HEDGE FUNDS REVIEW

Investor and regulatory pressures continue to force change in hedge fund corporate governance

Divergent views for tricky problem

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Institutional investors and regulators are agitating for stronger of hedge fund corporate governance, with majority independent boards with the expertise and time to oversee activities.

Good corporate governance and running a hedge fund used to be considered polar opposites, but times change. Following 2008 the industry has undergone a transformation and now the topic is widely discussed as investors and regulators push for transparency and accountability.

Pinning down just what people mean by better corporate governance of the hedge fund industry is tricky.

The first Code of Best Practice on corporate governance was produced in 1992 by the Committee on the Financial Aspects of Corporate Governance, known as the Cadbury Committee. Its report fits into the Anglo-American corporate tradition of favouring checks and balances compared with more implicit regulation. Its recommendations were widely welcomed, although there was doubt as to how effective the provisions would prove when companies were under no obligation to enforce them.

Carne Global Financial Services, a provider of independent directors to hedge funds among other services, defines it as “the system by which hedge funds are directed and controlled. The directors are responsible for governance and their responsibilities include supervising the management of funds and reporting to investors. The directors’ actions are subject to applicable laws and regulations and they must act in the best interests of investors.”

Whatever definition is used, corporate governance has a lot to do with the attitude of those running a company.

The origins of the hedge fund industry in the US led to a divergence of views on the subject. While most European management companies followed the UK practice with the majority having independent boards, US managers have only gradually moved towards this model with an acceleration spurred by investor preferences following 2008.

Despite the fact opinion now favours a majority of independent directors, there is still much debate about who should actually sit on boards. Opinion is divided over the different models for providing directors, the composition of boards and if regulation should dictate the answers to these and other questions of corporate governance.

Each party in the debate has a different agenda making it hard to identify a single model as the most favoured. As has happened in the past, most believe investors will have the final word on the matter. As institutional money into hedge funds increases, so will the pressure for the funds to follow the corporate governance guidelines set by investors.

As Cayman is still home to more hedge funds than any other domicile and also home of the largest network of director service providers, many have looked to the jurisdiction to lead the way in finding a resolution to the questions surrounding board composition and competence.

However, some question exactly what is wrong with current corporate governance standards in hedge funds. “To a certain extent the arguments regarding the failures of fund governance are overblown,” says Josh Dambacher, partner at law firm Schulte Roth & Zabel.

“Although 2008 and 2009 were a tough period for funds, by and large many of the fund directors criticised for having too many directorships did a pretty good job precisely because they had experience on the boards of a broad array of funds. In the overwhelming majority of cases where funds were under pressure, the directors stepped up and made decisions that were in the best interest of the fund and its investors,” adds Dambacher.

Protective instincts

Others say the majority of directors take their role seriously. The cases of a director failing to protect investor interests have been few. Perhaps the case highlighting the problems most publicly was the Weavering case. The Grand Court of the Cayman Islands found the directors of the liquidated Cayman-domiciled Weavering Macro Fixed Income Fund guilty of wilful default in the discharge of their duties after an investigation (later abandoned by the UK's Serious Fraud Office) into allegations of fraud against Weavering Capital, the UK manager of the fund. The directors in this case were the brother and stepfather of Weavering Capital's chief executive and managing director Magnus Peterson.

The English High Court judgement in the case against the directors of the UK investment managers, including the wife of Peterson, rejected the argument that she could rely on the control and oversight of other professionals such as the auditor and administrator to raise concerns about the swap transactions, which were the root of the fraud accusations. There were no independent directors on the board.

Other cases making their way through the system could also have an impact on corporate governance. One is a case in New York against Walkers Fund Services (WFS) in relation to the failed Bear Stearns Structured Credit Fund. The liquidators are suing two directors from WFS for failing to spot that the Bear Stearns fund was buying toxic assets from its parent company, generally seen as what caused the fund to fail.

A case which has received less attention is that of AIM Global Fund, a unit trust set up by Japanese AIJ Investment Advisers. The trustee was HSBC. "It will be an interesting counterpoint to the role of directors in corporate funds, especially in the context of the debate about so-called 'jumbo directors' and the director services model," says Jeremy Walton, partner in the Cayman practice group and head of litigation and insolvency at Appleby.

