Providing better investor protection

Redefining the Role of the Non-Executive Director

Introduction

The hedge fund industry has experienced major changes over the last 20 years. What was once a secretive backwater of the financial world has become an important part of mainstream investments. An investor base of high net worth individuals, making decisions about their family wealth, has made way for pension funds, insurance companies, endowments and other large institutional investors. Hedge funds have obviously welcomed the huge inflows of capital and have altered their business models to meet the more stringent compliance and governance requirements of institutions. However, as has become increasingly clear to investors through a number of high profile blow-ups, there is at least one legacy area where hedge funds have *not* meaningfully improved their standards, leaving an important weakness in the service provided. This weakness is the role of the non-executive director

Hedge fund investors are being poorly served by offshore boards that are frequently under-qualified, over-stretched and not sufficiently independent from the influence of the fund manager. As a consequence, this internal watchdog has come to be regarded by both investors and regulators as essentially toothless.

This White Paper will review the responsibilities of the non-executive director, examine the alternative approaches to filling this position and suggest improvements that can upgrade this governance role and offer investors a higher standard of protection going forward.

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Duties of the Non-Executive Director

An offshore fund, structured as a limited company, will typically be run by a board of non-executive directors. This board is charged with managing the fund's affairs through its relationship with a series of service providers, most important of which is the fund manager. The fund's directors accept a responsibility to supervise the activities of the business and they have a duty of care to the company and, by extension, also to its shareholders.

Usually, the director's role is focused on high level oversight ensuring that on a day-to-day basis, the fund is properly structured, legally compliant and delivering a satisfactory level of service to its shareholders. However, on occasion, such as when disputes arise, the directors are required to step in and ensure that the interests of all shareholders are being protected. Essentially, the non-executive director should be an important internal safeguard, ensuring that the fund manager does not have a completely free hand with investors' capital.

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Qualifications for the role

There are no formal qualifications to becoming a non-executive director, beyond completing due diligence questionnaires by the offshore regulators, a residency requirement in some jurisdictions and limited restrictions by listing exchanges. However, there are guidelines which have been compiled by various industry bodies and regulators, as to the appropriate levels of expertise and independence within the board.

"best practice for any Fund would be to have a majority of independent offshore directors and to avoid appointing Directors who represent the advisers or service providers" - AIMA

AIMA suggests that a Fund board includes "a diversity of skills, experience and backgrounds". In addition to accounting and administration skills, it says that directors "must have the necessary collective expertise to understand the Fund's trading". AIMA also describes "best practice for any Fund would be to have a majority of independent offshore directors and to avoid appointing Directors who represent the advisers or service providers to the Fund because of the potential for conflicts of interest" [i]

Similarly, the Walker Report, commissioned by the UK government to explore failings in the banking system, in its very first recommendation suggests that non-executive directors "have the knowledge and understanding of the business to enable them to contribute effectively". The report also says that "the most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom" [ii] .

The fund manager is being supervised by a conflicted and incomplete board, lacking the skillset to actually understand what is in the portfolio

The Hedge Fund Standards Board concurs, saying that "fund boards should have sufficient collective expertise, availability and be otherwise qualified to understand the investment policy and strategies of the fund and the attendant risks". In its description of best practice the HFSB advocates "a majority of independent directors who can hold the manager directly to account" [iii] .

However, despite the guidelines, non-executive directors have historically been drawn mainly from the pool of offshore service providers who, while competent in the fields of administration, custody and investment law, typically do not provide any depth of actual investment experience. The fund manager is therefore being supervised by a conflicted and incomplete board, lacking the skillset to actually understand what is going on within the portfolio.

In a regulated onshore market, this skills gap would be quickly filled by appropriately qualified individuals. However, due to a combination of complacency, protectionism and inertia, this anomaly has been allowed to persist in the offshore market. To compound the problem, offshore directors have frequently taken on large portfolios of directorships, sometimes hundreds of funds, leaving themselves insufficient time to dedicate to the issues of any one.

In a regulated onshore market this skills gap would be quickly filled. But a combination of complacency, protectionism and inertia has allowed this anomaly to persist offshore.

