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AIFMD

How Hedge Fund Managers Can Meet Insurance Requirements Under AIFMD

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The alternative investment fund managers directive (AIFMD) imposes specific requirements for hedge fund managers and others marketing to investors in Europe to maintain either adequate capital or professional indemnity/errors & omissions insurance (PI) sufficient to cover certain potential claims. However, while alternative investment fund managers (AIFMs) in the E.U. are able to choose from many AIFMD-compliant products that meet the requirements of the directive and other insurance needs, the PI policies purchased locally by many U.S. and other non-E.U. AIFMs may not comply with the requirements of AIFMD. This article examines the requirements for PI insurance under AIFMD; the availability of such insurance to AIFMs; common areas where insurance policies fall short of the AIFMD compliance requirements; and AIFMD-compliant insurance solutions available to U.S. AIFMs. See also "Passports, Platforms and Private Placement: Options for Marketing Funds in Europe in the Post-AIFMD Era," Hedge Fund Law Report, Vol. 8, No. 17 (Apr. 30, 2015).

Background

AIFMD was implemented on 22 July 2013 and came into effect in July 2014. In general terms, the directive applies to all AIFMs managing asset classes that fall outside of the scope of UCITS (subject to a small number of exemptions). See "Answers to Questions Most Frequently Asked by U.S. and Other Non-E.U. Managers on the Impact and Implementation of the AIFMD," Hedge Fund Law Report, Vol. 8, No. 1 (Jan. 8, 2015).

Part of the AIFMD relates to marketing of funds. In order to market to E.U. investors, AIFMs must now comply with either the requirements of AIFMD or the requirements of a National Private Placement Regime (NPPR). The alternative is to abandon E.U. marketing efforts completely and rely upon reverse solicitation. See "What Is the Difference Between Marketing and Reverse Solicitation Under the AIFMD?," Hedge Fund Law Report, Vol. 7, No. 42 (Nov. 6, 2014). In the U.K., whether an AIFM chooses to become fully compliant with AIFMD or to market under the NPPR, an AIFM must satisfy certain conditions – as detailed in regulations 57, 58 and 59 of the U.K. Alternative Investment Fund Managers Regulations 2013 (the U.K. Implementing Regulations).

One of these regulations ties back Article 9(7) of the AIFMD, which requires AIFMs to address potential professional liability risks resulting from an AIFM's activities by either:

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1. Holding additional own funds which are appropriate to cover potential liability risks arising from professional negligence; or
2. Purchasing a professional indemnity/errors & omissions insurance (PI) policy which provides indemnification for liability arising from professional negligence risk.

These two routes require different calculations in respect of the amount of own funds that are required to be held or the limit of indemnity that is required to be provided by insurance.

- *Own Funds*: An AIFM must hold own funds of at least 0.01% (0.008% where the U.K. Financial Conduct Authority (FCA) deems appropriate, based upon risk profile and capital adequacy) of the value of the applicable alternative investment fund (AIF).
- *Insurance*: Professional indemnity insurance limits of liability must be considered appropriate to protect investors from damage resulting from any professional risks of the AIFM. The minimum limit of indemnity required is calculated at 0.7% of AUM per individual claim and 0.9% of AUM for claims in the aggregate per year.

It is required that the calculations be adjusted at the end of each financial year; however, any erosion to the level of own funds or insurance limit of indemnity as a result of a claim requires the AIFM to make the adjustment immediately.

The AIFM must also be seen to have established, implemented and applied procedures to monitor on an ongoing basis the appropriateness of the own funds or insurance versus the value of AUM, calculated by the sum of all assets of all AIFs managed by the AIFM, including assets acquired through leverage.

Insurance

In the event that an AIFM chooses to address the requirements of AIFMD through the purchase of insurance, it is important that the AIFM ensures the insurance not only satisfies the limit of indemnity requirements detailed above but also provides specific coverage and minimum term requirements.

An AIFM must first take out, and maintain at all times, professional indemnity insurance that:

1. Shall have an initial term of no less than one year;
2. Shall have a notice period for cancellation of at least 90 days;
3. Shall cover professional liability risks as defined in AIFMD Article 12(1) and (2); and
4. Is taken from an E.U. or non-E.U. undertaking authorised to provide professional indemnity insurance, in accordance with Union law or national law.

