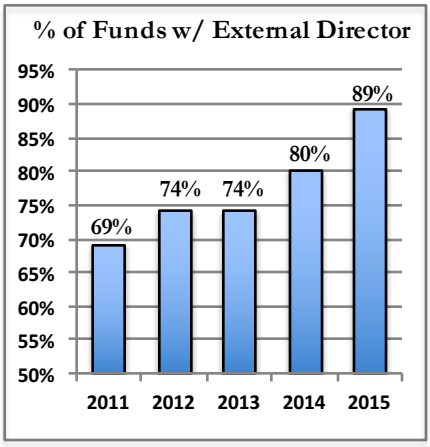
Best Practices Series
February 2016

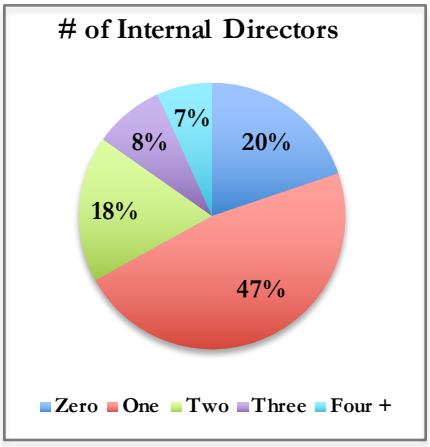
Fund Governance Trends: 2015 Industry Data & Recommended Best Practices

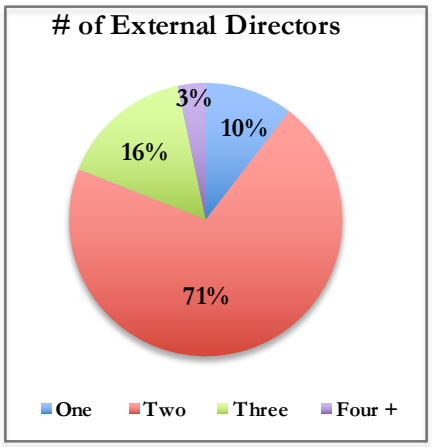
EXECUTIVE SUMMARY

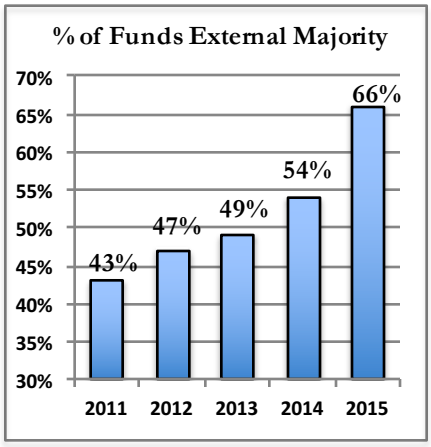
- Last year's white paper tracked an emerging trend of changes being made to existing fund boards. That trend continued in 2015 with 18% of funds making some change to their external directors. Like last year, larger fund managers ($1B+ in AUM) were more likely to make changes than smaller managers. More than half of those changes were to "swap" external directors, often with the desire to split their board or manage changes at directorship firms.
- This year's white paper tackles a new theme: the increased willingness of funds to hire directors from smaller, boutique directorship shops. One way to measure this is the market share of the four largest directorship firms. In 2011, the four largest firms had a 41% market share. By 2015, the four largest firms' market share had dropped to 36% and two of the largest firms in 2011 were no longer in the top four.
- Calendar-year 2015 SEC data shows a continuation of the trends that started in 2014 towards improving the profile of hedge fund boards and specifically their external directors. Using Form D data on 2,251 Cayman funds, we find that almost 90% now have at least one external director and 66% now have a majority of external directors, up from only 43% five years ago.
- The move towards "split boards" where external directors work for different firms remains an important feature of institutional boards, especially for UK-based managers.
- While fund boards continue to diversify, fund boards of US-managers typically lack directors with investment or risk backgrounds. Market and risk backgrounds are more common on European funds, especially the larger ones. This hole persists despite evidence that investors covet this background.
- In this issue, we update our views on best practices in fund governance for board composition, responsibilities, meetings and shareholder interaction.

