

Issues facing the hedge fund industry: an insurance perspective

Lucy Macdonald and Peter Vamvakidis of Travelers Insurance provide an insurance perspective on some of the current key issues affecting the hedge fund industry.

Q In which areas are you seeing the most insurance claims at present and are there any new areas of potential exposure to claims?

A Continuing themes are negligence and operational errors, along with regulatory investigations. While there is an increasing awareness around cyber exposures and data breaches, and we do see some claims in this area, we are yet to see a dramatic increase.

A particularly interesting trend we've seen is the increased amount of outsourcing firms have been doing – in particular, new entrants to the space are outsourcing a large amount of their functions. From an insurance perspective, it is vital to have a well-developed understanding of your contracts. While you may be outsourcing a function, the liability and responsibility 'buck' can still stop with the firms and their managers.

We regularly stress to clients that they need to make sure they know what their limits of liability are, and where they are indemnified contractually between their service providers. Often the potential downside or risk is actually greater than the contractual indemnity provides for.

For example, with a fund administrator you may only be indemnified for double the fees incurred. Claims could be significantly larger than that. It's of particular importance for smaller managers to conduct rigorous due diligence on their outsourced service providers and to be critical of the contracts in place.

Q What other issues are concerning your insured clients?



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A As insurers we tend to focus on where claims come from and the inherent risks in that regard. However, we know that our fund manager clients have a whole range of concerns and issues, of which actual claims may only comprise a small part. Regulatory scrutiny, for example, can give rise to costly investigations but outside of a claim context has led to a renewed focus on fees charged to investors. This in turn gives rise to a range of other issues and considerations including investment in compliance and risk management, operational management, and of course, crucially, investor satisfaction.

There has been a lot of noise, especially at the start of 2018, around whether managers are charging active fees for what are effectively passive returns. While performance is undoubtedly the most important USP, in a landscape of increasing pressure, both from investors and regulators, it's important for firms to consider what other advantages they have to offer over their competitors.

Aside from performance, we have also recently experienced more

conversation around ESG investing and the demands of the millennial investor. The profile of the modern investor is changing but it may be some time before the majority of funds under management are held by the 'millennial generation'.

Q What, if any, client concerns are you currently experiencing around data breaches and GDPR?

A GDPR has been on everyone's radar for a while, and there is a certain amount of caution, although in comparison with other industries most hedge funds hold a relatively small amount of personal data. We, along with our insured clients, are still waiting to see the impact of GDPR on claims as the legislation has only been in force since 25 May 2018.

The main issue concerning fund managers is that GDPR brings with it a greater burden of disclosure. We have seen, for example, a claim made by an offshore fund manager whose systems were breached by a third party obtaining access to personal data. Luckily the forensic investigation (the costs of which were reimbursed by a financial institutions insurance policy underwritten by Travelers) caught the breach early, prevented any further breach, and since it was isolated at an early stage there was no requirement for the fund manager to report the issue to investors or the local regulator. Under the new regime, notwithstanding the minimal impact of the breach, it is likely that the issue would have had to be reported, and may have risked significant negative publicity and investor queries

or complaints, let alone regulatory action. However, again, the full impact of the enhanced obligations to disclose remains to be seen.

A On the whole, while GDPR is a regulation which has received a lot of attention and is absolutely something all managers need to be prepared for and compliant with, it is something we believe the vast majority of managers have under control. The working groups we've sat in with give the overall sense that GDPR hasn't proven nearly as onerous as Mifid II.

