

## **Hedge Funds Governance Series**

### **Part 1 - Overview**

#### **Introduction**

This will be the first in a series of four articles that will discuss the governance of hedge funds, based on the current economic and financial environment. It has become clear that the investors are beginning to require improved controls and governance for hedge funds and this need will need to be met by investment advisors.

Recent research has shown that 91% of all investors have indicated that they would not consider investing in hedge funds that did not meet their required governance standards. Furthermore, 80% of all investors have indicated that governance is one of their most important issues, with 76% of investors indicating that they had previously turned down an offer to invest in a fund due to concerns over governance. This data has been substantiated by further research carried out by Ernst & Young (i). Legal rulings, for example Weaving (ii) also highlight the fact that investment advisors that offer funds that have inadequate governance could find themselves in a serious legal situation.

Overall, governance is now one of the main concerns for investors, and makes up a significant part of and due diligence study when considering new investments. This raises the question, what is sufficient governance, and how can good governance be attained?

#### **Towards Good Governance**

This first article in our series on hedge funds will attempt to give an overview of hedge fund governance, and introduce the most important aspects of good governance. We will expend upon each of these aspects in further articles. By the end of the series, we will have defined good governance fully, and demonstrated tangible solutions on how to achieve good governance.

Before we continue, it should be pointed out that good governance does not mean meeting a set of minimum standards. Good governance means deploying a solid infrastructure that is reviewed and maintained regularly, with a view to providing excellence. Once deployed, this infrastructure will need to meet the demands of investors, and be capable of passing due diligence. This governance infrastructure will also need to interface with the existing business

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processes used for managing all other aspects of the hedge fund. This series of articles will help to educate readers, and assist them in achieving high standards of governance.

### **Good Governance Defined**

We will begin by discussing what hedge fund governance is. Hedge fund governance is a term used to encompass all of the systems and business processes that directly affect how the fund is controlled and managed. Ultimately, it is the fund directors that carry the responsibility for governance, and they have a responsibility to manage the fund, as well as reporting directly to investors. Directors are legally bound to act in the best interests of investors.

The operation and administration of the fund is usually delegated to third parties, including the auditor, broker, administrator and investment advisor. For this reason, the fund directors act in the capacity of an oversight committee, managing and monitoring the activities undertaken by all parties involved with the operation of the hedge fund. This is a tangible commitment, and requires the fund directors to take an active role in fund management.

We should point out that fund directors are actually members of the board of the investment fund, and not members of the board of the company acting as an investment advisor. Each of the directors has a real obligation to the fund investors. It is important to understand that individual directors are seen to be individuals that have no commercial connection with the investment advisor, or any of the third party service providers that make up the overall administration and management infrastructure. Additionally, directors will almost always have a work history that includes roles such as fund administration, financial law or investment management.

A robust governance policy will encompass the full range of fund related business processes, and will be the major tool for assuring investors that the fund is being managed in a professional and responsible way, and that best effort is being made to minimize risk exposure due to bad management.

Future articles in this series will cover the following topics:

### **Fund Directors**

The key to ensuring that the role of directors is covered sufficiently is finding the right people to populate the fund's board. Investors and investment advisors need to define what they require from directors.

### **Effective Board Meetings**

Setting the frequency of board meetings, deciding who needs to attend, developing the contents of the board pack and choosing agenda items are all important considerations.

### **Solving Conflicts of Interest**

Conflicts of interest can and do arise from time to time, and are a major issue for investors. The investment advisor needs to be educated on the types of conflicts of interest that can arise, and be equipped to resolve them quickly and efficiently. We will give examples of the types of conflicts that are most common, and define a set of processes for dealing with conflicts of interest.

### **Fund Operation**

A definition and explanation of all the systems and processes that make up the activities of operating the fund. This includes accounting, over fund payment control and management of cross trades. We will also discuss the required operational policy and associated documentation.

### **Reporting to Investors**

A definition of best practices for communicating with investors. We will cover the proper auditing of financial statements, and how to prepare industry standard investment updates.

