Risks and Insurances for Alternative Investment Fund Managers within the AIFMD and the Delegated Regulation 231/2013

(Riesgos y Seguros de los Gestores de Fondos de Inversión Alternativos en el marco del Reglamento Delegado 231/2013 y Directiva GFIA)

Gerolamo Chiavari
Managing Director, Ribé Salat M&A Advisors
Board Member EMEA, Assurex Global

Clotilde Chiavari - BA (Hons.)
Graduate LLB student - University of Exeter

Avv. Andrea Conso
Partner, AC Group - Annunziata & Conso

Dr. Carlo Giuliani
Associate, AC Group - Annunziata & Conso

Dr. Giuseppe Bongiovanni
Junior Associate, AC Group - Annunziata & Conso

Sumario: 1. Introduction. 2. The Legislation. 2.1. The coverage of AIFMs’ risks of professional negligence liability. 2.2. The rationale of the provisions: prudential supervision and risk management. 2.3. The principles set forth in the recitals of Delegated Regulation 231/2013. 2.4. The specific rules of Delegated Regulation 231/2013: the choice between additional own funds and professional indemnity insurance. 3. The Analysis. 3.1. Managers’ Responsibilities. 3.2. Risk Management Obligations. 3.3. Risks of the AIFMs. 3.4. A specific focus on Risks of Portfolio Companies. 3.5. Self-Insurance or “Real Insurance”? 3.6. Self-Insurance vs. “Real Insurance” (Practical Examples). 4. Conclusion

Abstract: This article will discuss the risks arising from the activities of Alternative Investment Fund Managers (“AIFMs”) and compare the options available to protect them against professional liability risks, leading to the conclusion that combining
professional indemnity insurance and additional own funds better protects both investors in Alternative Investment Funds (“AIFs”) and AIFMs, than own funds alone.

**Keywords:** Capital Requirements, Insurance, Risk Management, AIFMD, Self-Insurance

**Resumen:** Este artículo analiza los riesgos de las actividades de los Gestores de Fondos de Inversión Alternativos (“GFIAs”) y compara las opciones disponibles para protegerlos contra los riesgos de responsabilidad profesional, llegando a la conclusión que la combinación de fondos propios adicionales con un seguro de responsabilidad profesional protege mejor tanto los inversores en Fondos de Inversión Alternativos (“FIAs”) como los GFIAs, que sólo los fondos propios adicionales.

**Palabras clave:** Requisitos mínimos de capital, Seguro, Gestión de Riesgos, GFI, Auto-Seguro

1. **Introduction**

1. Following the entry into force of the “Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010” (“AIFMD”) in 2011, on 19 December 2012 the European Commission adopted the Level 2 Regulation pursuant to the AIFMD framework, i.e.: the Commission Delegated Regulation (UE) no 231/2013 of 19 December 2012, supplementing AIFMD with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (“Delegated Regulation 231/2013”), to be applied from July 2013. Not all countries implemented the Directive and Level 2 regulation by the 22nd July 2013 deadline, and various countries received a formal request from the European Commission to provide notification of the measures taken to fully comply with the AIFMD framework. All countries have now transposed the Directive into national law.

2. The Directive lays down the rules for the authorisation, ongoing operation and transparency of the managers of alternative investment funds (AIFMs) which manage and/or market alternative investment funds (AIFs) in the European Union.

3. The Directive applies to all EU and non-EU AIFMs. It does not apply to a number of entities of a different nature, such as holding companies; institutions for occupational
retirement; national central banks; national, regional and local governments; employee participation schemes; and securitisation special purpose entities.\(^1\)

4. “AIFs” means collective investment undertakings, including investment compartments thereof, which:
   (i) raise capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors; and
   (ii) do not require authorisation pursuant to Article 5 of Directive 2009/65/EC.\(^2\)

5. “AIFMs” means legal persons whose regular business is managing one or more AIFs.