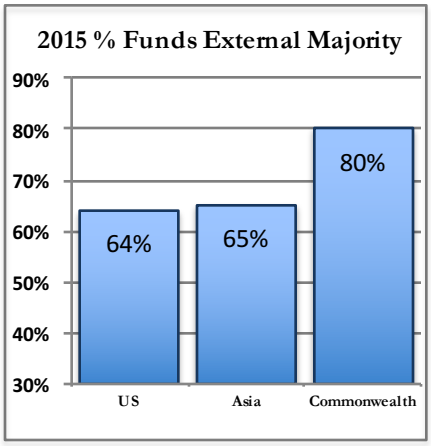
Chart Summary

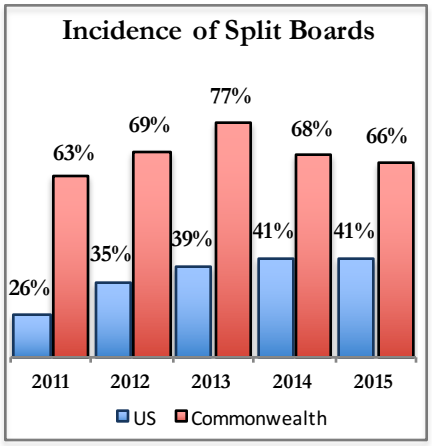


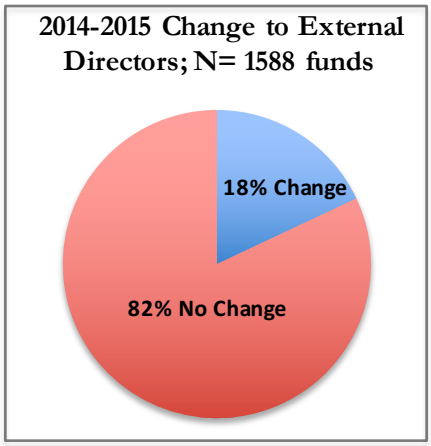


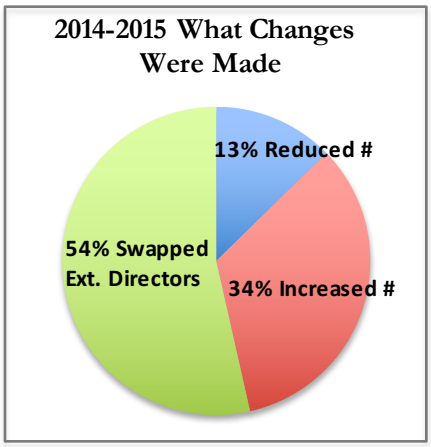


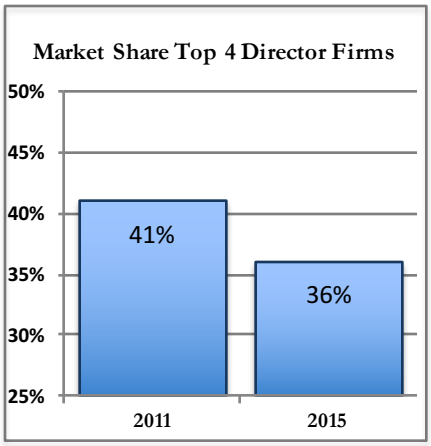












After a busy regulatory season for governance in 2013-14, last year was set up as a year to digest changes. Instead, we saw the continuation, if not acceleration, of important trends. Most striking were three areas: First, the need for an external director on fund boards now appears to be widely understood. In the five years since we started collecting this data, the percentage of funds with external directors has increased more than 20% to 89%. Second, there also appears to be widespread acceptance that boards should have a majority of external directors. Five years ago, only 43% of funds had an external majority. Now that number is 66%. Both of these changes represent some "catch-up" where US managers are increasingly adopting the practices evident in the UK and other Commonwealth countries. In other words, US managers are catching up to global best practices.