### **Valuation Policy**

Many investors now consider it compulsory that fund management includes a well-defined policy for valuation. We will take a look at the director's discretion to value, and discuss the proper wording of the fund's offering memorandum.

### **Monitoring Risk**

Risk management is a pivotal factor of hedge fund governance; with the fund directors playing a vital role in making sure that the full spectrum of governance policies are followed. This includes policies covering aspects such as compliance, pricing, liquidity and credit risk.

### **Confidentiality**

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Fund directors have a legal obligation to operate some form of privacy policy, with regards to the disclosure of sensitive documents such as meeting minutes, letters and other key documents.

- (i) Coming of Age: Annual Hedge Fund Survey 2011 (Greenwich Associates/Ernst & Young)
- (ii) Weaving Macro Fixed Income Fund Limited (in liquidation) vs. Stefan Peterson and Hans Ekstrom.

### **Part 2 - Directors**

#### **Introduction**

This is the second part of our four part series of articles that discuss hedge fund governance. In this article we will be take a look at the responsibilities and functions of hedge fund directors.

Independent research has demonstrated that some 87% of all hedge fund investors would prefer that the hedge fund's board be made up of independent directors. This presents a significant challenge to most hedge funds, as it can be somewhat difficult to define just what is expected of independent directors, both individually, and acting as a non-executive governing body.

#### **The Role and Responsibilities of Directors**

The core responsibilities of directors is commonly defined by a combination of legal requirements both statutory and regulatory, as well as the policies already in place to govern the hedge fun itself. Commercial and common law are often used as the basis for drafting the key responsibilities of hedge fund directors.

These fiduciary duties can include:

- Directors must have the freedom to exercise their influence completely independently, keeping the best interests of the fund in mind at all times.
- Directors must only exercise their powers in the best interest of the fund, and solely for the purpose that the powers were originally granted.
- Directors must not misuse or misappropriate company assets.
- Directors will strive to never create any form of conflict between their own personal interests, and the best interests of the fund.
- Directors should not be constrained in exercising their discretion when it comes to ensure that the fund is governed well.

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Director's obligation of due care:

- Directors are obligated to stay abreast of all issues affecting the fund.
- Directors are obligated to ensure that they receive and act upon relevant information regarding the operating of the fund, to enable them to undertake their duties effectively.
- Directors will never act in any way that could be construed to conflict with the best interests of the fund.

### **Director Independence and Acting Independently**

Investors will usually expect a high percentage of hedge fund directors to be fully independent. Directors that are not independent are more prone to coming into conflict with the best interest of the funds.

An independent director can be defined as an individual who has no personal, economic, financial or commercial ties with any parties involved in the operation of the fund, and this include third party service providers, investors and the investment advisor.

As the name implies, independent directors must have the freedom to work independently, and are required to utilize their skills, knowledge and experience towards the best interests of the fund. Independent directors are able to rely upon other directors in the discharge of their duties, but must also act proactively in their own right.

### **Required Skills and Experience**

Independent research has shown that over 70% of investors fully expect for a senior stakeholder from the investment advisor to take a place on the board. This is somewhat contrary to the usual requirement of directors to be independent. However, this director acts as a liaison between the board and the investment advisor, providing critical information, data, and information about the current operation of the fund.

It is understood that individual directors may well not be experts in every aspect of hedge fund management and operation. Best practice states that it is preferable to select a range of independent directors with skillsets that complement each other.

The minimum number of independent board members should be three, excluding the director connected with the investment advisor. A skill spread including accountancy, auditing,

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administration, regulation and law are preferable. Breadth of experience should be considerable, and each director should display a level of expertise in their specific skillset.

### **Commitment**

Each independent director will need to make sure that they can allocated enough time and resources to discharge their responsibilities in an effective manner, and with due diligence and the best interests of the fund in mind at all time. When selecting independent directors it is important to take commitment into consideration, and ensure that each appointed director is capable of fulfilling their role.