6. Each AIF managed shall have a single AIFM, which shall be responsible for ensuring compliance with this Directive. The AIFM shall be either: (a) an external manager; or (b) the AIF itself, which shall then be authorised as an AIFM.\(^3\)

7. An AIFM has to ensure that the potential professional liability risks resulting from its activities are appropriately covered either by way of additional own funds or by way of professional indemnity insurance.\(^4\)

8. To cover potential professional liability risks resulting from their activities, AIFMs shall either:
   (a) have additional own funds that are appropriate to cover potential liability risks arising from professional negligence; or
   (b) hold a professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered.\(^5\)

9. Own funds, including any additional own funds as referred to in point (a) of paragraph 7, of AIFMD, shall be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions.\(^6\)

---

6. Ibid.
2. The Legislation

2.1. The coverage of AIFMs’ risks of professional negligence liability

One of the most relevant novelties introduced by the AIFMD was the provision included in article 9, paragraph 7, letters a) and b) requiring both internally managed AIFs and external AIFMs to adopt proper measures to cover the potential risks of liability for professional negligence, arising from the provision of their activities.

In particular, AIFMD provides that AIFMs shall choose between two different alternatives, in order to fully comply with the “initial capital and own funds” requirements, pursuant to articles 9: the provision under paragraph 7 states that: “to cover potential professional liability risks resulting from activities AIFMs may carry out pursuant to this Directive, both internally managed AIFs and external AIFMs shall either: a) have additional own funds which are appropriate to cover potential liability risks arising from professional negligence; or b) hold a professional indemnity insurance against liability arising from professional negligence which is appropriate to the risks covered”.

With specific regard to the additional own funds requirement under paragraph 7, letter a), mentioned above, it is not strictly mandatory for AIFMs to fully keep such funds in cash, since they may be invested in different assets, but subject to compliance with certain particular requirements: articles 9, paragraph 8, of AIFMD adds, in fact, that “own funds, including any additional own funds as referred to in point (a) of paragraph 7, shall be invested in liquid assets or assets readily convertible to cash in the short term and shall not include speculative positions”. Hence, such additional own funds shall be invested in assets which, although formally different from cash, are substantially equivalent to it.

2.2. The rationale of the provisions: prudential supervision and risk management

On the basis of such core provisions of AIFMD, it is possible to understand the whole rationale behind the rules provided for under article 9, paragraph 7: such rules may in fact be included in the “prudential supervision” regulation, a sector in which the European Legislator has introduced several remarkable changes during the recent years, in the banking, securities and insurance sectors.

Such part of the European financial regulation is focused on capital adequacy of entities acting in the financial sectors and on the idea that such professional supervised operators shall properly assess their own funds, both from a qualitative and quantitative perspective, in order to cover all essential risks related to their operations.
Focusing then on the asset management activity, pursuant to the specific AIFMD framework, it shall be highlighted that in such sector, prudential supervision lays emphasis on AIFMs’ responsibility to ensure their “sound and prudent management”\(^7\), and to evaluate the level of own funds needed to cover the risks arising from their activity, both from an internal and external perspective, i.e.: (i) not only to maintain the capital and integrity of the AIFM itself, but most of all (ii) to safeguard the position of the AIFs managed by the AIFM and their investors, which might be potentially affected by a default of the AIFM, as the entity responsible for the management of their assets.

Indeed, such risk may be strengthened in case of claims from third parties, arising from alleged maladministration, misconduct and non-compliance with its professional duties, which might lead to charges and legal disputes, and result in the possible erosion of the AIFM’s assets.

Hence, in order to guarantee a measure of defence for the AIFM from the potential harm deriving from such claims, AIFMD has set forth the rules on the additional own funds requirement in article 9, paragraph 8, providing for a different graduation of self-assessment for AIFMs: indeed, as already mentioned above, AIFMs may comply with such requirement either by a strictly internal measure, i.e. to keep additional own funds deemed as appropriate against liability risks arising from professional negligence, or by “shifting” such liability risks to entities other than the AIFMs themselves, i.e. insurance companies, by the execution of professional indemnity insurance against liability arising from professional negligence.