In relation to (3) above, AIFMs must secure cover for the various named perils as detailed in Article 12 of the Delegated Regulation as well as meet other minimum standards. These perils include, without being limited to, risks of:

1. Loss of documents evidencing title of assets on the AIF;
2. Misrepresentations or misleading statements made to the AIF or its investors;
3. Acts, errors or omissions resulting in a breach of: (a) legal and regulatory obligations; (b) duty of skill and care towards the AIF and its investors; (c) fiduciary duties; (d) obligations of

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confidentiality; (e) AIF rules or instruments of incorporation; (f) terms of appointment of the AIFM by the AIF;

4. Failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts;
5. Improperly carried out valuation of assets or calculation of unit/share prices; and
6. Losses arising from business disruption, system failures, failure of transaction processing or process management.

Insurance Availability

AIFMs in the E.U. are now relatively well served with insurance products that provide AIFMD-compliant cover. Many compliant products have been developed by brokers and insurers to meet the requirements of the directive as well as other insurance needs. However, in the U.S., where AIFMs tend to insure locally, the situation is somewhat different. Even though PI insurance take up rates are high, in general the PI policies being provided by local insurers do not comply with the requirements of AIFMD. For more on hedge fund insurance, see "Hedge Fund Insurance Benchmarking Survey Reveals Trends and Views Concerning Insurance Purchasing, Pricing, Coverage Limits, Frequency of Claims and Quality of Claims Service," Hedge Fund Law Report, Vol. 5, No. 27 (Jul. 12, 2012).

Many AIFMs (and their brokers) believe that in order to meet the requirements of AIFMD, they must ensure only that their insurance policies name the perils detailed in Article 12. However, this is only one component of compliance and there is a need to develop awareness in the marketplace on how to attain effective and fully compliant insurance cover.

Common Compliance Failures

While many insurers offer to endorse a standard PI policy with a list of the perils detailed in Article 12, this is only the first step to becoming compliant. Unless additional steps are taken, a policy will remain outside of the required regulatory parameters set out by the AIFMD and E.U. regulators, such as the U.K.'s FCA. Below, we list a number of areas where policies have been seen to fall short of the AIFMD compliance requirements.

Blended Policies

Blended policies across multiple coverages (e.g., PI and crime) are often purchased by AIFMs. In these cases, it is common that there is a combined aggregate limit of indemnity across all insurance coverages. As such AIFMD PI required limits of indemnity have the potential to be eroded by losses arising outside of AIFMD PI. For example, an insured could suffer a crime claim which erodes the overall aggregate limit that also covers AIFMD PI. In this case the compulsory insurance limit could be exhausted by a claim outside of the scope of AIFMD, leaving the insured without the limit of indemnity required to meet its regulatory obligations. Blended policies should not be considered as being compliant with AIFMD unless there is a "ring-fenced" limit of indemnity available to satisfy the AIFMD PI requirement only.

Standalone PI Policies

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Even where insureds purchase PI as a standalone limit, the limit will still continue to have the potential to be eroded by losses arising from claims unconnected to the provision of services by the AIFM to the AIF. U.S. AIFMs will provide services to funds and investors outside of the scope of AIFMD (most likely, the majority of their business will be in the U.S., of course), and therefore insureds generally buy cover for their domestic and global exposures under the same policy. However, if it is possible for a non-AIFMD claim to erode the AIFMD PI limit of indemnity, then the policy should not be considered compliant. Again, as with the blended policy example above, the compulsory PI insurance must be ring-fenced from other PI claims outside of the scope of AIFMD.

Non-Standard Exclusions

An AIFM may believe that an insurer is offering an AIFMD-compliant product because the Article 12 perils are listed, but there could be non-standard exclusions in the policy that require additional capital to be held. Many U.S. policies have exclusions that are deemed “non-standard” by regulators, and additional capital is needed to be held against any excluded exposures. Such exclusions may, for example, exclude prior acts, mechanical failures or insolvency. AIFMs should make use of their internal risk management processes to calculate the amount of own funds additional capital which are needed to cover these PI policy exclusions, to make certain that an AIFM can meet its professional liabilities in the event of an exclusion. Alternatively, any policy being adapted for AIFMD should not apply exclusions that are deemed non-standard to AIFMD claims which would negate the requirement for additional own funds.

