State of the Market Report for Fund & Investment Managers

October 2010

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FINANCIAL RISKS

Including a specially commissioned report by JLT from CMS Cameron McKenna LLP,
Hedge Fund Managers: The Impact of the FSA's 2010 Agenda

Distinctive. Choice.

JLT is an international group of Risk Specialists and Employee Benefits Consultants and one of the largest of its type in the world. We offer a distinctive choice to our clients and partners through our combination of independence, scale and specialism.

As an independent business, we are able to operate with autonomy and flexibility. We have the scale to provide solutions to the complex demands of the world's leading companies and to deliver global servicing whilst recognising that the needs of each of our clients is unique.

By developing highly specialised services, we provide our clients with a depth of expertise and experience. The value we create is driven through the personal determination of our 6,200 highly motivated and skilled people.

1. Introduction

In March 2009, JLT Specialty Limited conducted a qualitative study to identify the impact of the Madoff fraud on the London insurance market for Directors' and Officers' (D&O) and Professional Liability policies in the fund management sector. We concluded that a 'two-tier market' was beginning to emerge and fund and investment managers were advised to do more to differentiate themselves in the insurance market and demonstrate senior commitment to insurance and risk management to prevent being penalised by Insurers.

As it turned out, we do not believe the level of paid claims arising out of Madoff and the financial market turmoil has reached initial expectations. Insurers and reinsurers still consider there to be a number of claims still to materialise, particularly derivative actions and we have witnessed an increase in the number of losses arising from administration errors.

However, our prediction of a tiered market was proven and looks set to remain in place in the medium term. Accompanying this two tier market are some significant market dynamics, which have prevented some of the other predictions made in our previous report from coming to fruition.

We now examine these market dynamics and provide an insider view of the current state of the insurance market for fund and investment managers. This reveals how the sector is being treated by insurers and confirms the importance of a professional approach to renewal. In particular, how an understanding of changing and emerging risks and the support of a specialist fund and investment management insurance broker are the keys to securing the optimal insurance and risk management programme.

2. Insurance market conditions

Our forecast that a tiered market was set to emerge became clearer throughout 2009 and into 2010. As we predicted, the premium increases that the established insurance markets were seeking did not materialise.

At the start of 2009, insurers were seeking an average 35% increase for 'clean' renewals. However, competitive market pressures meant that a much lower increase resulted. These market pressures, caused by the entrance of new players into the market, in combination with the withdrawal of insurers from other sectors, led to increased appetite to write UK business. Added to this, as domestic markets became stronger, there was generally less business coming to London, placing further pressure on the established London market insurers to maintain premium income from this sector.

As a result, the average premium increase in 2009 was closer to a 10% increase for those fund managers with no exposure to Madoff and the US subprime crisis. However, it is important to note that those risks exposed to Madoff and US subprime did face significant changes to their renewal.

Policy wording restrictions which were muted, to narrow the scope of insurance cover, did not materialise. The fact that the established insurers were unable to secure premium increases at the level that they wished, combined with the lack of changes to policy scope, meant that many fund and investment managers had a more straightforward renewal than generally expected - and could do so without significantly altering the way in which their risk profile or risk management was structured.

What happened in 2010

- New entrants into the market.
- A movement of individual underwriters and teams increased competitive pressures.
- Insurers were originally seeking 10-15% premium increase, but renewals are now expected to renew with no premium increase.

What could happen in 2011

- There will be no shortage in insurance capacity and the 'hard' insurance market which has not materialised yet, is unlikely to emerge in the near future.
- Additional new entrants are expected to enter the market, prolonging market pressures on the established insurers in terms of policy scope and premium price.
- The established insurers will remain under the increased market pressures outlined.
- Expect policy wording developments, particularly around coverage provided for regulatory actions.
- Competition will provide an environment for innovation product development.
- There may be a contraction of reinsurance capacity as prior years claims experience continues to deteriorate. This may have an impact on available capacity.

3. Risks

There are three primary areas for loss which fund and investment managers are advised to incorporate with greater emphasis into their risk management strategy:

3.1. Administrative losses

Administrative losses (sometimes referred to as 'fat finger losses') have become more prevalent as a result of the global economic crisis and general market downturn. In these cases, the client of the fund or investment manager must be put back in the same financial position as they were before the mistake. Clients have high expectations of their professional advisors and in difficult economic times, greater scrutiny leads to a rise in claims against fund and investment management firms.

3.2. Fraud

Madoff-type schemes, such as 'Ponzi' schemes which pay 'profits' to existing investors paid for by funds from new investors are another type of risk to be considered. These are generally conducted on a far smaller scale than the Madoff fraud and we have seen many other high-profile fraud cases come to light since Madoff. Insurance to protect against direct losses from fraud, cover for the legal liability in the event of professional negligence and D&O cover are all essential purchases for fund and investment managers.