In order not to leave too wide a margin of discretion to AIFMs, the AIFMD has granted the Commission the power to better define how AIFMs shall comply with such requirements. In particular, article 9, paragraph 9, of AIFMD, states that “the Commission shall adopt, by means of delegated acts in accordance with Article 56 and subject to the conditions of Articles 57 and 58, measures in relation to paragraph 7 of this Article specifying: (a) the risks the additional own funds or the professional indemnity insurance must cover; (b) the conditions for determining the appropriateness of additional own funds or the coverage of the professional indemnity insurance; and (c) the manner of determining ongoing adjustments of the additional own funds or of the coverage of the professional indemnity insurance”.

The Commission has implemented article 9, paragraph 9, of AIFMD through the Delegated Regulation 231/2013.

\(^7\) DIRECTIVE 2011/61/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 8 June 2011, art. 8 (d).
2.3. The principles set forth in the recitals of Delegated Regulation 231/2013

First of all, as a preliminary remark, it should be highlighted that the need for AIFMs to choose whether to cover potential risks of professional liability by additional own funds or by an appropriate professional indemnity insurance is dealt with in recitals from 32 to 38 of Delegated Regulation 231/2013, which are essential to understand the whole legal framework at stake together with Section 3 of the same Delegated Regulation 231/2013 (“Additional own funds and professional indemnity insurance”).

According to recital no. 32, a common understanding of the potential professional liability risks to be covered is an essential condition for the uniform application of article 9, paragraph 7, of the AIFMD. The general specification of the risks arising from an AIFM’s professional negligence should determine the features of the relevant risk events and identify the scope of potential professional liability, including damage or loss caused by persons who are directly performing activities for which the AIFM has legal responsibility: in particular, such persons include not only AIFM’s directors, officers or staff, but also persons performing activities under a delegation arrangement with the AIFM. In such perspective, it is important to highlight that the liability of the AIFM should not be affected by delegation or sub-delegation, and that the AIFM should provide adequate coverage for professional risks related not only to its strictly internal organization, but also to “third parties for whom it is legally liable”.

In accordance with recital no. 33, in order to ensure common understanding of the general specification, “a list of examples should serve as benchmark for identifying potential professional liability risk events”, consisting of a wide range of events resulting from negligent actions, errors or omissions (e.g. loss of documents evidencing title to investments, mis-representations, or breach of the various obligations or duties incumbent on the AIFM). To be more precise, recital no. 33 clarifies that professional liability may arise also from criticalities recorded at the level of the AIFM’s internal structural organization. As an example, the Commission refers to “the failure to prevent, by means of adequate internal control systems, fraudulent behaviour within the AIFM’s organization”, as well as “valuations that are improperly carried out” and “damage resulting from failure to carry out sufficient due diligence on an investment that turned out to be fraudulent” (of course, with the exception of losses incurred because an investment has lost value as a mere result of adverse market conditions, which should not be covered).

In addition, recitals no. 34 and 35 introduce an interesting perspective, by stating that AIFMs’ potential professional liability risks shall be managed both from a qualitative and quantitative point of view: in fact, AIFMs shall deal with the matter at stake inside their risk management policy, by implementing adequate policies and procedures for
operational risk management, taking into proper consideration the nature, scale and complexity of the business. The Commission then requires AIFMs to comply with “quantitative minimum benchmarks” to ensure a proper level of coverage of professional liability risks, which should be determined by the AIFM as a specific percentage of the value of portfolios of AIFs managed (calculated as the sum of the absolute value of all assets of all AIFs managed, irrespective of whether they are acquired through use of leverage or with investors’ money). According to the Commission, coverage through professional indemnity insurance is evaluated - by nature – “more uncertain” compared to coverage provided through additional own funds: hence, different percentages should apply to such different instruments, used for covering professional liability risk.

In order for such professional indemnity insurance to be effective, in covering losses that result from insured events, recital no. 36 states that it should be taken out from an “insurance undertaking which is authorised to provide professional indemnity insurance”, hence: EU insurance undertakings and non-EU undertakings, to the extent that they are permitted to provide such insurance service by Union law or by national law.

