Corporate Governance

A few questions and suggested answers on goose sauce

CAROLINE HOARE, IPAF

A great deal of ink has been spilt recently on the subject of hedge fund boards and corporate governance generally. The Weavering case put the fear of God into the industry (well, that was surely the Cayman judiciary's intention) and the FT article in November 2011 apparently came as a total surprise to many, who were "scandalised" by the fact that some offshore hedge funds had directors who sat on literally hundreds of boards. Where on earth has everybody been? This has been the status quo for years and everyone in the industry has known it and nodded it through. Now, however, the spotlight is on this issue and some of us, who smugly say we have seen this coming for some time and have conducted affairs rather differently, are saying "about time too". To be fair, AIMA and HFSB have been making this point for a long time, but a lot of their good words and advice has fallen on deaf ears.

Ten years ago, directors of offshore fund boards were usually supplied by the service providers (lawyers, administrators etc). Then about five years ago, clients started insisting that fund boards had a majority of independent directors, so a lot of golfing friends were invited on to provide the independence, even if they'd never heard of or invested in a hedge fund. Now the hedge fund industry is being forced to grow up rather quickly and one aspect of this is manifesting itself in the requirement to appoint board members who are not only independent, but also experienced and knowledgeable.

So, message to portfolio managers: do it for yourselves! Non-executive directors on hedge fund boards are there for several reasons, one of which is to protect the shareholders (i.e. your investors). Do you really think your investors want to be treated as if you don't care? This is hardly the sort of message that is going to attract the institutional investor. So I want to make the point that what is sauce for the goose is also sauce for the gander: it is in your interests to ensure that the board members of your offshore fund are competent to make a real contribution and not just owners of fancy fountain pens to sign all those minutes.

Why should anyone bother to take notice of this advice?

The average investment manager has very little interest in his offshore fund board and certainly doesn't want that board interfering in the running of "his" fund.

The first – and most cynical – answer is that the sort of investors most funds want (pensions, endowments, institutions) will not invest in a fund unless they are satisfied that all elements of the fund's corporate governance are satisfactory. When due diligence teams are evaluating funds for possible investment, they are probably looking at literally hundreds of funds. It is important to understand that they are always looking at reasons not to invest, not for reasons to invest. So an unsatisfactory board can raise a red flag that will mean the fund won't make it past the due diligence team to the investment committee – and no one will ever be any the wiser. Most of the time the portfolio manager won't get told why the investment didn't arrive, but a poor board tells the due diligence team that the investment adviser doesn't care enough about his investors to want good governance – or doesn't want that level of oversight. There is a wide perception that investment advisers prefer passive boards.

Secondly, a good board might actually be able to help. The board's ultimate purpose is to control and direct. Operational failure and disagreements between the investment management company principals are the most common causes of hedge fund failure. In both these cases, a proactive, properly briefed and committed board could contribute to mitigate or even prevent these problems.

How should directors be chosen?

The first quality that is needed is an iron backbone. Portfolio managers tend to be alpha male individuals and used to getting their own way. Moral courage is necessary to manage conflicts of interest and to act ethically, despite commercial or social pressures to do otherwise.

Secondly, directors need to understand how a hedge fund works. Direct hands-on experience and expertise are extremely helpful. Hedge funds are unusual companies, in the sense that all executive management is outsourced to third party providers; the directors need to be able to assess the performance of those providers.

Thirdly, they need to be independent from the investment manager. They need to remember that they are representing the shareholders – i.e., the investors. It sounds obvious, but they shouldn't be family members or grateful old friends who need the money. Avoid these conflicts of interest.

Fourthly, the fund's directors need to have the time to devote to their duties and the commitment to devote that time.

What about board composition?

A lot of investors like the portfolio manager to be on the board to ensure he has exposure to the liability. Others think the board should be fully independent. There are good arguments on both sides. A diversity of skills and backgrounds is obviously sensible. One of the problems of the hedge fund industry is that it is comparatively young. Therefore there isn't the huge supply of retired "hedgies" out there, who are available to serve. The other problem is that they have to be offshore, thereby excluding a great deal of available talent. Ideally, therefore, find directors who have actually got their hands dirty in the industry and really understand the issues that hedge funds have to address and the way they are run – because they've lived through it and done it themselves.

What should directors do that they don't do now?

The Board is there to hold the investment manager to account for his performance and conduct. This cannot be done from a position of ignorance.

For a start, the directors should visit the investment management company at least once a year and get to know senior management, especially the COO and the risk manager. Real and regular board meetings should be held in person. They should put in place some mechanisms for receiving important and relevant information e.g. the same risk reports from the administrator that the investment manager receives. They should also ensure that the risk manager (so often a marzipan-layer appointment) should be able to call them directly without prior internal authorisation.

What should the investment management companies do that they don't do now?

Choose fund directors with care and good sense and pay them properly. Remuneration should reflect their duties and responsibilities and the value of their time spent. US funds still seem to think they can get a decent director for their offshore vehicle for $5,000 p.a. Now that really is a scandal! There is possibly even more ink currently being spilled on the subject of women directors. While the author has to declare an interest here, maybe it's worth remembering that a lot of women are rather good at risk evaluation and keeping difficult children under control.

Postscript: It does seem wrong that investment vehicles cannot be governed by the best and brightest of the sort of people who invest in them. Is it impossible that there should be something similar to the investment management exemption rules to permit alternative funds to have onshore directors without threatening their tax status? This is a fiction – and everyone knows it – and there just aren't enough people in the Cayman Islands…

ABOUT THE AUTHOR

Caroline Hoare was called to the Bar in 1978 and admitted to the Roll of Solicitors in 1985. She was the CEO of hedge fund manager GLC Ltd from 2001 to 2010 and was also a director of GLC. All current IPAF principals are available to serve as non-executive directors for both offshore and onshore companies.