Historically, most of the changes in governance occurred at the margin with new funds. One of the biggest changes in the past two years has been the increased willingness of funds, especially larger funds, to make changes to their existing fund boards. This is the third area of continued momentum. In both 2014 and 2015 almost one-fifth of funds made some change to their external board line-up. Most of these changes involved swapping a current external director with a new external director, often to split the board or to respond to changes in directorship firms. (More on the changes in directorship firms below.) The other common change was to add an external director, often to secure an external majority.

Inroads Made by Boutique Firms

A trend we highlighted last year was the increased disruption/turnover in the directorship industry. This year we measure this by looking at the market share of the largest governance service providers. Two points are worth mentioning. First, the fund governance industry itself is not a "concentrated" industry. The top four service providers hold 36% of all the external board seats. A popularly accepted measure is that industries where the four largest firms are below 40% are considered not concentrated. Second, the data suggests that smaller or boutique firms are making inroads. The top four firms have lost 5% of their market share versus five years ago and two of the top four firms from 2011 have dropped out of the top spots. The "winners" appear to be the higher touch, or boutique firms that consciously limit capacity.

SEC Director Data

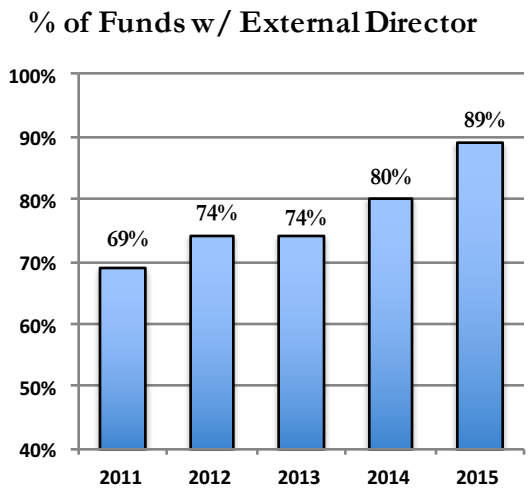
In our description of the current state of governance, we will be relying on calendar-year 2015 data made available by the US Securities and Exchange Commission ("SEC"). Some offshore funds file a Form D or D/A (an amended Form D) with the SEC -- typically to allow them to issue securities exempt from SEC registration to tax-exempt US investors, such as foundations, endowments or public retirement plans. Data from the Form D, therefore, does not capture the entire fund universe. One simple estimate of the completeness of the data set is that there were 10,940 funds registered in Cayman Islands as of December 31, 2015, while our Form D dataset shows 2,251 Cayman funds filing a Form D. Therefore, we are capturing approximately 21% of all Cayman funds. We should also note that our data may be over-estimating the quality of fund governance practices. The universe of funds that file a Form D with the SEC is large but is not a random selection of all funds. Funds that can successfully market to US tax-exempt investors are more likely to pay attention to important issues like governance. A more complete description of the data is available in Appendix I.

Board Composition Distribution

Based on our data, we were able to identify individuals as either internal or external directors. To put it briefly, an internal director either works for the investment manager/advisor or for an organization with an ownership interest in the investment manager/advisor. An external director is anybody on a fund board that doesn't fit the criteria for an internal director. The distribution of board seats looks like the following:

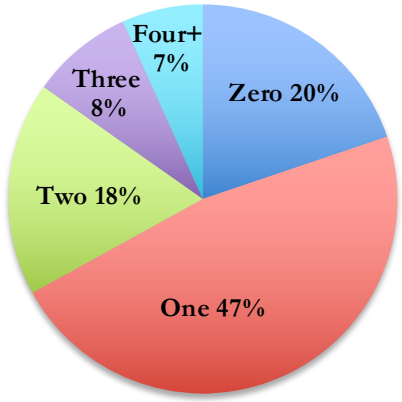
Number of Internal Directors \ Number of External Directors	0	1	2	3+	Sum
0		1%	12%	7%	20%
1	2%	3%	38%	4%	47%
2	4%	4%	6%	4%	18%
3+	5%	2%	6%	2%	15%
Sum	11%	9%	63%	17%	

Funds continue to move towards having external directors on their boards.



