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This *Alert* was created as part of a global, cooperative process that mirrors the spirit that we at Willis consistently employ. Our financial institutions (FI) colleagues in the UK and in our global Executive Risks Practice issued a version of this piece in response to a need they saw, and we have adapted it for our North American audience. This kind of joint perspective is really at the heart of our *Glocal* service model – global resources, delivered locally. We use global knowledge, adapted for local conditions and applied to specific client situations, to help you improve how you manage risk, and in doing so, run your business more efficiently.

Hedge funds have in the past been something of a world apart in the FI industry. As such, they have not had to deal with some of the issues faced by their FI brethren, including many Management Liability questions. That's changing. For hedge fund professionals who may have thought little about such things, we offer a bit of background about the field of Executive Risks coverage, and how these coverages might positively impact your business.

It is our pleasure to serve you. Please contact me, Duncan, Michael or Hugh, or your local Client Advocate, if you have any questions.

– John Bayeux, *FI Industry Practice Leader*

## Management Liability and the Hedge Funds

The hedge fund industry is one of the fastest growing financial sectors in the world, but until recently was not very well understood by anyone outside its corner of the investment community. There have been very few significant financial losses and as a result the industry has avoided both the regulatory and media spotlights.

However, as the attraction of hedge funds continues to grow, and hedge fund-related criminal cases begin to mount, regulators and tax authorities are now showing more interest. The expansion of regulatory requirements, external auditing and media coverage has led to an increase in the likelihood of litigation from fund investors.

Historically, very few funds and investment managers have purchased Management Liability insurance, as they have been satisfied that their experience, coupled with their internal reporting systems, would ensure that errors and subsequent losses would be identified quickly and that losses would be minimal.

Those who did purchase insurance often found that insurers did not understand the complexity of their operations. As a result, they were charged inflated premiums. They also found that off-the-shelf policies didn't always provide the level of protection they required.

Recently, investment managers have recognized that the costs of defending an action, even a spurious action, can be substantial and these costs can impact their bottom line. The hedge fund industry is catching up to other FI segments, in terms of making



Management Liability insurance a part of the standard conduct of business. Regulated investors such as pension funds have started to insist that their investment managers hold Professional Liability insurance and more and more investment management agreements are making this a legal requirement. Most municipal investors will require proof of insurance as part of their request for proposal process.

Risk management for hedge funds and fund managers is becoming its own subspecialty, requiring identification of key risk exposures and negotiation of specialized policies to ensure that the required level of protection is provided. This kind of dedicated focus is now crucial to obtaining comprehensive coverage at a competitive price.

### The Basics of Management Liability

The key areas of coverage offered by insurers are:

- Directors and Officers Liability insurance (D&O)
- Professional Liability/Errors & Omissions insurance (E&O)
- Crime Insurance (Fidelity)

Directors and officers of a fund are personally liable for any claims that may be made against them and this personal liability is unlimited. A D&O policy provides cover for them for claims arising from wrongful or alleged wrongful acts and either indemnifies the directors and officers directly, or in those cases where the fund provides an indemnity to the directors and officers, the policy reimburses the fund. The financial implications of a legal action can be disastrous, with legal costs alone running into thousands if not millions of dollars. A D&O liability policy can prove to be crucial in funding legal costs as they are incurred during the defense of any claim.

E&O insurance provides protection for management against third-party liabilities arising out of the provision of its professional services. Such liabilities may arise from:

- Breach of agreed investment parameters
- Breach of management contracts
- Perceived underperformance
- Alleged dishonest acts of employees
- Lack of due diligence prior to investments
- Incorrectly executed trades
- Failure of internal risk control

E&O policies provide indemnity in the event of errors or omissions by third-party service providers appointed by the management entity. They cover mitigation costs, enabling the management entity to help put to right an erroneous situation before it escalates.

Crime/Fidelity insurance provides protection against dishonest, fraudulent or malicious acts committed by employees. All types of employee theft are covered, with the exception of theft of confidential information. Crime/Fidelity policies also cover fraudulent transactions, computer fraud, computer virus damage and the physical loss, damage or destruction of property due to non-employee criminal activity. The definition of property in this case includes financial documents, securities, cash, etc. This is not the case with property as it is defined in typical commercial Property policy language.

The huge sums involved in hedge funds mean that employee or third-party fraud can have huge negative implications for investors. Most crime claims occur where there is easy access to operational systems and in many cases involve collusion between two or more persons. Criminal activity, it must be noted, is not the only action for which fund managers are liable. Mismanagement also counts.

### Hedge Fund Cases

The first major hedge fund collapse involved Askin Capital Management's Granite Fund, which lost approximately \$600 million in 1994 as a result of poor management. When it was liquidated, Askin had assets of only \$30 million, falling from a one-time high of \$2 billion.

This case resulted in a settlement of \$40 million with New York Attorney General Eliot Spitzer. The hedge fund allegedly invested in specific mutual funds in exchange for an opportunity to illegally late trade in mutual fund shares. The case allegedly involved several other hedge funds in the US.

The next major landmark case came in 2000. The Tiger Funds were at the time seen as one of the most stable of all the hedge fund groups. However, a collection of short bets against the rise of the new technology stocks saw the highly leveraged funds close within one year of posting their first substantial losses. Assets of the Tiger Funds plunged from roughly \$20 billion in 1998 to about \$6.5 billion in 2000. The beginning of the end occurred when the fund lost \$2 billion on a bad bet against the Japanese Yen.

Then came 2005. Of the four big hedge fund-related criminal cases in 2005, the story of Bayer Management LLC probably sent the most shockwaves through the industry. For many years, the two principals of the firm falsely stated fund values and trading gains while taking profits for themselves.

The three other cases were significant as well.

- **Aman.** In Singapore, the internal risk controls of one of the country's largest hedge funds, Aman Capital Global Fund, were called into question following derivatives trading losses of more than \$43 million. The fund is now closed.
- **GLG Partners.** GLG admitted significant flaws in its trading model, causing a drop in its credit fund. This is especially noteworthy as other banks and funds have used similar models.
- **Perry Corporation.** This US-based hedge fund owned seven million shares of a company which was to be acquired by Mylan Labs. To support the acquisition, Perry purchased a 9.9 percent stake in Mylan, which it immediately hedged with an equal short position. A rival investor in Mylan sued Perry, seeking to strip the hedge fund of its voting rights since it had no real economic interest in Mylan. In the ensuing litigation, Perry incurred significant legal costs.

Management Liability insurance is likely to be part of the future for most companies in the hedge fund business. They are also likely to seek the advice of an experienced risk management advisor to help them best respond to their changing risk environment.

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