Moreover, it is interesting to highlight that recital no. 37 includes the possibility for AIFMs to mix the two different instruments mentioned above (i.e. professional indemnity insurance and additional own funds). In fact, it is stated that AIFMs and insurance undertakings may provide for a more flexible content of the appropriate professional indemnity insurance, by agreeing on a “defined excess” clause, i.e. a clause providing that a defined amount shall be borne by the AIFM as the first part of any loss. In case such a defined excess is agreed upon, the AIFM should provide own funds corresponding to the defined amount of loss to be borne by the AIFM. Such own funds should be in addition to the initial capital of the AIFM and to the own funds provided by the AIFM pursuant to Article 9, paragraph 3, of AIFMD.

Recital no. 38 refers to the organizational and monitoring requirements to be implemented by AIFMs: the Commission states that the adequacy of coverage (through additional own funds or professional indemnity insurance) should be reviewed at least once a year, and in any case AIFMs should have procedures in place that ensure ongoing monitoring of the total value of AIF portfolios managed and ongoing adjustments to the amount of coverage of professional liability risks should there be significant mismatches identified. The same recital also provides for the possibility for competent authorities to differently graduate the requirements pursuant to article 9, paragraph 7, of AIFMD, based on the particular condition of individual AIFMs: in fact, “the competent authority of the home Member State of an AIFM may lower or increase the minimum requirement for additional

---

own funds, after taking into account the risk profile of the AIFM, its loss history and the adequacy of its additional own funds or professional indemnity insurance”.

2.4. The specific rules of Delegated Regulation 231/2013: the choice between additional own funds and professional indemnity insurance

Following the analysis of the relevant recitals above, it is now necessary to move to the dispositions under articles 12, 13, 14 and 15, included in Section 3 of the Delegated Regulation 231/2013.

Starting from article 12, such provision includes a more detailed list of the professional liability risks to be covered pursuant to article 9, paragraph 7, of AIFMD, i.e. “risks of loss or damage caused by a relevant person through the negligent performance of activities for which the AIFM has legal responsibility”. According to article 12, paragraph 2, professional liability risks shall include (without being limited to) risks of: (a) loss of documents evidencing title of assets of the AIF; (b) misrepresentations or misleading statements made to the AIF or its investors; (c) 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; (vi) terms of appointment of the AIFM by the AIF; (d) failure to establish, implement and maintain appropriate procedures to prevent dishonest, fraudulent or malicious acts; (e) improperly carried out valuation of assets or calculation of unit/share prices; (f) losses arising from business disruption, system failures, failure of transaction processing or process management”.

Article 13 focuses on the “qualitative requirements” addressing professional liability risks, and goes into the details of the internal measures to be adopted to mitigate operational risks, as a part of the overall activities to be carried out by the AIFM’s “risk management” control function. It is stated that an AIFM shall set up a historical loss database, in which any operational failures, loss and damage experienced shall be recorded: such database shall record, without being limited to, any professional liability risks as referred to in article 12, paragraph 2, that have materialised. Moreover, within the risk management framework the AIFM shall make use of its internal historical loss data and, where appropriate, of external data, scenario analysis and factors reflecting the business environment and internal control systems.

In articles 14 and 15, the Commission focuses instead on the “quantitative requirements”, by providing a detailed regulation of the two alternative measures to be adopted by AIFMs: “additional own funds” (article 14) or “professional indemnity insurance” (article 15).
According to article 14, if an AIFM chooses to cover professional liability risks through additional own funds, it shall provide additional own funds for covering liability risks arising from professional negligence at least equal to 0.01% of the value of the portfolios of AIFs managed. It is clarified that the value of the portfolios of AIFs managed shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value.

In terms of periodic monitoring of such requirement, AIFMs shall recalculate the additional own funds requirement at the end of each financial year, and adjust the amount of additional own funds accordingly. From a procedural perspective, AIFMs shall establish, implement and apply procedures to monitor on an ongoing basis the value of the portfolios of AIFs managed, and if before the annual recalculation referred above, the value of the portfolios of AIFs managed increases significantly, the AIFM shall without undue delay recalculate the additional own funds requirement and shall adjust the additional own funds accordingly.