"One argument often made concerns the importance of having individuals on boards, which is slightly undermined when you look at unit trusts where your trustee is a faceless entity (and often a 'brand name' bank). Some people have been wondering if corporate governance in hedge funds should move closer to or further away from the unit trust model so whatever happens in the AIM case is liable to have an impact on that debate," Walton concludes.

Investors complain they have difficulty getting information about the composition of the board, relationships between the directors and the investment manager, details of board meetings as well as the number of directorships held by an individual. This lack of information affects their perceptions of what is happening within the fund.

"Perceptions can be a stumbling block," says Ingrid Pierce, partner and head of the Cayman Islands investment funds group at law firm Walkers. Greater transparency is one way to counteract this, she believes.

As a show of its commitment to this concept, Walkers sold its director services along with the rest of Walkers Management Services to Intertrust earlier this year. The reason for the sale was that some of its clients perceived a conflict of interest in a law firm providing directors to the hedge funds and managers, to which it sometimes also provided legal advice, despite the fact there were strict separation of the businesses.

"There has been a push for a true independence," says Pierce. "While it has worked extremely well in the past to have directors to a fund provided by an affiliate to a law firm – and that will continue for a while – some clients are resistant to that model. They wanted a provider of fiduciary services which is independent from the law firm so that the directors are independent not just of the investment manager but independent of any service provider." This is part of a shift as investors take more interest in board composition.

Raising standards

The solution to many of the concerns around corporate governance appears to be simply more disclosure and transparency. As usual, definitions of what transparency constitutes in the case of directorships is a debatable point. Some providers go public about the number of 'relationships' they have with hedge funds while others flatly refuse to give any numbers (at least publicly).

Investors such as fund of hedge funds Hermes BPK and pension fund Universities Superannuation Scheme (USS) in the UK have written to regulators expressing concerns about standards of corporate governance.

The Hedge Fund Standards Board (HFSB) has been trying to find agreement on industry standards. In its last update of the HFSB code placed more emphasis on the importance of directors.

Vincent Vandenbroucke, a partner and head of operational due diligence at Hermes BPK, says his organisation has been pushing for change for some time but only recently has gained support.

One area Hermes thinks is lacking in boards is investment expertise. "Most of the boards have proper expertise in terms of legal, tax, accounting, finance and compliance," he says.

"Where they potentially lack a bit of expertise is on the investment side and yet we are asking directors to review the activities of an investment manager. One of the questions we ask directors is how they ensure that the liquidity of the underlying positions matches that offered to the investors. This is on the face of it a simple question but it is one which gives us a great insight into whether directors are fulfilling one of their fiduciary duties, particularly in the light of the liquidity crisis of 2008."

Prior to 2008 the majority of investors rarely considered the composition of boards or the credentials of individual members. Checks on board members are now part of standard due diligence questionnaires. Close attention is given to just how many directorships individuals hold as well as competence and expertise.

When doing due diligence on a fund, Hermes will ask the directors to fill in a detailed questionnaire designed to make them think about their role.

Regulators are also under pressure to prevent frauds and misbehaviour, including insider trading. The result has been more emphasis on corporate governance with, for example, the UK's Financial Services Authority taking a closer interest in the board structures of hedge funds.

"[Regulators] have been feeling significant heat from the investor population saying 'you need to do a better job to prevent fraud and protect investors' and that is having a knock-on effect," says Appleby's Walton. He also thinks competition between jurisdictions is driving standards of corporate governance, particularly with less popular domiciles emphasising best practice and high standards.

The Dodd-Frank Act has gone some way to transforming corporate governance in US investment managers. "Certainly the Dodd-Frank change to bring more managers into the regulatory net focuses the attention of those managers onto their compliance programmes and the requirements of the SEC [Securities and Exchange Commission] regime," says Carne's Ackerley.

"That makes them think more pointedly about the policies and procedures around the funds, not just their own management shop and it allows them to connect the dots in terms of corporate governance and why it is a good thing," he adds.

The Cayman Islands Monetary Authority (Cima) is also expected to announce its planned reforms concerning directorships soon. It has been conducting an in-depth review of its regulatory framework for corporate governance and previously announced that it will be making changes this year.

Elsewhere there are other pressures on the industry to change how it is structured. While most Cayman funds are structured as companies and therefore have boards of directors, the limited partnership structure used mainly by onshore US hedge funds does not have a board. Decisions about the fund are made by the general partner, which is the investment manager.

With pressure on improving corporate governance largely coming from European investors that are invested in Cayman company structures this may change.