Each year has approximately 230 actual working days (excluding weekends, public holidays and holiday leave). Depending upon the frequency of bard meetings, there will only be a limited number of time slots a director can fulfill. When constructing a hedge fund board, this often limited availability of directors should be taken into consideration.

### **Non-Executive Function**

Independent hedge fund directors are expected to work in a non-executive capacity. This simply implies that they are not involved in the administration and operation of the fund in a day to day capacity. However, they are expected to keep themselves informed of operational activities, and make sure that they have a set of processes in place to perform their role as management overseers.

Directors are fully responsible for monitoring the performance of third party service providers that are working under contractual obligation. This entails ensuring that all parties are working within compliance boundaries outlined in their contract, and within other fund documentation including the offering memorandum and other key documentation.

## **Part 3 - Board Meetings**

### **Introduction**

This is the third article in the series that covers the subject of hedge fund governance. In this article we will take a look at the reason for regular board meetings, and propose a recommended set of best practices to facilitate these meetings.

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Fund directors are expected to act as overseers for fund management, and ensuring that all parties, including external service providers are acting within the fund's defined governance policy. Regular board meetings are vital in ensuring that issues are addressed by the board.

### **Meeting Frequency and Attendance**

Although regular board meetings are crucial to the management of a hedge fund, the frequency of board meetings will often differ between funds. However, it is vital to set up a schedule of a minimum number of meetings per year. Most investors expect the board to meet at least four times a year, with some investors only requiring two meetings per year.

Logistically, the organizing of hedge fund board meetings can be problematic. It is likely that individual directors will reside in different countries, often widely apart. This problem can be negated somewhat by exploiting technology, such as conference calling, to host the meeting. If some form of conference calling (audio or video) is used to host the majority of board meetings, it is advisable that directors meet face to face at least once a year.

This is a crucial element of selecting hedge fund directors, the selection of a director should take in to consideration the individual's ability to attend regular board meetings.

### **The Meeting Secretary and Convening of the Board Meetings**

A meeting secretary should be appointed, who will be responsible for organizing the regular board meetings, and also distributing all documentation pertaining to these meetings. Depending upon the region that the hedge fund is incorporated in, there may be no legal requirement to appoint a company secretary. However, best practice would dictate that a company secretary is appointed, or an outside service provider contracted to provide the same service. This will include organizing board meetings, taking minutes and dealing with other ad-hoc issues as required.

### **Providing Notice and Board Meeting Agenda**

The company secretary should distribute a draft notice of any upcoming board meetings. This draft notice should include a proposed agenda, as well as any supporting documentation. Delivering this draft notice early will give each attendee the ability to add agenda items, and propose changes to the meeting structure. Once a response has been received from each director, and the meeting agenda has been finalized, it should be distributed to each attendee, along with a board pack.

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### **Issuing a Board Pack**

The meeting secretary will need to send a board pack to each attendee well in advance of the scheduled meeting. The board pack will contain all of the pertinent documentations that will be required for the forthcoming meeting. A typical board pack will contain the following:

- The agenda
- Minutes of previous meetings
- Administrators report
- Audited financial statements (if required)
- Auditors letter of representation (if required)
- Any other documents

### **The Appointment of a Chairman**

One of the attending directors can be selected as the chairman prior to the meeting. However, it is more normal for the chairman to be selected when the meeting is convened. The chairman is responsible for making sure that the meeting is conducted in an efficient manner, and that all agenda items are covered. It should be noted that the chairman does not usually have an extra vote, to help resolve deadlock issues. This is the major reason why it is preferable to have a board made up of an uneven number of directors.

### **Required Attendees**

The company secretaries, and all directors, are required to attend every board meeting. Additional attendees may be invited by the directors, to provide expert insight and opinion. These additional attendees will most usually be representatives of any third party service providers, the administration team and the investment advisor, and where financial documents need to be signed and approved, the fund auditor.

All board meetings should be treated as strictly confidential, and for this reason it may be best to only invite outside parties for the period of time that their expertise is required or relevant. As an example, the fund auditor would only need to be present during the discussion, approval and signing of financial statements, and not be privy to other agenda items.