In summary, the non-executive director owes a duty of care to the investor and should be adequately qualified and available to perform that function. However, investors have learned that, in practice, directors frequently lack expertise, time and motivation and often cannot be relied upon to protect their interests. In practically every fund collapse to date, the offshore directors have missed the danger signals and provided no advance warning to investors

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Background to the Role

Historically, offshore directors have usually been handed the roles by default rather than being actively chosen by the fund manager. At launch, the new hedge fund manager chooses a domestic lawyer and prime broker, who assist him in selecting a domicile, an offshore lawyer and an administrator. The offshore board is then constructed, primarily of individuals drawn from these offshore counterparties. The hedge fund manager treats the offshore directors as a necessary inconvenience and is happy to pay the lowest price for minimal oversight. The offshore lawyers and administrators treat the role as a perk of the job and see no problem in becoming board members on large numbers of funds.

Investors have learned to discount the importance and reliability of the non-executive director

The board of directors, supposedly looking after investors' interests, is then composed of individuals drawn from firms whose business depends wholly on the fund manager. As such, in addition to lacking an investment skillset, they usually have insufficient motivation to disagree with or challenge the manager, or to report any misgivings to the investors.

Investors therefore have learned to discount the importance and reliability of the non-executive director and to make their investments on the assumption that the directors will add little value. This, in turn, discourages a culture of culpability and encourages the practice of multiple board memberships, where individuals hire themselves out as board members to literally hundreds of funds. Where hedge fund blow-ups have occurred, there have been few repercussions for these roving non-executive directors, they simply lose a small portion of their income and move on to the next board.

Active Director Selection

In some cases, the hedge fund managers have not simply accepted the directors handed to them by the service providers, but have actively sourced their own directors who they feel can better represent the fund. While this would seem, on the face of it, to be a superior solution, in practice the level of oversight and protection afforded to investors is often not meaningfully better.

When fund blow-ups have occurred , there have been few repercussions for the offshore directors

Given the absence of an obvious pool of independent candidates, when hedge funds select their own non-executive directors they often turn to one of two main sources ; 1. ex-colleagues from the financial sector or 2. captains of industry. Both of these are effectively references on the character or expertise of the fund manager rather than sources of critical on-going oversight of the fund.

When the director is an ex-colleague of the fund manager he can testify to the manager's competence and honesty in the role, but he is usually also an old friend. He cannot be relied on for an impartial opinion or regular oversight of the portfolio. Talking to these individuals will usually confirm that they do not perform on-going monitoring of the portfolio, have never challenged any management decision and do not request relevant information on a regular basis. The role is typically taken on as a favour.

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The other source of non-executive directors is senior industry figures or politicians. These are sometimes chosen by very large funds with financial or political clout and are a signal to investors that the fund has grown to become a respectable institution in its own right. While investors can possibly take comfort from this, they would be naïve to expect regular portfolio oversight from these "trophy" directors and, as the recent financial crisis has shown, being large and well-connected doesn't protect a fund, or its investors, from failure.

Post Financial Crisis

Due Diligence

In the wake of the Madoff case and the financial crisis, investors have tightened up on the areas of compliance and governance. The increasing popularity of UCITs hedge funds testifies to the demand for better transparency and liquidity from the investment community. In theory, the role of the non-executive director has also been improved. Some service providers have acknowledged the implicit conflicts on interest and no longer offer this role. Many investors have now added a checkbox to their due diligence questionnaires to confirm that the fund's board is comprised of "independent" directors.

However, closer inspection of the checkbox often reveals that the due diligence actually conducted on these directors remains minimal and the service they provide is little changed.

Even now, in the wake of high-profile fund blow-ups, investors continue to regard the non-executive director as an irrelevance

A study of over 200 fund-of-funds conducted in June 2010 examined the importance they placed on various aspects of operational due diligence. One of the key conclusions of the study was :

The role of the board of directors of offshore funds is dangerously minimized with less than 2% of investors covering these items during due diligence [(iv)] **.**

The evidence suggests that, even now in the wake of high profile fund blow-ups, directors rarely receive phone calls from prospective investors to confirm their identities, directorship histories or qualifications for the role. The obvious conclusion is that investors continue to regard the non-executive director as an irrelevance.

Directorship Services

The largest recent change to the provision of non-executive directors is that the offshore administrators are now more reluctant to fill this role. Instead we have seen the emergence of specialist firms who provide hedge funds with offshore directors.

