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The top 10 things every alternative investment fund manager needs to know about professional indemnity insurance under the Alternative Investment Fund Managers Directive

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Why should I read this?

If a full scope EU alternative investment fund manager (an "**AIFM**") chooses to use a professional indemnity (PI) insurance policy (a "**PI policy**") to cover its professional liability risks pursuant to article 9(7) of the Alternative Investment Fund Managers Directive 2011/61/EU as implemented by the AIFMD's Delegated Regulation (EU) 231/2013 and the FCA Handbook (together the "**AIFMD**") it is **the AIFM's responsibility** and not its insurer's or its broker's to ensure that the PI policy is compliant with the relevant rules.

1. How does PI insurance feature in the AIFMD?

Under article 9(7) of the AIFMD, full scope EU AIFMs may elect to use either a PI policy or own funds in respect of their professional liability risks.

An AIFM cannot mix and match the "PI policy" and the "own funds" options, but instead must elect to use one approach or the other (although note that an AIFM may be required to hold additional own funds under the PI policy option - please see section 8 below for more details).

2. When do I need to decide which option to take?

In order to be authorised to operate under the AIFMD, an existing FCA-regulated investment manager must complete a Variation of Permission ("VOP") form. (Firms seeking FCA authorisation for the first time must complete a VOP form but must also submit a specified application pack, the contents of which will depend on the type of firm concerned.)

The VOP form requires the AIFM to specify whether it intends to cover its professional liability risks by holding own funds or a PI policy.

If an AIFM indicates in the VOP form that it intends to hold a PI policy to cover its professional liability risks, it must also set out the "business line exclusions" contained in that PI policy (please see section 8 below for more details on the treatment of PI policy exclusions).

To operate as an AIFM, a firm requiring authorisation must have had its application approved by the FCA by 22 July 2014 at the latest. The FCA has recommended that firms submit their VOP forms by no later than 22 January 2014, thereby allowing it time to deal with any queries or deficiencies in the information provided ahead of the 22 July 2014 deadline.

3. How do the "own funds" and "PI policy" options compare?

The "own funds" option requires an AIFM to hold 0.01% of the value of the portfolios of all the alternative investment funds ("AIFs") it manages (the "AuM"); whereas the "PI policy" option requires the PI policy limit to cover at least 0.7% of AuM per claim and 0.9% of AuM in the aggregate for all claims.

The AuM is calculated as the sum of the absolute value of all assets of all AIFs managed (including the value of any portfolios in respect of which the AIFM has delegated portfolio or risk management), regardless of whether the assets are acquired through the use of leverage or with investors' money.

We understand that, in practice, many AIF investors are insisting on the "PI policy" option because of the higher level of protection it offers. Travelers Insurance Company Limited ("Travelers") has kindly allowed us to share the table below, which illustrates the costs and coverage implications of the two options.

Traveler's comparison table

TRAVELERS

AuM	Per Claim Limit of 0.7%	Agg Limit Calculated at 0.9% AUM	Travelers' Benchmark Limit	Estimated Excess	Estimated Premium[1]	Total Capital Required	Own Funds Alternative	Additional Insurance Cost	Additional Insurance Benefit
50,000,000	350,000	450,000	2,825,000	50,000	15,000	65,000	5,000	60,000	445,000
100,000,000	700,000	900,000	5,650,000	50,000	15,000	65,000	10,000	55,000	890,000
250,000,000	1,750,000	2,250,000	6,450,000	75,000	20,000	95,000	25,000	70,000	2,225,000
500,000,000	3,500,000	4,500,000	11,650,000	75,000	29,000	104,000	50,000	54,000	4,450,000
1,000,000,000	7,000,000	9,000,000	23,300,000	100,000	52,500	152,500	100,000	52,500	8,900,000
2,500,000,000	17,500,000	22,500,000	25,000,000	100,000	115,000	215,000	250,000	-35,000	22,250,000
5,000,000,000	35,000,000	45,000,000	25,000,000	250,000	220,000	470,000	500,000	-30,000	44,500,000
10,000,000,000	70,000,000	90,000,000	44,000,000	500,000	500,000	1,000,000	1,000,000	0	89,000,000
20,000,000,000	140,000,000	180,000,000	88,000,000	500,000	1,000,000	1,500,000	2,000,000	-500,000	178,000,000
30,000,000,000	210,000,000	270,000,000	132,000,000	1,000,000	1,500,000	2,500,000	3,000,000	-500,000	267,000,000
40,000,000,000	280,000,000	360,000,000	176,000,000	1,000,000	2,000,000	3,000,000	4,000,000	-1,000,000	356,000,000