### **Keeping of Minutes and Matters Arising**

The company secretary will be responsible for documenting the meeting commentary, the business conducted and the decisions arrived at. Decisions that are made as a meeting

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resolution are legally binding, and therefore it is vital that they are recorded accurately. During the meeting, discussion will almost always raise a number of action points, and the company secretary is responsible for document these action points, these will often be included in the appendix to the minutes, as a list of matters arising. This appendix should clearly list all matters arising, and their current status, either open (requiring action) or closed.

### **Keeping Written Resolutions**

Formal resolutions that the directors implement should be documented and tracked outside of the board meeting. These resolutions will usually be in matters that the directors have direct authority to influence, such as exercising their right to waive certain restrictions, like periods of notice and subscription levels. An efficient method for the company secretary to monitor and track these resolutions is to keep a written record of each resolution, along with any supporting documentation, which can be distributed to each director for sign off. These written resolutions are legally binding, in the same way the meeting resolutions are, but are not deemed to be in effect until signed off by each director.

### **The Articles of Association**

The hedge fund will operate within the scope of its articles of association that will define the boundaries and limits of the power of the board of directors, and their key duties. Any resolution presented should always be considered, agreed upon and implemented in accordance with the articles of association.

## **Part 4 - Conflicts of Interest**

### **Introduction**

This is the fourth article in a series that discusses the key aspects of hedge fund governance. This article will cover conflicts of interest, present some key examples, and discuss resolution options.

There are usually a number of different parties involved in the administration and operation of a hedge fund. Each of these parties will have a set of duties and responsibilities that defines their role. However, each of these parties will most usually also have their own commercial interests outside of the duties they are expected to disburse on behalf of the fund. This situation means that conflicts of interest will regularly emerge, throughout the entire lifecycle of the hedge fund.

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We can define a conflict of interest as being any time that an involved party is found to be in a situation that could possibly affected their impartiality and judgment in matters pertaining to the operation of the hedge fund. This conflict of interest will have the probability of influencing the actions of the affected party, with regards to their disbursement of duties towards the hedge fund.

A definitive list of reasons/causes for conflicts of interest to arise is impossible to define. However, in most cases, it is deemed sufficient that a set of processes and practices are in place to ensure that all conflicts of interest are identified and addressed in a diligent fashion.

Below are listed some (by no means all) of the reasons or causes for a conflict of interest to arise.

### **Examples of Conflicts of Interest**

- *Multiple Fund Trades:* If the manager of a fund is operating more than one investment portfolio, they may place a buy or a sell order with a broker, before allocating the stock across different portfolios. A risk is exposed whereby this allocation could provide and unfair advantage to one of these portfolios.
- *Cross Trades:* A conflict of interest can arise when a fund manager instigates a buy or sell trade across multiple funds under their management. Due to the fund manager managing multiple funds, each of which should be treated equally with regard to buy and sell price, a conflict of interest may arise.
- *Incentive Fees:* If the fund is set up to pay the investment advisor some form of performance related bonus or fee, then the investment advisor may seek to boost the performance of a fund artificially, to secure higher levels of remuneration. This could expose the fund to unnecessary financial risk. An oversight committee should monitor the fund's portfolio and ensure that it is being operated within acceptable risk boundaries, and in line with the fund's constitutive documents.
- *Director's Interests and Remuneration:* Commercial and financial interests of the board of directors should be declared with a view to highlighting any potential cause for conflict of interest. Any other directorships should be considered, especially those that see the director sitting on the board of multiple funds. Most usually a director or their company will receive a fee from each hedge fund, and a large percentage of the director's income may be derived from these fees, indeed, they may be entirely

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financially dependent upon them. The fee is usually dictated by the fund sponsors, and it is important that directors are loyal to the fund, and not to the sponsors who are responsible for setting their level of remuneration.