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Usually these firms are effectively spin-offs of the administrators, staffed by individuals who would have previously occupied the directorship roles in-house. On the plus side, they are more independent of manager influence and often have strong backgrounds in fund compliance, audit, accounting and administration - all important elements of fund governance.

However, as with the offshore law firms; the other main supply of director candidates, they continue to lack meaningful expertise in portfolio management. In addition, they often serve on the boards of hundreds of funds, in some cases refusing to disclose how many directorships they hold. They justify this business model by claiming that information technology and junior support staff enable them to service large numbers of funds simultaneously.

AIMA's warning that "particular care should be exercised where the potential Director is to be provided by a professional services firm. It is not uncommon for such candidates to have several hundred other directorships and very little time and attention to devote to another directorship" is largely ignored [(i)].

This level of service continues to demonstrate the old industry mind-set where hedge fund directors are seen as a necessary inconvenience. The director is not regarded as a key safeguard of investors' interests, but a back-office functionary whose objective is to process as many funds as possible through the system, as quickly as possible.

If the alternative investment industry is to meet the governance standards of institutional investors through the next 20 years, then this mind-set needs to change. Directors should be there to serve and protect the company and its shareholders. The board should act as a check and balance against the influence of the fund manager. Handing off this responsibility to junior staff and IT systems is not an adequate performance of the governance function.

Summary

This standard of governance is allowed to persist because investors are not conducting sufficient due diligence

The offshore board of directors remains an anachronism. In the wake of the financial crisis, some improvements have been made but large steps remain to be taken. Best practice corporate governance is typically not being observed and shareholders' interests are not being sufficiently protected. In the majority of cases the offshore board comprises of a team of individuals without any asset management experience. Often they will be directors across large numbers of funds with insufficient time to allocate to each, particularly in times of stress when investors will need their assistance most. With offshore service providers still a major source of directors, the hedge fund manager retains an inappropriate level of influence over the decisions made by the offshore board. This standard of governance is allowed to persist because investors are typically not conducting sufficient due diligence on the non-executive directors of their investments.

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The Solution : Experience, Independence and Fewer Roles

Multiple Directorships

The practice of large scale multiple directorships needs to be reviewed. This is a hang-over from a previous age and reflects badly on the modern hedge fund industry. A full-time director, with resources at his disposal can possibly make a case for being on tens of boards, but hundreds should no longer be acceptable. Investors need to conduct more thorough due diligence on the identities and workloads of offshore directors and insist that every director has the time at his disposal to properly oversee their investments.

Reference Checking

Institutional investors have a duty of care to their own investors when considering the offshore board. The FRC's Stewardship Code says that they should ensure that "board and committee structures are effective, and that independent directors provide adequate oversight" [v].

Directors who have demonstrated obvious failures of duty in the past should be named and shamed

Investors should be fully aware of who the offshore directors are, what experience they possess and what their directorship history is. Individuals who have demonstrated obvious failures of their duty in the past should be named and shamed. There have been calls for the various offshore regulators to establish public databases of hedge fund directors, listing their current and previous roles. This idea should be encouraged.

Investment Experience

Within the make-up of most boards, the most obvious omission is the lack of alternative investment experience. While directors with administrative and legal backgrounds bring important experience to the table, the effective governance of the fund has to be seriously compromised if none of the directors has a knowledge of the underlying investment strategy.

AIMA's guidelines, the HFSB and the Walker report all stress the need for investment expertise to be part of the makeup of any fund board, but in practice this advice is rarely followed.

Investors should have the comfort of knowing that an experienced asset manager is part of the team monitoring the fund

Investors should have the comfort of knowing that an experienced asset manager is part of the team monitoring the fund's activities on their behalf. The individual should have proven experience in the field and a reputation to protect. They should have sufficient time to devote to each fund and have the character to challenge the fund manager, and other service providers, when necessary.

The addition of this skillset should not be seen as a burden by the hedge fund manager. Enlightened hedge funds already recognise that the alternative investment industry needs to be more professional in its dealings with institutional investors.

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Sourcing Talent

Part of the reason for the status quo is the absence of suitable candidates for these directorship roles. Progressive hedge funds are already looking for offshore directors who adequately reflect the calibre of their firm and demonstrate the high standards of governance they wish to set, but they often struggle to fill these positions.