- There is a net cost to buying insurance up to a EUR 1bn fund – however there is a net benefit of funds available at all sizes.
- There is a net benefit to buying insurance from a cost perspective from EUR 1bn upwards.
- Managers over EUR2.5bn AUM are likely to buy more limit, using Travelers' benchmark limit as a guide.

Applying the figures in the Traveler's table, and looking at the "Additional Insurance Benefit" in the final column, the "PI policy" option potentially offers more financial protection to investors than the "own funds" option. For example, where the AuM is £250m, the "PI policy" option potentially offers £2.2m of benefit over and above that offered by the "own funds" option

4. Which "professional liability risks" are required to be covered under the AIFMD?

The AIFMD requires that "the professional risks to be covered pursuant to article 9(7)...shall be risks of loss or damage caused by a relevant person through the negligent performance of activities for which the AIFM has legal responsibility." (Our emphasis added)

Professional risks

The AIFMD also includes a list of specific but non-exhaustive examples of professional liability risks which an AIFM must cover.

[1] These premiums are estimates only, and are based on the average of a broad range of possibilities.

The examples of professional liability risks which must be covered are:

loss of documents evidencing title to assets of the AIF;

misrepresentations or misleading statements made to the AIF or its investors;

acts, errors or omissions resulting in a breach of: (i) legal and regulatory obligations; (ii) duty of skill and care towards the AIF and its investors; (iii) fiduciary duties; (iv) obligations of confidentiality; (v) AIF rules or instruments of incorporation; or (vi) terms of appointment of the AIFM by the AIF;

failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts;

improperly carried out valuation of assets or calculation of unit/share prices; and

losses arising from business disruption, system failures, failure of transaction processing or process management.

Caused by a "relevant person"

A "relevant person" in relation to an AIFM is defined as any of the following:

a director, partner or equivalent or manager of the AIFM;

an employee of the AIFM, or any other natural person whose services are placed at the disposal and under the control of the AIFM and who is involved in the provision of collective portfolio management services by the AIFM;

a natural or legal person who is directly involved in the provision of services to the AIFM under a delegation arrangement to third parties for the purpose of the provision of collective portfolio management by the AIFM.

In our experience, this is an area where policies are often not in compliance with the AIFMD because the full meaning of "relevant person" has not been included within the policy wording.

5. What further terms of the PI policy are prescribed?

In addition to covering the risks set out in 4 above, in order for a PI policy to be AIFMD-compliant it must:

- have an initial term of no less than one year;
- have a notice period for cancellation of at least 90 days; and
- be taken out with a third party entity which is authorised (inside or outside of the EU) to provide professional indemnity insurance in accordance with its local law.

6. Can I cover more than one entity under my "AIFMD policy"?

Yes.

The FCA Handbook, which implements a number of the provisions of the AIFMD, states that "a firm may satisfy its requirements for professional indemnity insurance with a policy that also provides cover to one or more entities other than the firm, provided that the policy satisfies the conditions of the [Delegation Regulation], exclusive of the cover provided to other entities" (our emphasis added).

This means that a qualifying PI policy must be capable of satisfying the requisite conditions (as set out in sections 3, 4 and 5 above) for each relevant firm, exclusive of the cover provided to the other entities.

In our experience, this is an area where policies are often not in compliance with the AIFMD.

7. Can the PI policy cover other types of loss other than "AIFMD loss" under the same policy?

There is no explicit restriction in the AIFMD that a qualifying PI policy must only cover professional liability risks (as set out in section 4 above) and not other risks such as fund liability, directors & officers' or crime cover.

