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D&O and E&O Insurance

Regulatory Compliance Association Hosts Program on Increased Risk for Hedge Fund Directors and Officers in the New Era of Heightened Regulation and Enforcement

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By Cara Griffith, *Hedge Fund Law Report*

On December 9, 2009, The Regulatory Compliance Association (RCA) hosted a program titled "Director and Officer Liability Escalate in the New Era of Heightened Regulation," as part of its CCO University Outreach Series. Walter Zebrowski, CIO and COO for Hedgemony Partners and Chairman of the RCA, explained in his introductory remarks that the "aftermath of the financial collapse coupled with the new era of heightened regulation shall significantly intensify the scrutiny and liability for directors and officers."

The event was moderated by Richard Maloy, Jr., CIC, CRM, Chairman and CEO of Maloy Risk Services. The panelists included Peter Welsh, a Partner at Ropes & Gray LLP; Ingrid Pierce, a Partner at Walkers; and Michael Pereira, Publisher of the Hedge Fund Law Report. The panelists discussed issues including: the increased effectiveness on the part of regulators, especially the SEC; pending legislation relating to registration of hedge fund managers, and the practical burdens that registration would (and would not) entail; liquidity and regulation of the insurance industry; demands from institutional investors and insurance underwriters for transparency from hedge funds and managers; the role of independent directors; claims trends, including insider trading (and 12 specific strategies that may be used to avoid insider trading allegations); the institutionalization of the hedge fund industry; and the changing directors and officers (D&O) insurance landscape. This article summarizes the speakers' insights on the foregoing issues, and highlights the salient points raised by the speakers on related topics.

SEC Activities

Opening the session, Welsh described recent activities at the Securities and Exchange Commission (SEC) and other regulatory bodies, noting that "there is no question that we are seeing an increase in effectiveness on the part of regulators, particularly the SEC." The SEC staff has been motivated by, among other things, negative press received over the handling of tips and potential leads that, if pursued, might have uncovered frauds that have ripened over the last 6 to 12 months. Welsh predicted private fund managers can expect exams conducted by the SEC's Office of Compliance Inspections and Examinations to be "more exacting and rigorous" and for staff to be "more skeptical in how they deal with investigation subjects."

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Welsh also noted that the SEC staff is more energized and organized than in the past. Chairman Mary Schapiro and Enforcement Director Robert Khuzami have fostered a sense of energy and urgency. Additionally, the restructuring of the SEC's Enforcement Division into specialized units or "brain trusts" was designed to "promote rapid response and highly effective advocacy." The investigative process has also been streamlined, Welsh said, making it "easier for Enforcement staff to open an investigation and to compel the production of documents." See "For Hedge Funds and Their Managers, the SEC's New Enforcement Initiatives May Increase the Likelihood, Speed and Vigor of Inspections and Examinations," Hedge Fund Law Report, Vol. 2, No. 33 (Aug. 19, 2009).

On investigation and enforcement trends at the SEC, Welsh commented that this year, more investigations have been opened, more formal orders issued and more suits brought than in the previous year. Additionally, more parallel civil and criminal investigations and cases have been brought. Welsh predicted that the SEC will increase its scrutiny of hedge funds and private fund managers, regardless of the size of their funds or assets under management.

Pending Legislation

Pereira provided a comparison of two bills pending before Congress, both of which would require hedge fund managers to register with the SEC: the Private Fund Investment Advisers Registration Act of 2009, which was incorporated into Title V of the Wall Street Reform and Consumer Protection Act of 2009 and was passed by the House on December 11, 2009 (House bill), and the Restoring American Financial Stability Act of 2009, which was introduced by Senator Dodd on November 10, 2009 (Dodd bill). While both bills eliminate the private adviser exemption in Section 203(b)(3) of the Investment Advisers Act of 1940 – meaning that under both bills there will be no specific exemption from registration for hedge fund managers – the Dodd bill contains an exemption from registration for an adviser to a "private equity fund," a term that would be defined by the SEC. Both bills provide an exemption for smaller fund managers with the House bill setting a threshold of less than $150 million in assets under management (AUM) and the Dodd bill setting the threshold at $100 million AUM.

Both bills require advisers to issue reports to the SEC and maintain records regarding funds. While the contents of the reports and access to the reports differs slightly in the two bills, it is noteworthy, Pereira said, that "the House bill (but not the Dodd bill) provides that a registered private fund adviser must provide reports not only to the SEC but also to investors, prospective investors, counterparties and creditors of any private fund advised by the manager." If this change were to become law, it would constitute a "radical departure" from the current level of privacy afforded to such information.