The reason for this is that the current situation is largely a closed-shop with few obvious points of access for new entrants. The current main providers of offshore directors are reluctant to give up roles that they have historically seen as a perk, especially when doing so reveals the weaknesses in their service.

Current providers of offshore directors are reluctant to give up roles that they see as a perk

Potential new directors from the hedge fund industry therefore need to be encouraged and paths opened to them. This could be done through the establishment of public lists of independent directorship candidates held by the prime brokers, lawyers or industry bodies. Alternatively, the funds could be encouraged to pay sourcing fees and the recruitment industry play a bigger part in filling these roles. Potential directors could also contact each other and affiliate to offer pools of talent to the industry.

Location & Taxation

For reasons of convenience, boards have a tendency to be comprised of individuals based in the same jurisdiction as the Fund, even when there is no regulatory requirement to do so. This is not necessary; provided that offshore and listing regulations are met, and the majority of the board are in different jurisdictions to the fund manager, then domestic taxation does not need to be a problem. Given recent cases where the US bankruptcy courts have found no offshore centre of main interest (COMI) even with resident Cayman directors, there is an argument that the typical offshore board needs to strengthen its case that the mind of management is overseas, with regards to taxation.

Funds need to become more flexible in constructing their boards if they want access to this talent

For a Fund to be considered offshore by the UK or US taxation authorities, it needs to show that the Fund is not just a brass plaque entity, but that central management and control are genuinely exercised offshore. If the Fund has a majority of independent directors with credibility and appropriate experience, then the argument that the board has real discretion is made much more convincingly, than if the board is staffed by service provider directors, who risk the perception that they are merely rubber-stamping the fund manager's decisions.

The main issue is that directors with alternative investment experience cannot be found in sufficient numbers in the tax-haven jurisdictions. Therefore, if Funds want access to this talent, they need to become more flexible when constructing their boards, and not just take the laziest option.

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Fees

Directors fees are not standardised and can range from under $10,000 per annum to $30,000 per annum or more, with an average of around $15,000. However these fees are paid by the Fund, hence it is the investors who ultimately have to bear this cost, and who should decide what represents value for money.

Given that even this wide variation in fees, when split across a pool of investors, probably works out at a difference of only a few hundred dollars each per annum, then within reason investors might be less concerned about the fee variation and more concerned about how much oversight they are actually getting for their money.

The onus is on Investors to make it clear that historic levels of service are no longer acceptable

Investor Pressure

None of the above will occur without pressure from the investment community. With the exception of an enlightened few, most hedge funds will choose to opt for less supervision rather than more. The onus is therefore on *investors* to make it clear that historic levels of service are no longer acceptable. They need to conduct more thorough due diligence on the identities of offshore directors and not merely tick a box to confirm their "independence".

The duty of care owed to the end-investor demands that investments are not made into funds with inadequate standards of oversight. This is particularly cogent for institutions such as Pension Funds, where the ultimate investor is the general public. It is not reasonable to tell these investors that stringent governance standards are being applied to the traditional part of their portfolios, but not to the alternative investments. Common-sense dictates that the same duty of care is owed on both.

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An institutional portfolio manager who doesn't demand best practice oversight on his hedge fund investments must be prepared to shoulder some of the blame when potentially avoidable blowups do occur.

Conclusion

Despite apparent improvements, offshore non-executive directors continue to provide insufficient oversight of the hedge fund manager and an important internal safeguard is not being properly applied. Tightening regulation is a clear sign that the regulatory authorities no longer trust the alternative industry to police itself. Standards of self-governance need to improve if this trend is not to follow a course where the investment freedom that enables hedge funds to succeed becomes ultimately regulated out of existence. This industry has however always attracted the brightest and the best, and the challenge of overcoming the legacy of directorship "light" is not beyond our abilities.

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About HedgeDirector

HedgeDirector is a provider of independent expert directors to hedge fund and Fund-of-fund boards. We represent an evolution in fund governance, with a growing team that consists entirely of current or ex hedge fund managers and fund-of-fund managers. All have extensive alternatives experience and have sufficient credibility and seniority to provide balance to the influence of the fund manager. We cap the number of directorships at a maximum of 15 each, and usually fewer. Our team offers a pool of industry knowledge across a wide range of strategies, markets and locations. Our aim is to upgrade governance of the fund and help ensure that investors' interests are being protected. Additional information is available at www.hedgedirector.com

Sources :

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