Cancellation Provisions

AIFMD policies need to have cancellation provisions of 90 days, as required under the directive. Many U.S. policies do not include this. The non-cancellation provision should also apply to non-payment of premium, which is very rare outside of specifically adapted AIFMD-compliant policies.

Insurer Authorisation

In general U.S. insurance policies are not provided by an insurer authorised to provide PI in accordance with Union law or national law. So even though an insurance policy may be adapted to include the perils listed in Article 12, the fact that the insurer may not be authorised to provide the insurance in accordance with Union Law could leave the AIFM unable to meet the requirements of AIFMD.

AIFMD-Compliant Insurance Solutions

With a lack of compliant products on offer from U.S. domestic insurers, many U.S. AIFMs may need to look further afield for their insurances. Lloyd’s of London can offer AIFMD-compliant solutions to U.S. AIFMs on a primary and excess basis and is able to offer its policies to most global jurisdictions. However, in some cases, the U.S. AIFM may be happy with its existing insurance placement and reluctant to move primary insurance relationships purely because of AIFMD requirements, especially when AIFMD-related risks may be a minor part of its business. However, it is also likely that such AIFMs will not want to buy an extensive separate PI insurance placement solely for the potential capital relief that an AIFMD-compliant policy would give them in the E.U.

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With the above in mind, the Lloyd's of London insurance market has recently seen the development of two new AIFMD-compliant excess insurance products to be offered to U.S. (and other non-E.U.) AIFMs who wish to meet the requirements of Article 9(7) of AIFMD through purchasing insurance. These products can attach at any excess point in an investment management blended insurance placement or standalone PI placement and offer follow-form cover.

However, it also offers a separate ring-fenced AIFMD limit if the first loss occurring under the policy is unrelated to AIFMD, plus a difference in conditions (DIC) extension for the elements of AIFMD-required cover which are not met by the underlying policy.

The reinstatement is offered so as to comply with the directive, as any AIFMD-related PI limit needs to respond solely to AIFMD claims. The DIC clause has the effect that any non-standard exclusions are removed in respect of AIFMD claims, in line with the Alternative Investment Management Association guidance.

As an excess DIC insurance product, the cover can sit above a non-compliant insurance product and drop down to provide primary cover where the primary policy is insufficient, thus meeting the requirements of AIFMD. These excess products allow an insured to maintain its primary insurance relationships whilst swapping excess capacity from its current capacity provider to Lloyd's of London without losing any cover. In fact, the excess cover offered is broader and offers a reinstatement of limits for AIFMD claims.

Conclusion

Since the introduction of insurance requirements under AIFMD, insurance has started to be seen not only as a necessity, but also as a means by which capital relief can be achieved and marketing advances made. Investors are now using the minimum insurance standards set out in AIFMD as their benchmark in respect of due diligence. Purchasing a compliant product can do more than merely satisfy regulators – it can provide capital relief and set a benchmark for the quality of an AIFM's insurance protection more generally. Satisfying the insurance requirements of AIFMD is an expectation of regulators and investors alike, so ensuring the insurance product purchased is truly compliant is more important than ever.

Given the increased focus on PI there is little doubt that, in order to meet the requirements of AIFMD, many non-E.U. AIFMs must change their insurance buying patterns. While regulatory issues will naturally be a focus of in-house or externally appointed compliance teams, it is also crucial that an AIFM's insurance broker is instructed to obtain policies which fully comply with its insurance requirements. What can be seen from the above is that simply endorsing an existing insurance policy with the perils listed in Article 12 is not satisfactory. AIFMs must ask their brokers and insurers how their AIFMD limit of indemnity is separate and distinct from all other coverages and how any exclusions which are contrary to AIFMD are to be managed.

Utilising the new AIFMD-compliant products offered through Lloyd's of London, AIFMs can meet the requirements of AIFMD and rest assured that they have compliant insurance in order to benefit from regulatory capital relief and meet the expectations of their demanding investor base.

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