



RISK AND REWARD

**WE PROTECT HEDGE FUND
MANAGERS FROM RISKS SO THEY
CAN HELP THEIR CLIENTS SUCCEED**



Introduction

Travelers has been underwriting hedge fund manager liability insurance for clients around the globe for over a decade. In that time, some clear patterns have emerged and we have seen insurance claims by hedge fund managers arise from three main problem areas. These problem areas aren't unique to the UK; in fact, they are presenting related challenges in the US.

The similarities and differences in claims demonstrate why it is so critical for us to share knowledge with our partners. We need to understand the diversity of risks to hedge fund managers and, in turn, continue to enhance the insurance and risk management services we offer our clients.

We believe there are three areas posing the greatest risk of insurance claims for the global hedge fund industry today:

1. Operational errors: These claims are administrative or processing errors that result in a loss to the client. They are sometimes called “fat-finger claims,” reflecting how easily and inadvertently certain mistakes can be made. A trader might accidentally buy double the amount of financial product intended, for example. Generally, if there is evidence of the intended transaction, the error will be regarded as negligence. There are then questions as to whether the error has caused loss and whether the insured has a liability, depending on the terms of their investment management agreement.

We have seen an increase in losses of this type with our insureds in the UK. For example: a hedge trade might take place where the insured neglected to purchase the correct, intended forward trade; where the insured intended to buy two tranches of 200 futures contracts but bought two of 400; or where the insured neglected to give the correct notice of an intended redemption from a fund. In each case the market moved unhelpfully before the appropriate action could be taken. Market volatility increases the potential for loss.

2. Regulatory investigations: In recent years we have noted an uptick in the number of regulatory investigations. Fund managers with global operations are subject to the requirements of a number of different regulators, so their exposure is increasing simply as a result of the legal costs of responding. In the UK, we have seen a number of regulatory investigations into the operations of financial institutions prompted by instances of fraud or negligence by individuals.

In the US, the Securities and Exchange Commission (SEC) is placing particular focus on ensuring fairness amongst market participants. This has brought about some sanctions in recent months. Alternative trading systems, which are gaining in popularity around the world, were the target of significant SEC penalties last year. The SEC sanctioned Barclays and Credit Suisse regarding their alternative trading systems, including a dark pool, and also sanctioned Merrill Lynch and Morgan Stanley, resulting in some of the largest-ever penalties against such trading systems.

Asset valuation, fee disclosure and trade allocations are subject to scrutiny from the SEC. The SEC is also focused on obtaining greater accountability from gatekeepers, such as hedge fund administrators, who ignored or missed fraud. That is likely to continue according to Dabney O’Riordan, Co-Chief of the SEC’s Asset Management Unit Enforcement Division¹.

3. Third-party claims for breach of investment mandate:

These claims are complaints from customers regarding investment strategy. For example, a disgruntled customer might claim their portfolio (or an individual investment) was too risky or too defensive for their preferred level of investment risk or agreed investment mandate. One of Travelers’ insured customers in the UK had an employee who engaged in a form of foreign exchange trading with client monies that was outside of their mandate. Now, claims for substantial losses are being pursued.

Monitoring hedge funds with US exposures

In the US hedge fund market, companies are facing a broader body of risks as scrutiny of the industry continues to intensify. Last year in the US, the SEC brought a record 186 enforcement actions against advisers. Among its most significant enforcement actions were insider trading charges, a \$415 million action against Merrill Lynch for violating customer protection rules, a \$267 million enforcement against JP Morgan for failing to disclose conflicts of interest, and FCPA violations settled by the charged companies for hundreds of millions of dollars. The SEC's enforcement priorities include insider trading and fraud, robust disclosure of conflicts of interest, fees and fair allocation of fees between adviser and funds, fair valuation of fund assets, FCPA violations, and holding gatekeepers accountable². Hedge fund managers should note that start-up companies valued at more than \$1 billion (Unicorns) are an area of interest and investigation for the SEC as well – former Chairman Mary Jo White³ confirmed as much in March 2016, and published reports have noted that the SEC sent inquiry letters to numerous late-stage, high-value private companies, seeking information on their compliance with rules regarding exemptions from securities registration.

At Travelers, we'll continue to monitor those risks and others as we help our insured customers protect themselves from a range of exposures – some of which reflect the SEC's priorities and others of which stretch beyond that territory. No area of risk is insignificant; claims, even in dismissed cases, can generate substantial costs.

Travelers' hedge fund claims in the US last year arose out of risks such as:

- Common law fraud
- Regulatory investigation and proceeding for market manipulation
- Employee dishonesty
- Asset valuation fraud
- Insider trading
- Personal loans and preferential treatment
- Control person liability
- Asset valuation issues

Here is a closer look at the types of risks we have encountered recently in the US and the consequences they generated for our insured customers:

- **Common law fraud:** When a hedge fund that invested in residential mortgaged-backed securities (RMBS) sustained significant losses, its investors sued the fund's managers for fraudulent inducement/concealment and negligent misrepresentation. They alleged the hedge fund knowingly or negligently made material misrepresentations and omissions in the investor presentation materials, which claimed the RMBS market remained a fundamentally sound asset class (despite having suffered recent losses) and that the fund was being defensively managed to avoid any significant losses. Though the claim was dismissed by the court on loss causation grounds, the hedge fund adviser paid approximately \$7 million in defence costs.
- **Regulatory investigation and proceeding – market manipulation:** The SEC and Commodity Futures Trading Commission (CFTC) launched a formal investigation into whether a hedge fund adviser engaged in market manipulation through churning. The CFTC brought an enforcement action against the adviser to the hedge fund, which settled for a \$7.5 million civil penalty, and the adviser paid more than \$10 million in defence costs.
- **Employee dishonesty:** Attorney Marc Drier, who had represented a large, well-known real estate developer, solicited \$75 million in loans from a hedge fund adviser for a fictitious fund. He claimed the developer was setting up a commercial real estate investment fund

structured with 50% cash from the developer and 50% debt, but the fund did not exist and Drier no longer represented the developer. He forged the signature of the developer's CFO on loan documents. The hedge fund suffered a \$75 million loss as a result, and while coverage was provided under the forgery section of Financial Institution Bond, the program limits were insufficient to cover the total loss.