We understand, however, that the FCA would expect that the "AIFMD loss" cover (see 3 above) should be exclusive of any other cover provided under the policy, so that the protection for investors under the AIFMD cannot be eroded by "non-AIFMD claims" such as fund liability, directors' & officers or crime.

In our experience, this is an area where policies are often not in compliance with the AIFMD.

8. If I elect to use the "PI policy" option, do I need to hold additional own funds in respect of the policy excess or any exclusions in my policy?

Additional own funds must be held in respect of any "agreed defined excess" payable under the PI policy.

The FCA has explained that it would normally take the view that AIFMs only need to hold own funds in respect of "non-standard" PI policy exclusions.

The Alternative Investment Management Association ("AIMA") has published guidance for its members dated November 2013 to assist AIFMs in determining whether PI policy exclusions would normally be regarded as "standard" or "non-standard". See www.aima.org. For example, exclusions of liability arising in respect of bodily injury, contractual liability or liability in respect of SEC violations would normally be regarded as "standard" exclusions.

Once the "non-standard" exclusions in a PI policy have been identified, AIFMs should use their tailored internal risk management processes to calculate the amount of own funds which would need to be held in respect of the PI policy exclusions to ensure that the AIFM could meet its professional liabilities in the event of a negligent act, error or omission.

If an AIFM indicates in the VOP form that it intends to hold a PI policy to cover its professional liability risks, it must also set out the "business line exclusions" contained in that PI policy. We understand that in this section the FCA expects applicants to provide details in respect of both:

"non-standard" exclusions contained in the PI Policy; and

any "standard" exclusions against which the AIFM has determined it should choose to hold additional own funds as part of its overall risk analysis.

9. What if I have "AIFMD claims" under the PI policy which exhaust the 0.9% limit?

There is no explicit requirement under the AIFMD to "top up" the cover if "AIFMD claims" exhaust the prescribed limits of liability (see 4 above).

It is however worth noting that the AIFMD provides that the relevant regulator may "increase the minimum requirement for additional own funds [to be held by an AIFM] after taking into account the risk profile of the AIFM, its loss history and the adequacy of its additional own funds or professional liability indemnity insurance".

With this in mind, and to ensure on-going compliance with the AIFMD, should its PI policy limit be depleted or exhausted, an AIFM may wish to consider holding a small amount of additional own funds voluntarily to reduce the risk of the FCA requesting, or compelling, it to hold a potentially larger amount of additional own funds.

10. How often do I need to review my PI policy for AIFMD compliance?

An AIFM must review its PI policy, and that policy's compliance with the requisite requirements (see sections 3, 4 and 5 above), at least once a year and in the event of any change which affects the policy's compliance with those requirements. For example, if there is a significant increase in the AIFM's AuM which might affect compliance with the prescribed limits of liability (see 3 above for more details).

For future information on insurance and the AIFMD, please contact:

Pollyanna Deane

Partner

T +44 20 7825 4303

E pollyanna.deane@simmons-simmons.com

Katherine Lamb

Supervising Associate

T +44 20 7825 4581

E katherine.lamb@simmons-simmons.com

For future information on the AIFMD generally, please contact:

Sarah Bowles

Partner

T +44 20 7825 4429

E sarah.bowles@simmons-simmons.com

Simmons & Simmons

Offices

Abu Dhabi
Simmons & Simmons Middle East LLP
Level 10 The ADNIC Building Khalifa Street
PO Box 5931 Abu Dhabi United Arab Emirates
T +971 2 651 9200 F +971 2 651 9201

Amsterdam
Simmons & Simmons LLP
PO Box 79023 1070 NB
Claude Debussylaan 247 1082 MC Amsterdam
The Netherlands
T +31 20 722 2500 F +31 20 722 2599

Beijing
Simmons & Simmons
33rd Floor China World Tower 3
1 Jianguomenwai Avenue
Beijing 100004 People's Republic of China
T +86 10 8588 4500 F +86 10 8588 4588