3.3. Regulatory

However, the greatest perceived risk currently facing fund and investment managers is regulatory risk.

Despite the coalition government's announcements that the Financial Services Authority (FSA) will be disbanded with the majority of its powers being restored to the Bank of England, for the time being the FSA will continue to show its teeth.

Financial crime will continue to be a priority for 2010 and onwards and it is likely that more criminal prosecutions will follow. The City was rocked earlier this year as the FSA carried out dawn raids in a joint operation with the Serious Organised Crime Agency (SOCA). Covert and intrusive surveillance is permitted and the FSA has the power to raid employees' homes for information.

Fund and investment managers may also increasingly find themselves liable for the actions of third party companies, such as their depositaries or sub-custodians as the FSA places new emphasis on the protection of client assets. A 'blame culture', which tends to heighten during falling markets, contributes to this perception that financial institutions are somehow responsible for the actions of connected third parties and can be at risk in the event that an error occurs.

We have yet to see the full political impact of how fund and investment managers are to be regulated. For example, the full implications of the U.S. Dodd-Frank Act are unclear at this stage. The jurisdictions in which managers are domiciled may become a great influence in terms of regulation.

Finally, since the economic crisis began, there has been new emphasis by governments around the world on the need for the efforts of the financial regulators to be co-ordinated. As a result, we are entering the start of truly global regulation, placing fund and investment managers at risk in multiple jurisdictions.

This heightened regulatory risk environment led JLT to commission a special report from CMS Cameron McKenna LLP, Hedge Fund Managers:The impact of FSA's 2010 Agenda. The full text of this report has been included.

4. Tips for ensuring your insurance cover responds to the changing environment

An insurance policy should provide protection against these changing risks, although it has come to our attention that there are a number of policies which are either not fit for purpose or contain significant restrictions in the scope of cover. These policies tend to be hybrids of established tried and tested wordings produced by insurers and/or brokers which purport to offer coverage which is in fact not included. It is therefore vital that fund and investment managers ensure that their coverage is sufficient.

4.1 Policy health-check

To help you, JLT will provide a free of charge independent review of your policy wordings. Having undertaken many of these health-checks we have found that most of these erroneous policies have incomplete or excluded coverage, particularly in relation to insolvency risks, regulatory risks and mitigation of risks. Aggregation of limits has also proven to be improperly constructed.

4.2 Limits of indemnity

Buying style and the drivers for purchasing the cover must also be assessed and a review of operational risk is always recommended, in order to map cover against risk and then eliminate, mitigate and transfer.

One particular change we recommend is for fund and investment managers to purchase higher limits of indemnity, with increased policy deductibles to offset additional costs. This type of insurance should realistically be classed as 'catastrophe cover' to reflect the probability of a claim, so it is important to buy a robust policy with more limit 'depth' (for a comparative premium price) with the understanding that in the event of a claim, the fund pays a slightly higher retention first.

We also note that the practice of aggregating limits of indemnity for managers and those of the fund itself should be reviewed. When disputes occur it is likely that relationships between the fund and the manager will not be harmonious. As such, the sharing of policy limits may not be beneficial.

4.3 Insurance scope

There are a wide variety of covers available in the London market and the scope of policy wordings varies tremendously. Yet generally the scope of the cover tends not to be too price-sensitive, so it is worth bearing in mind that you may be able to purchase a better quality of policy, with far greater coverage, for a negligible, if any, variation in price.

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Appendix

Hedge Fund Managers: the impact of FSA's 2010 Agenda

The combination of continued negotiation of the Alternative Investment Fund Managers Directive at European level, the FSA's previously stated intention not to stifle the vitality of hedge fund manager activity in the UK and the aftershocks of the financial crisis, make for a challenging environment in which hedge fund managers operate. In this article we highlight some important developments that hedge fund managers should be following, together with the FSA's likely areas of particular focus for hedge fund managers in 2010 and 2011.

The Alternative Investment Fund Managers Directive:

At the time of writing, the European Council, Parliament and Commission are in "trialogue" negotiations to attempt to reconcile considerable differences of opinion on the controversial draft Directive which will, among other things, provide for stricter EU regulation of hedge funds. What measures the AIFMD ultimately contains, and how these will be translated into UK law, remains to be seen. It appears, however, that despite being home to 80% of the EU hedge fund industry the UK is set to be outnumbered in its opposition to the AIFMD by other European states which have lent it their support.

Meanwhile, the G20 countries have committed to "strengthen financial market infrastructure by accelerating the implementation of strong measures to improve transparency and regulatory oversight of hedge funds, credit rating agencies and OTC derivatives in an internationally consistent and non-discriminatory way".