- **Asset valuation fraud:** A criminal complaint and SEC enforcement action alleged a hedge fund manager defrauded the fund's investors by intentionally inflating the month-end valuation of illiquid securities held by the fund. The hedge fund manager was accused of inflating the fund's overall net asset value each month by tens of millions of dollars and misleading investors about the liquidity of those securities. He used fictitious valuations obtained from "friendly" broker-dealers, which resulted in higher fees as well as higher bonuses because he received a percentage of his net trading profits. A jury convicted the hedge fund manager of criminal fraud and he is appealing the conviction.
- **Insider trading:** An SEC formal investigation of insider trading by a hedge fund resulted in an enforcement action, which was settled prior to trial. The hedge fund adviser agreed to settle insider trading charges and beneficial ownership reporting violations by paying nearly \$5 million and agreeing to onsite monitoring by an independent compliance consultant with access to their electronic communications and trading records. The adviser also agreed to make monthly certifications to the SEC for five years that he is not aware of material non-public information prior to any trades. Lastly, the adviser agreed to outsource his beneficial ownership certification to an outside law firm acceptable to the SEC. The adviser spent millions on defense costs.
- **Personal loans and preferential treatment:** When a hedge fund made a large loan to the principal and CIO of the hedge fund's adviser while the hedge fund was in "lock down," it sparked an SEC and criminal investigation. The CIO used proceeds of the loan to

pay his tax liabilities. The SEC also investigated redemptions given to major investors. The SEC filed an enforcement action against the CIO, hedge fund adviser entity, and former COO, alleging misuse of client funds and fraud in connection with the loan, as well as breach of fiduciary duties in connection with the preferential redemptions. The adviser and CIO settled with the SEC, and admitted to the allegations of wrongdoing as part of the settlement. They also agreed to pay more than \$15 million in penalties and disgorgement. The CIO agreed to a five-year bar from the securities industry. Their defence costs exceeded \$10 million.

- **Control person liability:** A hedge fund invested in a publicly traded Asian technology company, which discovered revenue recognition problems and made a substantial restatement of its financials as a result. When the company's stock price dropped, investors filed securities class-action lawsuits. Shareholders alleged the hedge fund was liable for the company's materially false or misleading financial statements and the fund incurred more than \$15 million in costs to defend and settle the claim.
- **Asset valuation issues:** A hedge fund adviser's valuation of certain thinly traded municipal bonds resulted in a formal SEC investigation and subsequent Wells Notice. The SEC concluded that the third-party-vendor pricing service the adviser used to value municipal bonds held by hedge funds provided inaccurate values beginning in approximately mid-August 2011, during a period of significant market volatility. At that time, the funds sold some of the municipal bonds at prices materially less than recorded, but the adviser continued to use the pricing service through the first quarter of 2013. The SEC concluded that the adviser received excess fees of more than \$400,000 and negligently violated the Investment Advisers Act of 1940. The adviser agreed to pay a \$130,000 penalty and returned \$440,000 to the funds.

Tailored protection for diverse risks

Travelers insures managers of some of the top hedge fund firms in the world based on assets under management. In the past decade, as we have seen risks evolve in the industry, we have also learned how to stay a step ahead of the exposures our insured customers face. The range of risk to the hedge fund industry is complex and broad – and one kind of insurance doesn't fit all circumstances. It's essential

for hedge fund managers to carefully consider their requirements and review their available coverage to ensure it is adequate. When they have the right cover supporting them, they gain the freedom, confidence and time to focus on what it takes to do their jobs well – without worrying about the challenges their risks may present down the line.

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¹ Practising Law Institute (PLI) SEC Speaks Conference, 24-25 February, 2017

² Examples taken from sec.gov

³ Mary Jo White, Corporate Governance Silicon Valley Initiative at the SEC-Rock Center (31 March 2016)

About Travelers

In today's dynamic world it is more important than ever for businesses to have insurance that addresses their evolving risks. Travelers provides a broad range of property, liability and professional indemnity insurance and risk solutions for the private, public and institutional sectors.

Whatever insurance needs you wish to discuss, we have the right people on hand to provide the insight and support you need.

Travelers has a comprehensive list of covers to protect your business, this includes:

Business Interruption

Employment Practices Liability

Property

Combined Package

Event Cancellation

Products Liability

Crime

Kidnap & Ransom

Public Liability

Criminal Protection Response

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Directors & Officers

Personal Accident & Travel

Employers' Liability

Professional Indemnity

Travelers Insurance Company Limited is part of The Travelers Companies, Inc. group, which is the third largest commercial property casualty insurer and second largest writer of personal insurance in the US. The group's success in the insurance industry reflects more than 150 years of experience and concerted effort to lead change.

Our customers benefit from:



The depth and breadth of our general and specialist insurance product offerings



Our risk management guidance and support services



Our fast, fair and effective approach to claims handling



Our considerable financial strength



Our expert underwriting



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