Hedge Fund Insurance: A Good Investment?

Hedge Fund managers spend endless amounts of time and money analyzing and determining the appropriate investments to hedge risk in their portfolios. Can one afford to disregard the risks in their business?

Originally set-up by Alfred Jones in 1949 to eliminate risk by holding long positions and short-selling other stocks, the Hedge Fund industry has mushroomed in size to an estimated $2 trillion, and over 10,000 funds. It is projected that over 20% of the New York Stock Exchange (NYSE) volume is hedge fund related. This along with the perceived lack of transparency in hedge fund reporting has led has led the public media (New York Times, CNBC, etc.) to declare the hedge fund the root of all evil.

Although headlines tend to focus on the spectacular blow-ups and frauds, the tremendous turnover in the industry is due to much less dramatic reasons. One third of funds fail within 3 years, fizzling out quietly due to operational issues such as the miscalculation of Net Asset Value's (NAV), or errors and mistakes.

Hedge Fund investors are paying for a fund's investment expertise. Fund managers need to be free from worry about how an honest mistake or error can open them up professionally and personally to tremendous liability.

> ***"Fund managers need to be free from worry about how an honest mistake or error can open them up professionally and personally"***

"Regulation – it is not so much carved in stone, as it is written in water."

As hedge funds have become more accessible to a larger population of investor, public interest has led to greater scrutiny. This will lead to an ever increasing environment of regulation from both Congress and the SEC.

> ***"… a fund is never free from regulatory oversight."***

Whether registered with the SEC, the state, or completely unregistered, a fund is never free from regulatory oversight. The SEC will enforce anti-fraud provisions (SEC rule 206(4) – 8) which may include deceptive or manipulative practice as well as misstatements, omitting of material fact or even true statements if not complete.

The SEC throws a "Surprise Party"

Of the past SEC cases which have focused on a failure to supervise, trade allocations, side letters, soft dollars, and valuations, the majority of cases brought by the SEC find "no wrong doing." However, the process a fund must go through to defend the inquiry will most likely cost hundreds of thousands of dollars to the fund and its investors, will drag down performance, and will tarnish a firm's reputation.

> ***"… defend the inquiry will most likely cost hundreds of thousands of dollars."***

"Glass, china, and reputation are easily cracked and never mended well"

- Ben Franklin

Reputation is of utmost importance to a fund's success and must be protected from the strain of an adverse event.

This is clearly illustrated by the fact that although the SEC's 2004 attempt to mandate hedge fund registration by 2006 was overturned later in the same year, the majority of funds that had registered with the SEC remain registered today.

A lawyer walks into a bar…

We have all heard the lawyer jokes. We live in a very litigious society and lawyers like the SEC not only see the large target on the hedge fund's backs, but their deep pockets as well. This has led to an unnerving increase in private litigation from unsatisfied investors, employees, business partners, vendors, competitors, and other outside parties.

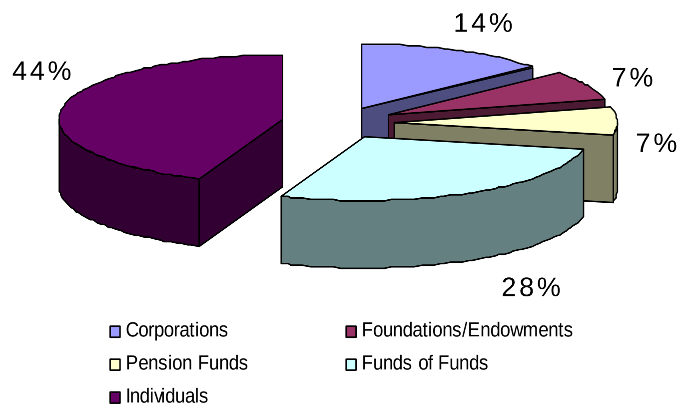
Your Doctor won't practice without it. Why would you?

Professional liability policies are similar to the malpractice insurance that many doctors would never practice without. The unique business and exposures of hedge funds have led to distinctive coverage that combines both a Directors & Officers (D&O) policy with an Errors & Omissions (E&O) insurance policy. The D&O policy insures Directors and Officers for claims against the fund and individual board member.

The E&O policy will provide coverage to past, present, and future directors, officers, managers, or employees for any breach of duty, neglect, error, misleading statement of omission in providing financial, economic, or investment advice and/or investment management services to the fund.

"…provide coverage to…employees for any breach of duty, neglect, error, misleading statement or omission…"

The chart below illustrates that larger sums of money are being invested by institutions, endowment plans, Fund of Funds, and pension plans. Beyond protecting a fund from its current investors, Professional Liability insurance coverage enhances a funds operations and infrastructure so it can attract the larger institutional investor.



Source: The Hennessee Group

In addition to attracting more assets, many funds are looking for this coverage in order to attract and retain top talent. Many potential Directors & Officers demand insurance and in fact, a fund that has an offshore entity is required to have an Independent board of directors and it is these members that are requiring coverage. A fund has absolutely no control over the regulatory environment. In addition to all the benefits of this coverage, it is important to note that regulatory investigations **are** covered claims under these policies.

Manager and officers will be personally liable if the fund is unable to indemnify them. In many cases the indemnity agreement within a fund's Offering Memorandum are useless because the fund is not financially viable.

Insurance companies are also aware of the continuing threat to hedge funds from litigators and regulators and have focused more resources on this market.

"Managers and officers will be personally liable if the fund is unable to indemnify them."

This expansion in capacity, along with claims experience has led to pricing pressures that have made this type of policy more affordable than ever.

The exceptional structure of hedge funds have made it extremely important to find experts that understand both your business and the complicated insurance market to be sure that your fund's exposures are properly calculated and covered.

A hedge fund's incentive fee can be justified by the fact that the fund's interests are aligned with those of its investor. Continue to put your client's interest first and added sense of security that they demand.

The hedge fund industry's size and its availability to a larger and growing portion of the investing public have resulted in an increased exposure to unforeseen and unwarranted risks. Professional Liability insurance is effective in transferring the unpredictable risks of regulatory investigations or private litigation to a third party.

"Transfer the unpredictable risks of regulatory investigations or private litigation to a third party."

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