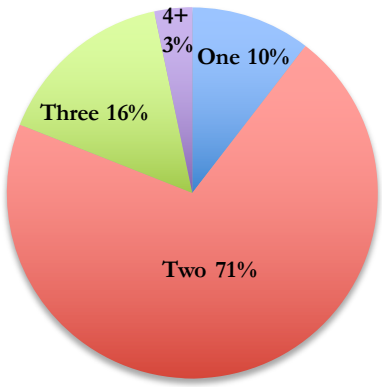
How Many Internal Directors?

Having a single internal director is the most common configuration, though there are still a range of configurations that are evident. Traditionally, the single internal director was the CIO or founder. Increasingly, the internal director is a COO/CFO who has more regular interaction with the board. Multiple internals are rare outside of the large asset management firms.



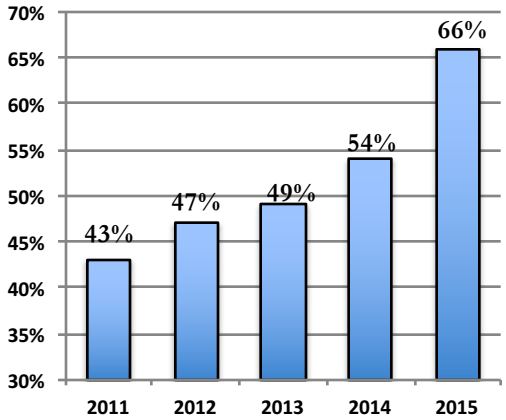
How Many External Directors?

For funds that have external directors, the most common number to have is two. With the appropriate director profiles, this is sufficient for many funds.



Do External Directors Have Control?

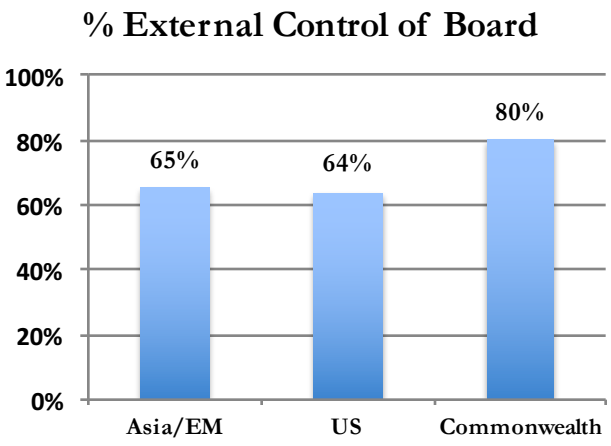
The data allows us to look at the question of who has majority control of a board. This view does not account for the possibility that either internal or external board members have super-voting rights. But based on the data, more funds have moved towards the preferred model of placing control in the hands of external directors.



How Does Manager Location Affect Practices?

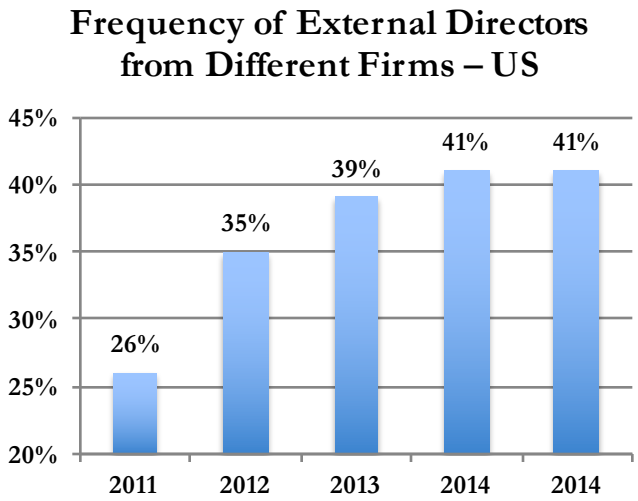
We grouped the data into regions based on the location of the investment advisor. The data suggests materially

different practices by region. As you can see from the data below, UK and Commonwealth countries (Canada, Australia, New Zealand, etc.) have corporate governance practices that are more developed than the US and Asia or other emerging market managers.