Market Abuse, Insider Dealing and Financial Crime:

The FSA is increasingly focusing on the detection and prevention of financial crime and has become more aggressive in its pursuit of wrongdoers. The Mansion House announcements of changes in regulatory structures will not alter this and financial crime is set to remain a high priority in 2010 and beyond.

In practical terms, this means that we can expect to see more civil fines being imposed for market abuse. As Margaret Cole, director of enforcement at the FSA, has said, *"The FSA expects market professionals to always be alert to obvious indications of wrongdoing"*[1]. This warning followed the FSA's successful action against Winterflood Securities for market abuse, which saw Winterflood fined £4 million and two of its traders fined £200,000 and £50,000[2]. The case demonstrated the FSA's willingness to pursue firms that have failed to detect wrongdoing and, significantly, the Court of Appeal found in the FSA's favour in confirming that there is no need to show an intention to mislead or distort the market in order to make out actionable market abuse[3]. In this case, the FSA considered there to be *"clear warning signs that should have made Winterflood think something was amiss but it failed to recognise and react to them"* – firms should take this as a warning that they cannot turn a blind eye to abusive practices.

The FSA is also committed to bringing more criminal prosecutions for insider dealing. The first ever criminal conviction for insider dealing was obtained in March 2009 and, since then, the FSA has secured 5 more custodial sentences. The FSA's appetite to bring such actions was demonstrated by the high-profile arrest, in March of this year, of six individuals (including one city hedge fund professional) by the FSA and the Serious Organised Crime Agency (SOCA) on suspicion of insider dealing[4]. This was followed swiftly by criminal charges against an ex-hedge fund manager for conspiracy to commit insider dealing, which were brought in April 2010[5]. So far a total of 11 cases are due to come to trial in 2011, but this number will undoubtedly increase as the FSA's efforts continue.

But the FSA's enforcement drive is by no means limited to insider dealing - cracking down on all types of fraud and financial crime are high on its agenda. In April 2009, for example, a portfolio manager was banned and fined £35,000 for deliberately mis-marking positions[6], and a similar action was brought in February of this year against a senior fund manager who was banned and fined £140,000 for deliberately mis-marking funds[7]. In May 2009, the FSA banned a trader at Morgan Stanley for mis-marking and fined him £105,000, and also fined Morgan Stanley itself £1.4 million for systems and controls failings in relation to the breach[8]. These are clearly issues that firms cannot afford to turn a blind eye to.

As well as increasing its enforcement activity, the FSA has introduced a new financial penalties regime which came into effect on 6 March 2010 and will apply to breaches committed on or after that date. This could see firms and individuals facing fines up to three times greater than previously. Prior to its introduction the FSA had in any event been demonstrating its intentions to increase fines, having issued its highest ever fine against an individual (totalling nearly £1m) in February 2010 for insider dealing.

The upshot is that firms will need to ensure they have robust and effective measures in place to prevent insider dealing and fraud, and can expect stiff penalties, as well as time, cost and reputational damage, if they fail to do so.

[1]See the FSA's press release on the Winterflood decision at
http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/046.shtml.

[2]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/071.shtml.

[3]Winterflood Securities and Others v Financial Services Authority [2010] EWCA Civ 423.

[4]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/052.shtml.

[5]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/075.shtml.

[6]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/057.shtml.

[7]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/022.shtml.

[8]See the FSA's press release at http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/063.shtml.

Valuations and Custody:

The FSA considers protection of client money and assets to be a "supervisory priority" for 2010 and has voiced its concerns that firms' controls over client assets are not always adequate. In the case of hedge funds, this issue is particularly relevant in assessing who will be liable where depositaries or sub-custodians fail in their client asset protection obligations.

The liabilities of depositories and sub-custodians are currently under debate at European level in the draft AIFMD, where the issue is proving controversial. What provisions are eventually adopted, and what this means under UK law, remains to be seen. However, it is clear that the security of client assets is very much a live issue for hedge fund managers, and they will need to assess carefully the contractual relationships they have in place with depositories and the nature of any sub-custody arrangements. Appropriate due diligence should be carried out (and regularly updated) on depositories and sub-custodians to ensure compliance with client assets obligations.

As a related issue, the FSA has also expressed concerns about the reliability of fund valuations. Failure to value funds correctly may lead to FSA enforcement action and fines, litigation and/or reputational damage for hedge fund managers. Particularly following Morgan Stanley's £1.4 million fine for systems and controls failures (see above), firms need to have adequate processes in place to prevent mis-marking and ensure accurate valuations.