The more noteworthy downsides of registration, noted Pereira, are that the potential disclosure of information can affect investments and returns, and the potential for surprise examinations. Nonetheless, while there may be no "upsides," registration may not be as bad as feared because "most top-level managers already operate as if they were registered because compliance-related demands from institutional investors are at least as rigorous if not more so than the requirements of the current bills." Of greater concern, said Pereira, is the Alternative Investment Fund Management Directive in Europe. While not expected to pass in its current form, "it is expected to pass in some form and potentially a more intrusive form than any U.S. bill currently pending." See "AIFM Directive: Loosening the Regulatory Noose," Hedge Fund Law Report, Vol. 2, No. 24 (Jun. 17, 2009); "Future Regulation of Private Funds: How the Draft EU Directive & US Legislative Proposals Compare," Hedge Fund Law Report, Vol. 2, No. 18 (May 7, 2009).

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Liquidity

On the process of managing liquidity, Walkers' Pierce said a board of directors may have several powers, depending upon the fund's constitutional documents, including imposing a gate, suspending redemptions, suspending the determination of a fund's net asset value or an asset's value and delaying payment of redemption proceeds. Choosing between these powers requires a determination of what is in the best interest of the fund and its investors. See "How Can Hedge Fund of Funds Managers Manage a 'Liquidity Mismatch' Between Their Funds and Underlying Hedge Funds?," Hedge Fund Law Report, Vol. 2, No. 40 (Oct. 7, 2009); "Investors Demand More Specificity in Hedge Fund Governing Documents Regarding Circumstances in which Liquidity Management Tools may be Used," Hedge Fund Law Report, Vol. 2, No. 30 (Jul. 29, 2009).

Other means of managing liquidity, particularly from a redemption standpoint, may come up in discussions with managers about who the investors are and whether they are serious about the redemption requests, Pierce said. There have been "cases where investors have put in protective redemption requests but were actually considering withdrawing them at the last minute." Giving an indication that the investor intends to withdraw, however, is not good enough. The request must be in writing, any withdrawal request must in writing, and both must be received before the redemption date, Pierce indicated. See "How Can Hedge Fund Managers Prevent or Mitigate Revocations of Redemption Requests?," Hedge Fund Law Report, Vol. 2, No. 21, (May 27, 2009).

Payment of redemptions in kind is also a useful mechanism to manage liquidity, but must be authorized by the fund's governing documents. Many challenges involving payments in kind revolve around whether the board is acting in the best interests of all shareholders, noted Pierce. Valuation also has been a challenging area. See "Can a Hedge Fund Make Redemption Payments 'In Kind' by way of the Issue of 'Participation Interests' in its own Illiquid Assets, and What is the Status of a Redeeming Investor who has not Received any Payment at All?," Hedge Fund Law Report, Vol. 2, No. 13 (Apr. 2, 2009).

Finally, in a wind-down, when the fund is monetizing its assets, Pierce said that directors must ensure there are sufficient reserves and holdbacks to discharge the anticipated expenses of the wind-down, including service provider fees and insurance premiums for D&O insurance coverage. The ability to charge the fund for coverage must be authorized by the fund's documents and the length and amount of coverage must be carefully considered. If insurance coverage lapses and there are further claims, the policy is not there and the fund will not be covered, noted Maloy. "Tail coverage" or extended-reporting coverage may be necessary.

Growing Role of Administrators

Events over the course of the last 6 to 12 months, including those involving self-custodied assets, have increased the volume and frequency of demands by institutional investors for third-party administrators. The basic purpose of such demands, Pereira said, is to help uncover and disclose frauds. But the problem is that many investors have invested significantly in in-house administrative functions, and "the underlying concern of the safety, custody and existence of assets and transparency of reporting can be addressed as well, and in some cases better, by in-house administration." The demands for third-party administrators, at least in some situations, are based on a more underlying concern – the transparency of assets – than can be addressed by simply outsourcing administrative functions. Hedge fund managers should attempt to address those concerns in discussions with investors, rather than accepting wholesale the

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demand for a third-party administrator, Pereira suggested. See "Hedge Fund Managers Retaining 'Private Regulators' to Demonstrate a Credible Commitment to Compliance," Hedge Fund Law Report, Vol. 2, No. 27, (Jul. 8, 2009).

Independent Directors

For offshore funds that must maintain an independent director, the trend is now moving from having one independent director to having several independent directors, Pierce noted. Although the demand for independence is largely investor-driven, managers are seeing the benefits of having an independent board that can take responsibility for making key decisions. In appointing an independent director, directors and officers should consider the length of time an independent director served as a director in a particular jurisdiction as well as the procedures used by the director, including contingency procedures, back-end support and technology.