Recalling the content of recital 38, the Commission states that the competent authority of the home Member State of the AIFM may authorise the AIFM to provide additional own funds lower than the amount referred to in article 14, paragraph 2, only if it is satisfied — on the basis of the historical loss data of the AIFM as recorded over an observation period of at least three years prior to the assessment — that the AIFM provides sufficient additional own funds to appropriately cover professional liability risks. The authorised lower amount of additional own funds shall be not less than 0.008% of the value of the portfolios of AIFs managed by the AIFM. On the other hand, the competent authority of the home Member State of the AIFM may also request the AIFM to provide additional own funds higher than the amount referred to in paragraph 2, if it is not satisfied that the AIFM has sufficient additional own funds to appropriately cover professional liability risks (in any case, should the competent authority consider the AIFM’s additional own funds to be insufficient, it shall give specific reasons for it).

Article 15 provides the main conditions that shall be complied with, in case AIFMs choose to cover professional liability risks through professional indemnity insurance. In particular, it is stated that the AIFM shall take out and maintain at all times professional indemnity insurance that: (a) shall have an initial term of no less than one year; (b) shall have a notice period for cancellation of at least 90 days; (c) shall cover professional liability risks as defined in Article 12 paragraphs 1 and 2; (d) is taken out from an EU or non-EU undertaking authorised to provide professional indemnity insurance, in accordance with Union law or national law; (e) is provided by a third party entity.
It is also specified - as anticipated in recital 37 - that, in case the AIFM and the undertaking agree upon a “defined excess”, this shall be fully covered by own funds, which are in addition to the own funds to be provided in accordance with Article 9, paragraphs 1 and 3 of AIFMD.

Paragraphs 3 and 4 of article 15 provide for specific levels to be complied with in order to ensure adequate insurance coverage: with reference to an individual claim, the coverage of the insurance shall be equal to at least 0.7% of the value of the portfolios of AIFs managed by the AIFM, calculated as set out in the second subparagraph of Article 14, paragraph 2; while the coverage of the insurance for claims in aggregate per year shall be equal to at least 0.9% of the value of the portfolios of AIFs managed by the AIFM, also calculated as set out in the second subparagraph of Article 14, paragraph 2.

Also, if the AIFM choose the “professional indemnity insurance” option, it is subject to certain monitoring duties: the AIFM shall review the professional indemnity insurance policy and its compliance with the requirements laid down in article 15 at least once a year, and in the event of any change which affects the policy’s compliance with the requirements in said article 15.

3. The Analysis

3.1. Managers’ Responsibilities

Every manager is responsible for their acts and decisions; in particular AIFMs, such as Private Equity and Venture Capital operators, have responsibilities regulated by AIFMD.

Managers are responsible towards all parties: investors, employees, public authorities and many other third parties. However directors of listed companies, differently from AIFMs, seem to be much more aware of their responsibilities and potential liabilities. This is possibly due to the fact that the press does not take much interest in cases other than well-known names, or due to the fact that investors in AIFs tend to be more prepared to take risks in exchange for higher potential returns.

All this does not however mean that a large financial loss, arising from insufficient risk management by AIFMs, would not attract an equally large claim by investors against the AIFMs themselves.
3.2. Risk Management Obligations

As analysed in Part 1 above, AIFMs are obliged to have appropriate qualitative internal control mechanisms to avoid or mitigate operational failures, including professional liability risks. Therefore, an AIFM should have, as part of its risk management unit, adequate policies and procedures for operational risk management, appropriate to the nature, scale and complexity of its business. Such procedures and policies should in any event enable an internal loss database to be built up to serve the purpose of assessing the operational risk profile.9

AIFMs must therefore make and implement plans to deal with potential losses, in a similar manner to what board members of large corporations do, to minimise and avoid risks that could affect investors’ funds.

Risk management requires the identification and analysis of all potential losses, avoiding those risks that are avoidable, assuming those risks that are considered as not having a serious effect, transferring those risks that are transferrable and insuring the remainder. Self-insurance is not a simple question of setting aside some funds, it actually requires the same process of identification, analysis, valuation, control and of finally making a provision in the balance sheet to cover the maximum probable loss that is being self-insured.

