

Hedge Funds and Corporate Governance: Who is driving the car?

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In the field of investments, investor confidence is primordial, and is partly ensured by a balance between the regulatory agencies mandates to protect investors from abuse, reducing informational asymmetries, and market efficiency. In making investment decisions, investors should be able to have confidence in the board of directors of a given hedge fund, acting in the interests of the investor; but as it is well known, such is not always the case. The regulators, on their part, have made efforts in regulating the hedge fund industry, but have overlooked the fact that they already require every fund to have its own watchdogs, namely its directors.

To benefit from favorable tax treatment and less stringent regulatory environments, Hedge Funds are usually registered in offshore jurisdictions and are structured as offshore companies with limited liabilities (Ltd.), offshore limited partnerships (L.P) or offshore trust companies. The Companies or Securities Act of each of those jurisdictions usually codifies the duties and/or obligations of the Board of Directors, as well as the company's officers, which may include directors.. For example, the Bermuda law states that every officer, "in exercising his powers and discharging his duties, must act honestly and in good faith with a view to the best interests of the company and exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"ⁱ. In other words, the basic duty of directors is to oversee the affairs and activities of the company and to be diligent in representing the interest of shareholders. In practice, the board of directors is responsible for negotiating and overseeing contracts with each entity with whom it conducts business, for example service providers to the fund, and to monitor their performance in accordance with the terms or obligations of the contracts. Taxation, anti-money laundering, compliance related issues will also be in the scope of the directors' responsibilities.

All those statements look quite compelling; investing in a hedge fund should only be a matter of selecting a good manager as all operational issues are taken care of by the board of directors. Unfortunately, investors in hedge funds are well aware that the average oversight exerted by

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directors is far from the above definition. However, directors are not the only culprits. Indeed, other persons may not fulfill their duties, such as:

- Regulators who do not enforce the requirements of their own law;
- Investment managers that are not committed to strong corporate governance;
- Directors who often see their role as fee-collectors, instead of officers having duties and obligations to its investors and regulatory agencies;
- Investors that do not exercise their rights to have a competent board of directors overseeing their investment
- Service providers that often wrongly perceive the investment manager as their client.

In most cases, the creation of the fund investment vehicle is initiated by an investment manager that seeks to raise capital from investors and manage assets according to his proprietary investment strategy. The investment manager is helped in the structuring process by legal advisors that will advise him in the choice of the jurisdiction and draft the initial offering documents to allow an optimal and “unconstrained” execution of the manager’s strategy. According to the Bermuda Monetary Authority, once a company has been incorporated the signatories to the memorandum, normally nominees resident in Bermuda, are the provisional directors of the company who act as such until the first members of the board of directors are elected. At the first annual general meeting, the shareholders will confirm the bylaws, elect the first members of the board of directors and appoint auditors. At that stage, depending on the share structure of the company, the voting rights can be held by either:

- the fund’s trustee in the case of a trust;
- the founder in the case of a structure with Founding shares; or
- the seed investors.

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Practically, the investment manager will usually be the only decision maker and will therefore be free to decide on the composition of the board of directors. A manager that seeks to build strong corporate governance will most likely hire directors based on certain criterion such as their independence, experience, qualifications, etc. In reality, most of the funds' board of directors are composed of manager's friends, employees of the service providers, seasoned professionals in various fields and sometime the directors will sit on the board of both the fund and the investment manager.

Directors can be categorized as: executive or non-executive and "interested" or "independent". Interested directors are employees of the fund's investment manager and should be considered as conflicted. Independent directors do not have any significant relationship with the fund's managers but shouldn't have any relationship with the fund's service providers so as to avoid any potential conflicts of interest. Other conflicts of interest can arise when a director is sitting on the board of two funds with different investment managers but substantially the same investment strategy or when a director sits on a number of other funds promoted by the same manager (and derive substantial income from this relationship with the manager). Executive directors are full-time employees involved in the day-to-day management of the company. Non-executive directors have a part-time and intermittent involvement with the company. It is, however, worth noting that non-executive directors have the same legal duties, responsibilities and potential liabilities as their executive counterparts.

According to the Statement of Guidance issued by the Cayman Islands Monetary Authority (CIMA) on corporate governance, the board of directors should be composed of a balance of appropriately skilled, experienced and qualified individuals who can make informed and independent judgments regarding the governance of the licensed entity. The qualifications required should include legal, investment, risk and company management, accounting, compliance, etc.

