Chapter Ten: Building an Effective Governance Program for Hedge Funds

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In the case of publicly-listed companies there are now well established standards of best practice and guidelines in respect of corporate governance. These standards have evolved through legislative and regulatory reforms and the initiatives of capital market participants over the last four years. For example, in July 2002, the Sarbanes-Oxley Act was enacted in the United States.

The corporate governance of public mutual funds is now a hot topic around the world. A series of mutual fund scandals in the US has heightened regulatory scrutiny of the fund sector in both the US and Canada. In the US, the SEC has recently mandated that the chairman and at least 75% of the board of directors of all public mutual funds must be totally independent from the fund manager. Here in Canada, the Canadian Securities Administrators have republished for public comment a proposed new National Instrument 81-107 entitled '*Independent Review Committee for Investment Funds'*. National Instrument 81-107 represents the regulators' latest attempt to tailor the emerging international standards on mutual fund governance to the specific structures of the Canadian fund industry.

Although the National Instrument is only applicable to investment funds which are offered to the public, even private hedge funds will experience pressure from investors to follow the same standards — particularly if they seek large institutional shareholders.

What is fund governance?

In the case of a company, 'corporate governance' relates to the activities of the board of directors of the company who are elected by, and are accountable to, the shareholders, and takes into account the role of management who are appointed by the board of directors and who are charged with the ongoing management of the corporation. In the case of a fund, 'fund governance' refers to the oversight role and decision-making processes of the governance body of that fund. If the fund is structured as a company, that means the board of directors and any board committees. If the fund is a unit trust, the governance body is the board of trustees and any committees of that board.

Whenever one is considering what the appropriate standards of governance are for a fund, it is important to bear in mind the perception that the regulators in Canada and throughout the world have of funds, which can best be summarized as follows: 'The national public interest and the interest of investors are adversely affected when investment companies (funds) are organized, operated and managed in the interest of others, rather than in the interest of their securityholders.'

Adequate oversight and effective decision-making are therefore seen as critical, by regulators, for the protection of the fund's securityholders.

Hedge funds are a special type of business

Unlike operating companies, a fund business usually outsources most of its operations, including the investment management and the administration functions. Hedge funds tend to be relatively small in comparison with public mutual fund organizations and rely more heavily than other funds on outsourcing many functions to third-party service providers.

This type of 'externalized management' is not common in other industries and makes hedge funds a special type of business. This outsourcing allows a small number of principals to manage very large amounts of assets. There is now over US$1 trillion under management in 8,000 hedge funds worldwide.

In addition, hedge fund securities are now being held by a much wider range of investors, including many individuals of modest net worth, either directly or through pension funds (which are increasingly investing in hedge funds).

This growth in assets under management and the widening of the investor base has already led to an increasing regulatory focus on hedge funds, especially from the US SEC (which will require hedge fund managers to be registered as from 1 February 2006).

But the governance issues are the same

As with any investment manager, a hedge fund manager can find itself in situations where its business and commercial interests conflict with its fiduciary duty to act in the best interests of the fund. As we have seen, the regulators believe that there is potential for abuse if a fund is organized, operated and managed in the interests of the investment manager and not the securityholders.

All investment managers can experience two different types of conflict situations — business conflicts and related-party conflicts. Now that investment management is increasingly just a part of a full service financial business, the potential for related-party conflicts is increasing. Although hedge fund managers tend to be independent entities — so have less 'related-party' conflicts — there are still plenty of potential business conflicts including, *inter alia*:

- inter-fund trading or purchasing or continuing to hold securities issued by an entity which is related to the manager;
- advising other investment funds or accounts at the same time as the hedge fund;
- having multiple business relationships with the main service providers to the fund;
- 'soft dollar' arrangements or directed brokerage; and
- deciding how to allocate trades between the fund and other accounts.

The role of the board

The board of directors or board of trustees (the board) of the fund is ultimately responsible for the operation of the fund — ie, it must assume leadership and control of the fund. Fund boards have, in addition to their general oversight responsibilities, an extra duty to monitor those areas where conflicts of interest might exist. Since many hedge funds now have institutional investors (such as pension funds) and some have several thousand individual investors, the governance standards of hedge fund boards can have a significant impact on a large number of investors, even though the funds themselves may not be listed or publicly traded.

It therefore makes sense for the Canadian hedge fund industry to voluntarily adopt international standards of fund governance in order to avoid giving Canadian regulators an excuse to start imposing such standards on them by way of unwanted regulatory oversight.

So what are the relevant fund governance standards for Canadian hedge funds?

Due to the unique organizational structure of funds, regulators sometimes require that they have a significant number of 'independent' directors. The independent directors are responsible for monitoring carefully the relationship between the fund and the manager and any other service providers. The term 'watchdog' has been used to describe the independent directors' role.