From an internal organization perspective, in order to assure the proper independence of the functions of Risk Management, it is stated that these shall be kept formally separated from the business units of the AIFMs: AIFMD indeed states that “AIFMs shall functionally and hierarchically separate the functions of risk management from the operating units, including from the functions of portfolio management.”10

With specific reference to the requirement of “Additional own funds and professional indemnity insurance”, which consists in a fundamental part of the AIFMs Risk Management framework, AIFMD states that - before the investment in the AIF - AIFMs shall make available to AIF investors a description of how the AIFM is complying with the requirements of Article 9(7), which says that AIFMs have to ensure that the potential professional liability risks resulting from their activities are appropriately covered either by way of additional own funds or by way of professional indemnity insurance.11

9 COMMISSION DELEGATED REGULATION (EU) No 231/2013 of 19 December 2012, art. 34.
3.3. Risks of the AIFMs

AIFMs, AIFs and their investors face numerous risks, some of which lies in their investment strategy carried out by the AIFMs and some others which are outside the control\(^\text{12}\). We can think of some risks often not properly taken into consideration, such as those linked to certain individuals in the organisation who are the “key” to their success: the protection of the firm from the disappearance or incapacity of these human assets or “rainmakers” is often called “key-person insurance”.

Other risks, that are unfortunately now becoming much better known, are the so called “cyber-risks”. An attack that obtains confidential data, including due diligence reports, draft SPAs, and financial information, could create a financial loss not only to the AIF but also to third parties, such as companies that are in the middle of an M&A process, their owners, managers, creditors, employees, and authorities. The risk of infringing data protection laws could certainly arise from cyber attacks but could also be a consequence of an insufficient quality of the AIFs‘ IT systems and their protection mechanisms. It is sufficient to mention that laptop computers, containing very delicate data, have been lost in various occasions by sophisticated public officers.

Employees and other individuals with access to the systems may also decide to take data to then sell it or extort a ransom from the owners. In the same way, access to systems may allow the transfer of client funds to their accounts as has happened in many occasions. Such money is very seldom recovered once it has travelled through different bank accounts and many offshore jurisdictions.

Many types of documents, such as title, notary documents and other paper documents are often valuable or costly to reconstruct. Defamation, breach of copyrights and other similar claims may incur important legal costs. Professional mistakes, sometimes defined as errors and omissions, also occur and have important consequences for the managers and for the investors of the AIF. Directors and officers have liabilities that go far beyond what entrepreneurs are aware of; the simple act of employing people attracts exposure to Employment Practices Litigation (EPL).

---

\(^{12}\) On such regard, it is useful to recall that the non-exhaustive list of professional liability risks, provided for by article 12 of Delegated Regulation 231/2013, is drafted in broad and open terms, and there seem to be no obstacles in encompassing new types of risk, recognised in the financial arena, also taking into due consideration the evolution of the market (e.g. cyber-risks, as described below).
3.4. A specific focus on risks of Portfolio Companies

The companies that form part of the AIFs’ portfolio, particularly when the AIFs’ activity is focused on the Private Equity sector, tend to be larger and more established, and their risks reflect their size.

The consequences of insufficient insurance may often lead to losses, tangible or intangible, to the shareholder value and, as a consequence, to the investors of the AIF.

Very often AIFMs review every aspect of the acquisitions executed on behalf of their AIFs, including financial, legal, taxation, employment, and contractual, and then forget to give the same importance to the operational risks of the activity of the acquired company and the insurance arrangements required.

The potential risks cover the entire spectrum of perils, from earthquakes to terrorism and from reputation to contamination.

It is therefore fundamental to treat the review of risks and insurances as importantly as the financial, contractual, management and other aspects of the company in which the AIFs’ assets are invested.

3.5. Self-Insurance or “Real” Insurance?

As explained above, AIFMD offers AIFMs the option to make a choice between setting aside additional funds with a minimum of 0,1% of the value of the portfolio of the AIFs managed (consisting this in a form of “self-insurance”) OR to transfer the risks to insurance to cover a minimum of 0,7% of the value of said portfolios per any individual claim, increasing to a minimum of 0,9% in the aggregate per year.