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Regulators and practitioners have defined several guidelines to what we should expect from directors. According to CIMAⁱⁱ, in relation to the risk management aspect, the board of directors should have in place systems to monitor independent risk functions and report deviations to an appropriate level of management. The board should also have adequate procedures to promote customer awareness of products and services and have in place a clear complaints procedure that is appropriately communicated to their clients. CIMA also stresses that the board should have in place an appropriate compliance committee or person that reports directly and regularly to the board on all compliance matters. Price Waterhouse Coppers (PWC) has provided several recommendations on the types of monitoring that should be exerted by the board of directorsⁱⁱⁱ. These recommendations include:

- Independent directors should meet with service providers a least once a year;
- Directors should check if service providers have SAS 70 reports;
- Directors should independently review the manager's risk management system and check that it is relevant to the chosen investment strategy; and
- Directors should also review the operations of the fund manager himself

The salary of the board members is a good indication of what should be expected from the directors. A standard level of remuneration for directors is approximately 3'500 (USD) per day (i.e. 7hrs at an hourly rate of 500/hr), which is not an exaggerated hourly salary for some of the high caliber members of certain boards. The director in that case will devote less than two hours every quarter to his task. This level of remuneration express the fact that the investment manager is not expecting a significant contribution from the director and its acceptance by the directors is also a recognition that he will not have to devote to much time and mind to the job. Directors' remuneration is usually disclosed in the fund's offering memorandum or can be found in the annual financial reports. Investors should devote great attention to the content of these reports.

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A prudent director should conduct a thorough due diligence of the fund before accepting to sit on its board. He should also ensure that the investment manager provides him access to all pertinent information, in a timely manner, on which he can make decisions so as to accomplish his duties and/or obligations set forth by the law of the jurisdiction in question.

At the fund's establishment, directors should be provided with the full set of the fund's constitutional documents including its offering memorandum, its memorandum and articles of association, and all agreements with the service providers. Once the fund is up and running the director must receive regular reports, particularly from the investment manager, the administrator and the prime broker. The directors must receive immediate notification from the investment manager and administrator should there be any breach of investment restrictions or issues related to the valuation of assets held by the fund. The next step for the directors is to analyze all this information at his disposal, such requiring time and the adequate tools to perform the necessary verifications. If the directors cannot devote enough time to the performance of those tasks they should be supported by perhaps another service provider that will report independently to them.

In the recent fraud case involving the PAAM fund, account statements were directly sent from the prime broker to the directors of the fund. However, the directors were forwarding this communication unopened to the investment manager. Should have they taken their role seriously, the directors could have saved several million dollar of loss from their clients, the fund's shareholders.

Directors should acknowledge that while they will outsource part of their duties to third parties the responsibilities remain those of the board. Directors should therefore not only monitor very closely not only the investment manager, but also all the other service providers, and ensure that those entities recognize the fund and not the investment manager as their client.

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The situation can thus be summarized as follow:

- In most cases, Directors are chosen exclusively by the investment manager who is a service provider to the fund. This consists of a first conflict of interest.
- Directors are often conflicted because of their past relationship with the investment manager, professionally or privately, or because of their other engagements. This consists of a second potential conflict of interest.
- Directors are sometimes under-remunerated and are therefore not very committed to it; and
- Directors don't have often the tools and/or experience to properly perform their oversight on the fund.

Investors in hedge funds seem to take this situation for granted and have to rely on their own due diligence to decide whether or not they will invest in the fund. However, investors don't have the same access to information as the directors do, and can therefore only obtain a partial view of the situation. Regulators have set-up a system to guarantee a satisfactory level of corporate governance at the hedge fund level but as of yet, no one seems to care and investment managers and directors are consequently benefiting of this situation at the expense of their shareholders. The cost of due diligence for investors is not trivial and usually require a lot of travelling and a dedicated in-house staff to perform the job. Why should investors bear the cost of due diligence, especially when it should be done by the directors?

Shareholders of an offshore fund (assuming that they have voting rights) have the right to ask for a change in the composition of the board. The difficulty in the enforcement of this right is primarily due to the size of each individual investor that usually cannot propose such a change on his own. However, large investors, detaining a high volume of shares, can and should get this extra level of confidence by placing one of their representatives on the board of the fund. Alternatively, a softer approach would be for shareholders to ensure that the directors are remunerated according to the job that has to be done and that they have the necessary tools and support in place to accomplish

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those tasks properly. Any extra costs could be spread among all the shareholders, and would have no significant impact on the fund performance.

ⁱ Bermuda Monetary Authority, Exempted Companies, “Procedure for the incorporation of companies in Bermuda”

ⁱⁱ Cayman Islands Monetary Authority, Statement of Guidance, Corporate Governance

ⁱⁱⁱ Asian Investor, July 2005, « Building a sound hedge fund operation »

About Hedge Fund Appraisal:

Hedge Fund Appraisal proposes high quality research services to investors in the hedge fund space. The range of services includes in-depth due diligence on hedge fund managers, as well as ah-hoc research on specific investment strategies. For more details, you can consult our website at www.hedgefundappraisal.com.

About the author:

Gabriel Kurland is the founder of Hedge Fund Appraisal. Mr. Kurland started his career in the hedge fund industry as a manager in the Hedge Fund Administration department of HSBC Republic in Geneva. In August 2002, he joined Anglo Irish Bank (Suisse), a Geneva based private bank with a strong hedge fund culture, as an analyst in the fund selection department and subsequently became the co-manager of the bank’s internal fund of hedge funds.

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