Transparency and Insurers

Ropes & Gray's Welsh noted that insurers are requiring greater amounts of information from fund managers applying for insurance, and as a result there "is a very real risk that if any of the information provided to the insurers or included in the application is not accurate, the insurer could try to avoid coverage under the policy on the grounds that it relied on the inaccurate information and was misled into issuing the policy." Because of this, Welsh said that fund managers should: avoid answering warranty questions when renewing coverage with an existing insurer; be wary of detailed application questionnaires; and ensure that their insurance policies have a severability provision.

Claims Trends

Pierce indicated that from an offshore perspective, investors are becoming increasingly active in seeking to challenge decisions made by the fund's governing body, although not as much litigation has been filed as was expected. The claims being made relate to redemption requests or a delay in the payments of redemption proceeds, and the results are highly fact-specific. There are a few cases pending that focus on the question of whether an investor may be entitled to petition for the winding up of a fund. Other challenges relate to terms negotiated in side letters. Directors and managers need to be particularly careful not to give up the fund's right to properly manage distress, Pierce said.

Insider Trading

In the current "enhanced enforcement environment with respect to insider trading," the number of insider trading enforcement actions has increased dramatically from last year and the techniques used by the SEC to investigate suspected insider trading have become increasingly aggressive and sophisticated. Pereira outlined the insider trading caselaw, noting that insider trading has five elements: (1) materiality of information; (2) nonpublic information; (3) scienter; (4) reliance by the plaintiff; and (5) a breach of fiduciary duty. A fiduciary duty can be breached by an insider, a tipper or a tippee. On tipping law, Pereira noted that an important takeaway from the Galleon complaints is that the "benefit" to the tipper does not have to be financial; it

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can be reputational. This is a broadening of the SEC's theory of who may be liable for insider trading. See "Billionaire Founder of Hedge Fund Manager Galleon Group, Raj Rajaratnam, Charged in Alleged Insider Trading Conspiracy," Hedge Fund Law Report, Vol. 2, No. 42 (Oct. 21, 2009).

Trading on the basis of a "mosaic," Pereira noted, is not insider trading. Under the mosaic theory, it is permissible to trade based on a combination of material, public information; immaterial, nonpublic information; and the thoughts, impressions and judgments of the trader to make trades (to the extent those thoughts, impressions and judgments are not themselves the product of material, nonpublic information). Hedge fund managers, who are in the business of gathering and acting on information, should have and enforce insider trading policies and procedures that accurately reflect current legal and regulatory developments. See "How Can Hedge Fund Managers Distinguish Between Market Color and Inside Information?," Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009); "How Can Hedge Fund Managers Talk to Corporate Insiders Without Violating Applicable Insider Trading Laws?," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

Pereira identified the following 12 practice points that can help hedge fund managers avoid insider trading allegations:

1. If you do not have written insider trading policies and procedures, adopt and implement them as soon as possible. This applies with equal force to registered and unregistered hedge fund managers. Even unregistered managers, he said, face a taskmaster more demanding than regulators – that is, institutional investors like pension funds. See "Key Elements of a Hedge Fund Manager's Insider Trading Policies and Procedures," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).
2. If you have written insider trading policies and procedures, revisit and if necessary revise them to make sure they accurately reflect recent legal and regulatory developments. See "When Do Hedge Fund Managers Have a Duty to Disclose Material, Nonpublic Information?," Hedge Fund Law Report, Vol. 2, No. 46 (Nov. 19, 2009).
3. The emphasis is on procedures. A written insider trading policy is not worth the paper it is written on if it is not consistently enforced. In any examination or investigation, regulators will ask for evidence that policies are actually enforced via procedures. "What Can Hedge Fund Managers Learn From the SEC's Failure to Catch Madoff? An Interview with Charles Lundelius, Senior Managing Director at FTI Consulting, Inc.," Hedge Fund Law Report, Vol. 2, No. 40 (Oct. 7, 2009).
4. That said, in the course of the SEC examinations, the SEC will examine not only a hedge fund adviser's compliance with its insider trading policies, but also the adequacy of those policies. The SEC has assessed civil penalties where it has found policies to be inadequate, even in the absence of an underlying violation. See *In re Gabelli & Co. and* GAMCO *Investors, Inc.*, Exchange Act Rel. No. 35,057, Investment Advisers Act Release Number 1,457 (Dec. 8, 1994). See also "Key Lessons from the Second Annual Hedge Fund Tax, Accounting & Administration Master Class: IFRS, Fair Value and SEC Examinations," Hedge Fund Law Report, Vol. 2, No. 21 (May 27, 2009).
5. Hedge fund managers should maintain watch lists or restricted lists of issuers about whom manager personnel have obtained material, nonpublic information, and should prohibit trading in those names by the funds as well as by manager personnel into personal accounts.