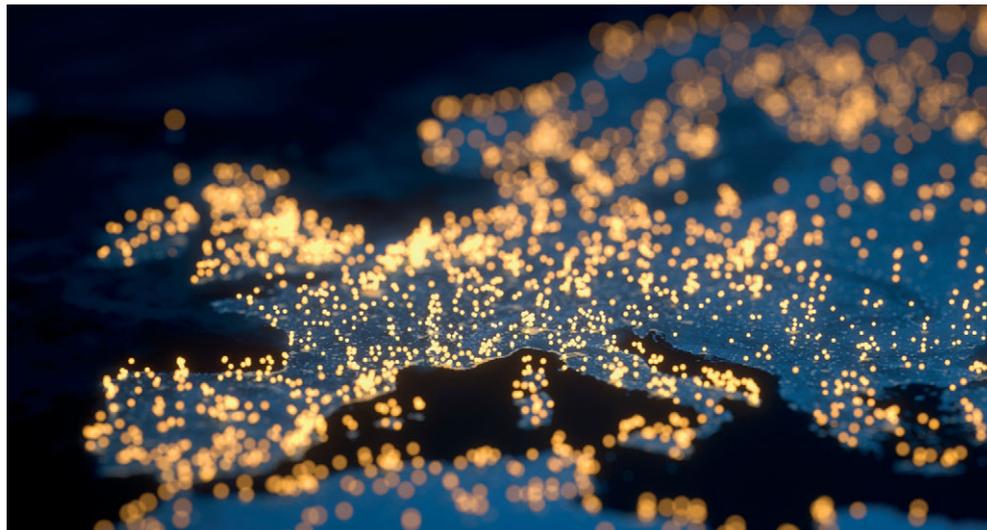
Q What issues are you seeing in relation to diversity and other employment practices in this industry?

A The employment piece feeds into conversations we've had with insured clients about how the employment environment is changing.

As an insurer of fund managers, Travelers can offer cover to entities both in the UK and Europe and will be able to continue to pay claims regardless of geographical movement of insured clients

Firstly, a priority for most fund managers (as with most employers) is how to attract and retain 'top talent'. Long-term loyalty is no longer a given in the modern day, so USPs such as being flexible and diverse are more important than ever in retaining staff. This is proving a challenge for some more traditional fund managers. In a similar vein, we've also heard some fund managers mention the increasing importance of the HR function – a discussion driven by the evolving needs of millennial employees.

Further, fund management, plainly speaking, is not the most diverse industry, and everyone is aware of that. Potential gender imbalance on the boards of larger managers is another matter being discussed. Managers are thinking about these matters, and how they can address them. The difficulty is that there is



not always the scope and the potential to address all of these issues as quickly as they would like.

The result of these issues from a risk perspective is an awareness around firms' and directors' responsibilities to consider these issues as a matter of employment law.

Clients of ours have asked questions around what employment practice liability coverages exist, which would account for instances of employees feeling they've been discriminated against, wrongfully dismissed and other cases of a similar nature.

At the moment these are primarily enquiries being made by higher profile managers with more staff members, but this rising trend will probably start filtering down to smaller managers over time.

Q What are your thoughts around ongoing regulatory scrutiny?

A With Mifid II finally behind most fund managers, attention is now turning to the FCA's upcoming Senior Managers and Certification Regime (SM&CR) which is set to commence in late 2019. Many firms have invested in their compliance teams in order to deal with the ongoing burden of regulatory compliance.

Q Brexit: What are the present levels of concern and the reasons for them?

A It depends on the individual firm and their business model as everyone is different. In our experience the level of concern is therefore

varied. Some have contingency plans in place and view the drama of Brexit as somewhat overplayed. We've spoken to some who are in fact benefiting from an investment perspective due to the depreciation of sterling caused by Brexit throughout this time of uncertainty.

The overriding concern for many, though, is that irrespective of whether they have a contingency plan ready for however Brexit plays out, it's hard to predict what effect it will have on their business. Distribution is a common concern, and whether this will be able to continue from London, or whether it will need to be external; in which case, this will necessarily mean movement of business and talent away from London, and this is a considerable concern over the long term.

In the short term, fund managers are concerned about the administrative burden and time spent working on arrangements and alternatives depending on the way Brexit plays out.

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This article was produced in conjunction with Travelers Insurance Company. For more information about Travelers, including further hedge fund claims examples, please contact Lucy Macdonald or Peter Vamvakidis (contact details can be provided upon request to HFM).