by means of insurance.

Liability insurance, beyond the AIFM-Directive's statutory requirements, is ever more important: Not only 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 fund-structure from claims for indemnification of the investors. It is therefore essential to adapt the insurance solution to the risk profile and the risk bearing capability of an AIFM.

Gregory Walker

Managing Director

Walker Risk Solution Ltd.

An der Lorze 7

6300 Zug

gregory.walker@risksolution.ch