"You are seeing advisory boards being formed to mimic as closely as possible Cayman company boards of directors," says Appleby's Walton. There are changes being made to the Cayman Islands Exempted Partnership Law to allow advisory boards to be formed without changing the tax efficiency of the structure and without exposing board members to the unlimited liability of general partners, he explains.

Whatever shapes directorships in future, the industry is likely to embrace change. "One of the things we have noticed over the past four years is if you are making sensible, credible suggestions that the manager believes will improve the robustness of the institutional offering, they tend to take it more seriously," says Pawel Kisielewski, a partner at Hermes BPK.

Both directors and the management companies they serve have generally seen the benefits of strengthening corporate governance. Although performance is still top of the list, funds that fail to come into line with investor expectations on corporate governance are unlikely to raise assets in the future, no matter how good their track record.

Modelling for independence

Several models for providing directors for hedge funds have emerged. One of the oldest – a largely dying practice – is to have the fund administrator as a board member.

However, fund administrator Apex Fund Services has a different view. Although many in this service area no longer provide directors for hedge fund boards, group managing director Peter Hughes provides both administration services and directors to hedge funds. He argues it is beneficial to the industry.

"I feel quite strongly that if an administrator has a position on the board, they are able to look after the investors better. They can make sure no bank account is set up that they are not aware of, make sure they are fully aware of all the broker accounts the fund manager sets up. That helps control the operations for the fund and is therefore beneficial to the shareholders," says Hughes.

Apex aims to have a director on the board of every fund for which it provides administration services. The company's insurers prefer this, Hughes says. He does not perceive this as a conflict of interest as long as he discloses the association and the ramifications of this are understood by the other board members.

While some may cling to old practices, the shift to institutional investors will dictate board composition much more in future. Institutional investors want a majority of independent directors on boards. Anecdotal evidence suggests since the 2008 financial crisis the vast majority of new fund launches domiciled in Cayman now have majority independent board members.

Besides the model of directors being offered by administrators and law firms, there are two other models widely used in Cayman. There are individual directors, who sometimes form small groups and larger director services providers.

These vary in size but the largest is DMS, which has gained much attention (not all of it good) for the way it provides director services. It operates a slick operation where directors are assisted by a host of administration staff, IT and other support systems. DMS, along with other of the larger providers, has been criticised for the number of directorships individuals at the company hold. Criticism is hard to judge as the number of directorships held by individuals is not made public by any provider, large or small.

The idea of imposing hard and fast limits for the number of directorships an individual can hold has been floated as one way to deal with the problem. Ireland considered adopting this approach but later dropped it as unworkable. No one, even those critical of the mass directorship models, believes imposing random limits is a solution.

One reason is the difficulty in trying to put a number on what is the maximum number of directorships any one person can hold. Not only is each directorship different, requiring different time commitments, no-one is sure how to count sub-funds. Trying to determine how many hours a director needs for basic duties is also fraught with exceptions and problems.

“I have a structured credit and mortgages background, so I tend to sit on boards of funds that invest in fixed income products,” explains Richard Ruffer, head of business development at Intertrust in Cayman. “Some of those are start-up managers and they are extremely time consuming. With one of my clients I don’t think a day goes by that I do not talk to him.”

However, that is not necessarily the norm. “I also sit on some very large institutional funds and a funds platform for a global bank. They have an army of people and detailed processes and procedures. It’s not often that issues come up and when they do, they are presented to me with detailed analysis,” Ruffer adds.

Despite the difficulty in agreeing a maximum number, some providers have decided to impose their own limits. Carne Global Financial Services has a company-wide cap of 30 manager relationships. It counts every different investment manager it provides services for as a different manager relationship.

“That is a headline number. We felt we needed to draw a line in the sand and say this is the most that we think somebody should be dealing with,” says John Ackerley, a director at Carne in Cayman. “However at this point in time nobody within the Carne group globally has 30 relationships and that is not through lack of opportunity, it is the greater risk approach we take to our portfolios and the time demands on us from those portfolios.”

Although Ackerley says Carne is in favour of keeping volumes of directorships low, he agrees an industry-wide limit would not be helpful because of the variation of workloads each director position presents.

While some investors are comfortable with the large director service providers, Scott Lennon, who set up 19 Degrees North Fund Services in December 2011, says he has noticed a shift in attitude. End investors want to know the name of board members and are less concerned which company they are from, he says. Funds are also creating more diversity among directors by sourcing people from different providers.

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