Split Boards

We see something similar when we look at another indicator of the quality of governance: the incidence of external directors coming from different firms ("split boards"). While it is sometimes described as more "efficient" to have two external directors from the same firm, it compromises the effectiveness of the second director for several reasons: (i) as a consequence of the history and culture of the organization providing the directors, the two directors are likely to have similar backgrounds, (ii) frequently the two directors will informally assign one of them to be a "lead director" and the other director will pay less attention and rely on the lead for information and guidance, and (iii) directors from the same firm may be more likely to defer to each other. Effectively this reduces the two external directors to something akin to one external director. This practice is common in less developed governance situations because the external directorship firm will frequently discount the price for the second director. This makes it appealing to start-up funds or firms that are looking for easy, turn-key answers. For Cayman funds, having a split board is significantly more common in funds that have non-US managers.



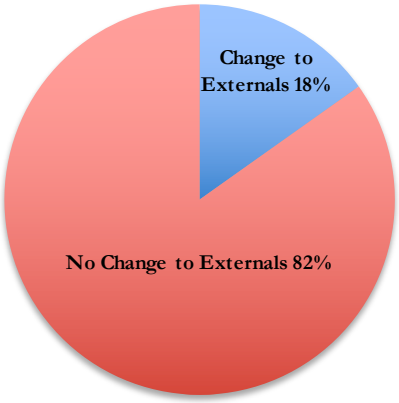
What do investors want?

Investors want managers to get value with their two external director slots. Since splitting the board allows for maximum diversity and independence, institutional investors have increasingly demanded split boards. While the lower incidence of split boards in the US (41%) versus the UK and other Commonwealth countries (where more than two-thirds historically have split boards) points to a missed opportunity, the good news is that the five-year trend data suggest that strong investor preferences are beginning to produce changes in the industry. One indication of this is that funds that were launched in 2015 have a higher incidence of split boards (49%) than the overall population (41%). As the total population starts to incorporate these recent trends, we expect the numbers to start to reflecting improved practices.

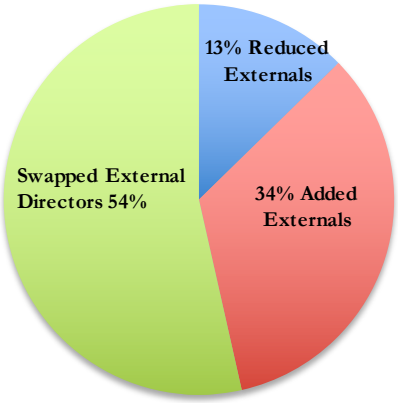
How Much Activity is There with Existing Boards?

Historically, managers have been slow to change their fund boards even as other aspects of the fund's operational and risk environment evolved with the size and the complexity of their investment strategies. 2014 and 2015 appear to mark a sea change in the level of activity that is taking place on existing boards. As seen on the chart on the following page, approximately one-in-five managers that filed a Form D in 2014 and 2015 made some change to their external board members.

2014-2015 Change to External Directors

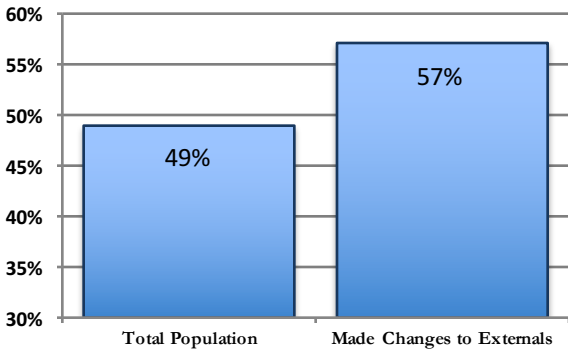


2014-2015 What Changes Were Made



Interestingly, larger managers (those with more than $1 billion in assets) were more likely to make changes. Overall, large managers represent about 49% of the 2,251 funds in the Cayman Form D universe. But large managers represent 57% of the funds that made some change to their external directors. The increased willingness of larger fund managers to consider these changes is likely the result of a higher sensitivity to the adoption of best practices.