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See "How to Prepare for an SEC Investigation: The Pequot Precedent," Hedge Fund Law Report, Vol. 2, No. 3 (Jan. 21, 2009).

6. Managers should use technology wherever possible to detect and prevent insider trading. For example, some compliance software can prohibit trading (at least on behalf of the funds) in names on a restricted list. See "As the Pace of Enforcement Activity Quickens, Hedge Fund Managers Refocus on the Law and Technology of Data Storage," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).
7. If a hedge fund manager suspects insider trading, it may initiate an internal investigation. In most cases (especially where the allegations relate to a high-level person), it is prudent to use outside counsel. See "For Hedge Fund Managers in a Heightened Enforcement Environment, Internal Investigations Can Help Prevent or Mitigate Criminal and Civil Charges," Hedge Fund Law Report, Vol. 2, No. 47 (Nov. 25, 2009).
8. A manager may consider the use of expert networks (also known as consultant aggregators or information brokers) to structure conversations with corporate insiders. Such networks can mitigate, but not eliminate, the risk of insider trading. See "For Hedge Fund Managers, Expert Networks Offer Access to Corporate Insiders While Mitigating (Though Not Eliminating) the Likelihood of Insider Trading Violations," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).
9. A manager may consider use of Big Boy letters, or disclaimers of reliance, in certain circumstances, especially for trading of distressed debtor bank debt. See "Big Boys Don't Cry: How 'Big Boy' Provisions Can Help Hedge Fund Managers Avoid Liability for Insider Trading Violations," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).
10. A manager may consider filtering information that may be material and nonpublic through the GC or CCO of the hedge fund manager. See "Best Practices for a Hedge Fund Manager General Counsel or Chief Compliance Officer that Suspects or Discovers Insider Trading by Manager Employees or Principals," Hedge Fund Law Report, Vol. 2, No. 48 (Dec. 3, 2009).
11. Where practicable, analysts or traders may consider obtaining written verification from the sources of corporate information that the information is not material and nonpublic. See "As Criminal Trial Looms, Small Victory for Bear Stearns Hedge Fund Manager Matthew Tannin," Hedge Fund Law Report, Vol. 2, No. 44 (Nov. 5, 2009).
12. A manager should set the tone at the top. It is the job of the top executives at a hedge fund manager to create a culture of compliance. See "Early and Often: Compliance Training Pays Big Dividends for Private Fund Advisers," Hedge Fund Law Report, Vol. 2, No. 27 (Jul. 8, 2009).

Welsh also commented that even funds that "considered themselves to be public shops are finding that they are receiving, or are at risk of receiving, material nonpublic information." In particular, this is an issue for funds with distressed or other debt investment strategies. While trading and compliance programs are important, said Welsh, it may also be possible to manage some issues through ethical walls and other similar programs. See "Key Elements of a Hedge Fund Manager's Insider Trading Policies and Procedures," Hedge Fund Law Report, Vol. 2, No. 43 (Oct. 29, 2009).

Institutionalization of the Industry

The process of building a legal and compliance function is important for both large and small organizations, said Welsh. Having such functions helps funds deal with problems and with

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regulators when there is an issue. "Demonstrating genuine, robust compliance efforts – and not just going through the motions – can be critical to getting a private fund organization out of any trouble it may find itself in." See "For Hedge Fund Managers in a Heightened Enforcement Environment, Internal Investigations Can Help Prevent or Mitigate Criminal and Civil Charges," Hedge Fund Law Report, Vol. 2, No. 47 (Nov. 25, 2009).

Changing Insurance Landscape

Although Welsh noted that some hedge fund managers resist purchasing insurance products on grounds that they are indemnified by their funds, he suggested that there are both difficulties with and limitations to indemnification, including a lack of coverage for conduct determined to constitute gross negligence or to violate securities laws. Welsh said that insurance products should cover regulatory investigations and a full range of investment activities and should extend to the entire insured organization. Additionally, because separate accounts are growing in prevalence, Welsh noted that it is important to ensure claims by separate accountholders are picked up. Finally, exclusions should be narrowly drafted and there should be coverage for defending claims even where the claim seeks amounts that would otherwise not be covered, such as fines and penalties.

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