Remuneration:

One result of the financial crisis is a renewed focus on the role of remuneration practices in encouraging the wrong types of behaviour. While the FSA's immediate scrutiny was of remuneration practices at banks, remuneration is a topic which merits review by all financial institutions. The FSA issued a consultation paper at the end of July[9] on changes to the Remuneration Code, which will extend its scope beyond the largest 26 banks and building societies to include most hedge fund managers. The application of the code will depend on whether a firm is classified as "high impact", "medium/high"/ "medium low" or "low impact", but hedge funds can expect regulatory intrusion into decisions on remuneration over the coming year. The consultation closes on 8 October 2010, and the revisions are proposed to take effect in January 2011.

In addition to any scrutiny by the FSA, investors are examining remuneration arrangements more closely, and some are issuing guidelines on the remuneration practices they expect of funds they invest in. In addition, there are proposals at European level to include provisions in the AIFMD to require those subject to the Directive to establish and maintain remuneration policies which are consistent with sound and effective risk management. While the future of the Directive itself may remain unclear, this thinking reflects the prevailing mood and remuneration should be an important issue on the agenda of all hedge fund managers.

Short selling:

Following the hasty introduction of a temporary ban on short-selling and accompanying disclosure requirements in September 2008, the FSA consulted in April of this year on the future of the short-selling regime[10] and recently issued its final rules and guidance[11]. While the ban on short selling was lifted in January 2009, the disclosure requirements will remain in force (subject to a narrowing of scope in as far as they apply to rights issues). At the time the ban was introduced, there were some questions raised as

[9] "CP 10/19: Revising the Remuneration Code", July 2010

[10] "CP10/11: Implementing Aspects of the Financial Services Act 2010", April 2010.

[11] "CP 10/18: Implementing Aspects of the Financial Services Act 2010, feedback on CP 10/11, final rules and further consultation", July 2010

to the legal basis on which the FSA was able to introduce it. The FSA has new statutory powers in the Financial Services Act, however, which it has relied on in introducing its latest rules and guidance. The FSA, in short, recognises that short selling is a legitimate technique in normal market conditions but as a result of the Financial Services Act 2010 the FSA retains the right to re-introduce a ban on short-selling should the economic circumstances warrant one.

There is no immediate change for firms in this area in terms of regulatory requirements but, significantly, any financial penalties imposed on firms that are in breach of short-selling disclosure requirements and/or any future prohibition on short selling will be assessed under the FSA's new five-point process[12], which may see fines treble in size from their previous levels.

Short selling has proved a contentious subject in the ongoing debate on the draft AIFMD. Again, it remains to be seen what measures are ultimately adopted. The European Commission proposed new measures on short selling on 15 September 2010 which will affect a wider audience than just hedge fund managers. Further regulation at a European level will therefore follow in due course, and it is to be hoped that what emerges out of the current discussions amounts to a joined-up regime.

Phone taping:

In March 2009, the FSA introduced rules[13] requiring firms to record "relevant" communications which, in this context, are conversations and other electronic communications involving the receipt of client orders, and the negotiation, agreement and arranging of transactions in equity, bond and financial and commodity derivatives markets. Firms are required to keep such recordings for 6 months. There is an exemption from these rules for discretionary investment managers when communicating with firms which they reasonably believe are subject to the taping rules, or when communicating with another party (not subject to the taping rules) on an infrequent basis with relevant communications only representing a small portion of their total telephone traffic.

At the time of introducing these rules in 2009, the FSA exempted mobile communications in response to concerns that the technology needed to capture them had not been sufficiently developed. Since then, however, the FSA considers that the technology available to firms has advanced and, in March 2010, it launched a consultation on removing the exemption for mobile phones[14]. The FSA now proposes requiring firms to tape all relevant communications made on mobile phones issued by firms for business use, and to take reasonable measures to prevent employees or contractors from making relevant communications using private equipment. The exemptions for discretionary investment managers described above will continue to apply in respect of mobile communications. Consultation on the proposals closed on 14 June 2010, and the FSA expects to issue finalised proposals in Q4 2010.

The taping rules form an important part of the FSA's crack-down on financial crime, as it considers taped communications to be an important source of evidence in investigations. The latest proposals may, however, prove onerous for firms and expose them to liability, particularly given the difficulties in policing mobile use by contractors.

[12]The new framework is based on the principles of disgorgement, discipline and deterrence and consists of the following five steps: (1) removing any profits made from the misconduct; (2) setting a figure to reflect the seriousness of the breach; (3) considering any aggravating and mitigating factors; (4) achieving the appropriate deterrent effect; and (5) applying any settlement discount.

[13]See "PS08/1: Telephone Recording: recording of voice conversations and electronic communications", March 2008.

[14]"CP10/7: Removing the mobile phone exemption", March 2010.

Should you wish to discuss any of the issues in this article further, please do not hesitate to contact Maxine Cupitt or Alison McHaffie, partners in CMS Cameron McKenna's Financial Services Team, whose details appear below:

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