In the US, public mutual funds have been required to have independent directors since 1940. In addition, the SEC has recently mandated that the chairman and at least 75% of the board of directors of all public mutual funds must now be totally independent from the fund manager.

Partly because of the extent of the potential conflicts, many hedge funds around the world are now appointing independent directors, even though they are not yet required to do so by regulations.

The proposed 'Canadian solution': independent review/advisory committees

In Canada, the proposed new National Instrument 81-107 entitled '*Independent Review Committee for Investment Funds*' is due to come into force later in 2005. NI 81-107, as promulgated for comments, is applicable to all investment funds which are offered to the public, including exchange-traded funds.

In the meantime, most private hedge funds will experience pressure to adopt the same standards from both existing and prospective shareholders.

Under NI 81-107, every public investment fund must set up an independent review committee (IRC). NI 81-107 states that a manager may not be able to objectively determine whether it is acting in the best interests of the mutual fund when it is in a conflict of interest situation. NI 81-107 therefore requires that any situation in which a reasonable person would question whether the manager has a conflict of interest must be referred by the manager to the IRC for a recommendation. An IRC must comprise at least three people who are totally 'independent' of the fund and the manager.

In the case of inter-fund trades and investments in related entities — which are currently prohibited by Canadian securities regulations — the manager cannot take action without the approval of the IRC.

Independent advisory board

In order to meet these new standards, every Canadian hedge fund should have the equivalent of an IRC. There are some hedge funds that already have such committees, although they are generally called ‘advisory boards’.

The advisory board provides independent oversight of the fund and the fund manager. Having an advisory board demonstrates to potential investors that the fund manager has considered the governance issues and has established an independent governance body for the protection of investors in the fund. In this way, the fund manager is able to act more as a service provider to the fund rather than as its controller.

Key issues for a fund board

In addition to the straight ‘conflict of interest’ issues, the independent directors on a fund’s board, and any independent advisory board, should be involved in the following key areas:

- the appointment of third-party service providers;
- the re-appointment of the investment manager;
- compliance issues;
- remuneration issues; and
- effective communication.

Appointment of third-party service providers

One of the prime duties of the directors of a hedge fund is to review and approve the appointment of all the third-party service providers. A hedge fund should only appoint reputable and experienced service providers appropriate for the size of the fund. The directors should ensure that all the service providers have the standing and expertise appropriate to their function for the hedge fund. The service provider’s role, responsibility and any service level commitments should be clearly documented in a service agreement approved by the board. The board should also monitor the performance and fee levels of all service providers on a periodic basis against the committed level of service.

Re-appointment of the manager

In the US, the independent mutual fund directors have to review the manager’s agreement annually and have the power to terminate the appointment. However, this power is rarely used. Some commentators have called for an equivalent power in Canada for public mutual funds.

This issue is less relevant in the context of hedge funds because investors select hedge funds based on the performance or trading magic of a specific manager or individual at the hedge fund management company.

Compliance issues

The recent temporary closure and high-profile investigation of the Portus fund of hedge funds group has clearly illustrated the importance for all hedge funds of regulatory compliance. Every hedge fund should therefore have a designated ‘compliance officer’.

In addition, where there is an advisory board, key staff or consultants with compliance issues that are not being addressed by the fund manager can raise those issues with this independent governance body.

Remuneration issues

For public companies, management remuneration has been a major public issue in the last few years. Independent mutual fund directors generally get a fixed annual fee or a ‘per meeting’ fee. Independent mutual fund director fees are increasing rapidly in the US and Canada.

In the area of manager remuneration, hedge funds can in some ways be said to be ahead of public companies, since the investment manager’s primary reward is the performance fee, which is based solely on the performance of the fund. The basic management fee for hedge funds tends to be much lower than that for traditional mutual funds (1–2% rather than 3–5%).

Moreover, where the performance fee methodology includes hurdles and high water marks, the investment manager is only rewarded when the investor’s holdings actually increase in value (contrast that with the so called ‘fat cat’ directors on public company boards).

Effective communication with securityholders

Corporate governance standards now require the adequate disclosure of information to investors on a consistent and timely basis. In the case of hedge funds, this means that regular performance data (and any commentary from the manager) is communicated to all securityholders as soon as possible after the net asset value is finalized following each valuation period.

The board should also seek to ensure that any material items of information or changes are disclosed to all investors affected by those items or changes (and generally not seek to differentiate communications to investors or the timing of disclosures, based on the size of the investor’s investment or the nature or content of the disclosure).

Conclusion

Due to the size of investors' assets now held by hedge funds and the expansion of the investor base, the governance standards demanded of publicly-listed companies and public investment funds, with some limitations, are broadly applicable to hedge funds.

Canadian hedge funds should therefore adopt international standards and have independent directors and/or establish an independent advisory board. Voluntary compliance now will help to avert the imposition on Canadian funds of more rigid governance standards in the future.

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