- *Favorable Dealing:* Hedge fund directors are often provided with a level of discretion when dealing with operational situations such as minimum subscriptions, notice periods and redemptions. Directors will be required to approach each case for consideration in its individual merits only. Care needs to be taken to ensure that the fund portfolio is maintained, and that its value does not become diluted due to directors exercising this discretion.
- *Soft Commissions/Dollars:* The investment advisor will often place trades with a particular broker, and in return may receive research data, or access to trading platforms in return. Whilst this is not a reason for conflict of interest per se, there have been multiple instances in the past where this arrangement has led to inappropriate trading, sometimes illegal. This type of trading relationship is regulated in the U.S.A and the UK to ensure this kind of conflict of interest cannot arise.
- *Side Letter:* It is normal for a hedge fund to initiate side letters with certain investors, that will give them certain privileges or rights that other investors do not have. These benefits can include such things as better commercial terms, a higher level of liquidity or enhanced reporting. Investors who are offered this kind of side letter will then in return, invest significantly higher levels of capital resulting in increased management fees for the investment advisor. It is important to monitor such side letters, and ensure that other investors are not unfairly impacted by these trading arrangements, and that they terms of the side letter are strictly adhered to.
- *Manager Marks:* The administrator of a hedge fund is usually responsible for obtaining the current market prices of the fund's portfolio, in order to calculate its current net value. Third party administrators will often provide an additional service, whereby they will employ a team of experts to calculate the value of hard to price securities, or they may offer a similar service by outsourcing the task to another party. When no such service is available, the investment advisor will often provide the evaluation. Any such valuation issued by the investment advisor will need to be verified, and processes put in place to ensure that investment advisors provided valuations are fair.
- *Personal Account Dealing:* Employees involved in the administration of the hedge fund will often be privy to information regarding the fund's portfolio. This information could be utilized for financial gain either by the employee, or one of their associates. A strict

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confidentiality policy must be put in place to fully prevent the use of fund financial data in this way.

- *Suspension of Net Asset Value:* In some situations, when uncertain market conditions exist, the ability to determine the hedge funds net value may be suspended. This should only ever occur to protect all investors. A suspension of this kind should only ever receive approval under the most extreme circumstances. It should not be used by the investment advisor to freeze income levels. Any suspension must be agreed by the board of directors.
- *Investment Adviser Fund Directors:* It is quite usual for a member of the investment advisory company to take a place on the board of fund directors. The ability for this director to provide vital information and data is seen as a significant enough reason to overlook the fact that they are not totally independent. However, any such appointed director will need to clearly understand that their loyalty and commitment is to the fund, and not to the investment advisor. Where a conflict of interest at board level arises due to this lack in independence, the director may need to excuse themselves from any decision made by the board.

### **What can be Done When a Conflict Arises?**

Any interactions or trading relationships that could potentially lead to a conflict of interest need to be identified, and documented. A conflict of interest presents a risk, or a possibility of risk to the hedge fund and its investors. By exercising a risk management approach to dealing with conflicts of interest they can often be entirely negated, or some form of mitigation found.

With most of the examples found above, there are ways to resolve the conflict of interest, or remove the risk attached to it. As an example, the investment advisor may voluntarily decide that they will not enter into any softing arrangements, and this would remove the conflict of interest entirely. Alternatively, there may be a clause in the fund's offering document, that specifically defines under which circumstances softing arrangements will be allowed, and also define a process for keeping such arrangement transparent. In some cases, risks arising from conflicts of interest can be transferred. An example of this would be cross trades, where the buy or sell price is verified by an independent party.

Overall, one of the key duties and responsibilities of independent hedge fund directors is to ensure that any conflicts of interest are highlighted and addressed quickly and efficiently,

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thus exposing the fund to as little risk as possible. Directors are expected to use their skills, knowledge and expertise to act in the best interests of the fund at all times, and exercise fair judgment to resolve any conflict of interest. Directors are expected to remain impartial, and if that impartiality becomes compromised, it needs to be highlighted so that it cannot negatively affect the fund or its investors.