Bristol
Simmons & Simmons LLP
One Linear Park Temple Quay
Bristol BS2 0PS United Kingdom
T +44 20 7628 2020 F +44 20 7628 2070

Brussels
Simmons & Simmons LLP
Avenue Louise 149 b 16 1050 Brussels Belgium
T +32 2 542 09 60 F +32 2 542 09 61

Doha
Simmons & Simmons Middle East LLP
Level 5 Al Mirqab Tower Al Corniche Street
PO Box 23540 Doha State of Qatar
T +974 4409 6700 F +974 4409 6701

Dubai
Simmons & Simmons Middle East LLP
Level 7 The Gate Village Building 10
Dubai International Financial Centre
PO Box 506688 Dubai United Arab Emirates
T +971 4 709 6600 F +971 4 709 6601

Düsseldorf
Simmons & Simmons LLP
BroadwayOffice Breite Straße 31
40213 Düsseldorf Germany
T +49 2 11-4 70 53-0 F +49 2 11-4 70 53-53

Frankfurt
Simmons & Simmons LLP
MesseTurm Friedrich-Ebert-Anlage 49
60308 Frankfurt am Main Germany
T +49 69-90 74 54-0 F +49 69-90 74 54-54

Funchal
Sociedade Rebelo de Sousa in association with
Simmons & Simmons
Av. Zarco nº2-2º 9000-069 Funchal Madeira
T +351 291 20 22 60 F +351 291 20 22 61

Hong Kong
Simmons & Simmons
13th Floor One Pacific Place
88 Queensway Hong Kong
T +852 2868 1131 F +852 2810 5040

Jeddah
Hammad & Al-Mehdar
in alliance with Simmons & Simmons
Office #609, King Road Tower, Malik Road,
PO Box 864 Jeddah 21421
Kingdom of Saudi Arabia
T +966 92000 4626 F +966 2 606 9190

Lisbon
Sociedade Rebelo de Sousa in association with
Simmons & Simmons
Rua D. Francisco Manuel de Melo 21
1070-085 Lisbon Portugal
T +351 21 313 2000 F +351 21 313 2001

London
Simmons & Simmons LLP
CityPoint One Ropemaker Street
London EC2Y 9SS United Kingdom
T +44 20 7628 2020 F +44 20 7628 2070

Madrid
Simmons & Simmons LLP
Calle Miguel Angel 11 5th floor 28010 Madrid Spain
T +34 91 426 2640 F +34 91 578 2157

Milan
Studio Legale Associato in affiliation with
Simmons & Simmons LLP
Corso Vittorio Emanuele II 1 20122 Milan Italy
T +39 02 72505.1 F +39 02 72505.505

Munich
Simmons & Simmons LLP
Lehel Carré, Thierschplatz 6
80538 Munich Germany
T +49 89-20 80 77 63-00 F +49 89-20 80 77 63-01

Paris
Simmons & Simmons LLP
5 boulevard de la Madeleine 75001 Paris France
T +33 1 53 29 16 29 F +33 1 53 29 16 30

Rome
Studio Legale Associato in affiliation with
Simmons & Simmons LLP
Via di San Basilio 72 00187 Rome Italy
T +39 06 80955.1 F +39 06 80955.955

Shanghai
Simmons & Simmons
40th Floor Park Place 1601 Nanjing Road West
Shanghai 200040 People's Republic of China
T +86 21 6249 0700 F +86 21 6249 0706

Singapore
Simmons & Simmons Asia LLP
#38-04 Marina Bay Financial Centre Tower 3
12 Marina Boulevard Singapore 018982
T +65 6831 5600 F +65 6831 5688

Tokyo
Simmons & Simmons Gaikokuho Jimu Bengoshi Jimusho
(Gaikokuho Joint Enterprise TMI Associates)
23rd floor Roppongi Hills Mori Tower
6-10-1 Roppongi Minato-ku Tokyo 106-6123 Japan
T +81 3 6438 5255 F +81 3 6438 5256

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