It is fairly obvious that the alternative offered to AIFMs is between Insurance and Self-Insurance, the latter requiring additional funds added to the minimum capital and potentially causing a loss to the AIFMs.

The reason behind the different value given to the two options is unclear as it would seem much more logical to combine them, as also expressly provided by the AIFMD; if an AIFM purchases insurance for a reasonable amount (we shall come back to this) and

---

13 It is useful to recall that, according to the European Commission, “as coverage through professional indemnity insurance is by nature more uncertain than coverage provided through additional own funds, different percentages should apply to the two different instruments used for covering professional liability risk” (recital no. 35 - Delegated Regulation 231/2013).
uses the own funds provision to cover a reasonable excess in addition to the own funds to be provided in accordance with Article 9(1) and (3) of AIFMD, the result would appear beneficial both to investors and to the AIFMs.

Many AIFMs managing smaller portfolios certainly realise that insurance can be an important differentiating factor from their competitors; protecting investors with a €10m, wide-scope insurance policy and a €100k excess would be perceived better than a simple €300k (for a portfolio of €300m) additional own funds as self-insurance.

For the AIFMs managing larger portfolios, there certainly is the possibility of combining insurance with self-insurance; the AIFMD requires 0,1% additional own funds, so for a €3bn portfolio this would represent €3m own funds. If the €3m are used as excess to an insurance of €20m, the AIFMD is complied with and the investors are much better protected.

### 3.6. Self-Insurance vs. “Real” Insurance (Practical Examples)

In order to better understand the requirements, let us take a practical example considering the following scenarios:

1) AIF with a total value of the portfolio of €300m
2) AIF with a total value of the portfolio of €1bn
3) AIF with a total value of the portfolio of €6bn

In the following table it seems clear that the protection for investors in smaller AIFs is rather limited, both with the option of self-insurance (own funds) and with the option of professional indemnity insurance.

At the same time, one can see that for an AIF with a portfolio of €6bn it would appear to make sense, at first sight, to increase the own funds by 0,1% rather than buying insurance for over €50 million.

<table>
<thead>
<tr>
<th>Case 1</th>
<th>Case 2</th>
<th>Case 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of portfolio</td>
<td>€300,000,000</td>
<td>€1,000,000,000</td>
</tr>
<tr>
<td>Self-Insurance minimum limit</td>
<td>0,1%</td>
<td>0,1%</td>
</tr>
<tr>
<td>Equivalent amount of own funds</td>
<td>€300,000</td>
<td>€1,000,000</td>
</tr>
<tr>
<td>Insurance minimum limit</td>
<td>0,7%</td>
<td>0,7%</td>
</tr>
<tr>
<td>Equivalent amount of insurance</td>
<td>€2,100,000</td>
<td>€7,000,000</td>
</tr>
</tbody>
</table>
### Case 1 | Case 2 | Case 3
--- | --- | ---
Insurance annual minimum limit | 0,9% | 0,9% | 0,9%
Equivalent amount of insurance | 2.700.000 € | 9.000.000 € | 54.000.000 €

However, if one considers it carefully, it makes much more sense to use the 0,1% own capital option to comply with the rule and to transfer the risk to insurance to protect €20 million with an excess of €200k. In this way, the AIFM is protected by a substantial insurance, and this is carried out at a reasonable cost, thanks to the excess.

### 4. Conclusion

Having analysed the activity of AIFMs, the laws and Regulations that direct them and the risks that both AIFs investors and AIFMs face, we consider that the combination of own funds and transfer of risks to insurance is the solution most beneficial to all parties.

Insurers and insurance brokers must produce an attractive package for AIFMs to consider. AIFMs must in turn insist on a proper protection of their AIFs and their investors, via insurance and own funds: indeed, an appropriate coverage in such sense, also included in the information set pursuant to article 23.1 (e) of AIFMD, is certainly evaluated by potential investors as a relevant point to assess the professional reliability of the AIFMs, before the investment in its AIFs is finally carried out.