$1B Funds as % of Fund Population



What Changes Were Made?

284 funds made changes to the external directors on their fund boards, but what changes did they make?

More than half of the funds that made some changes did so to swap external directors. While the reasons for these swaps vary, there were likely two important catalysts. The first catalyst was a desire by some managers so split their boards (i.e. to move from two external directors at the same firm to two directors at different firms). A second catalyst appears to be a result of elevated turnover at some directorship firms. Suffice to say that while the regulatory environment for fund boards appears to have slowed a bit, the activity level at many private fund boards appears to be increasing.

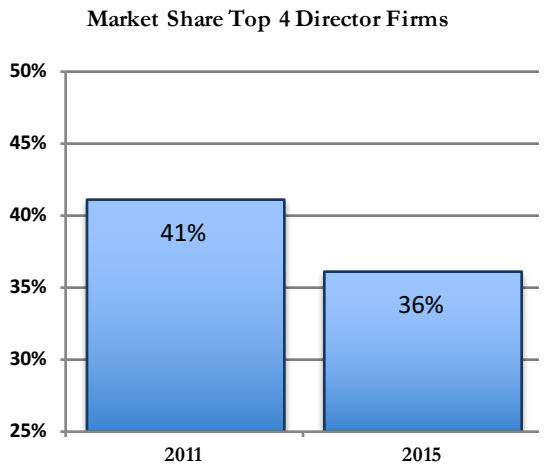
Governance Industry Changes

We have commented more than once that there has been an increased level of turnover and change in the governance industry. This year we looked at the market share of various providers and compared it to past years. Our goal was two-fold. First, we wanted to be able to identify whether the industry was "concentrated," where the largest providers have the bulk of the market share, or "competitive" where there are a large number of material service providers. A common measure of competitiveness is the four-firm concentration ratio. This is a product of the percentage of output controlled by the four largest firms. In this case, the "output" are external board seats. In our sample of 2,251 funds, there are 4,270 board seats that

are filled by external directors. The largest four firms represent 1,547 or 36% of the total. Suffice to say, we can describe the governance industry as competitive.

Our second objective was to identify whether the larger firms were gaining or losing market share as a measure of the inroads made by smaller, boutique firms. We did this by comparing the four-firm market share five years ago in the first year of our survey. The results are striking. Not only have the top four firms lost 5% of market share, but the half of the top-four are no longer in the top-four. It would also appear that the "winners" are the firms that are more transparent about their capacity and promise higher-touch, higher quality offerings.

The data suggests that funds are increasingly willing to hire some of the smaller, boutique firms either as a diversifier in split board situations, or as part of an effort to upgrade their governance practices.



The SFA View on Best Practices in Fund Governance

Let's start with the obvious: almost all hedge funds are started at the instigation of a particular investment manager as a vehicle to effectuate a particular investment strategy or approach. This differs importantly from a traditional corporate model where directors are actively involved in setting a strategic direction or vision and hiring management to execute on it. Investors in corporations that suffer poor management may reasonably expect the board to appoint new managers. But investors in hedge funds make the hiring/firing decisions themselves by sticking with or redeeming from their investments.

But this increased investor responsibility does not mean that directors cannot add significant value. Investors should be protected from conflicts of interest, from misrepresentations of investment strategies or risks, and from misconduct or fraud. Investment managers benefit from having knowledgeable professionals involved with their funds who can guide processes where conflicts may exist, and be available to investors that have concerns.

Best Practices: An Absolute or Relative Concept?

Discussions of best practices often start with a fixed concept – the ideal, so to speak. But perhaps a more realistic view of best practices is to acknowledge that practices should evolve depending on the resources, size and complexity of a fund or fund complex. The primary problem with regard to hedge fund governance isn't a lack of awareness of how boards should be constituted or how boards should practice. The problem is the apparent stickiness or inertia of boards and practices that made sense when funds were $50 million but no longer make sense when they are ten or twenty times that size. In other areas, we expect funds to evolve as their assets, strategies and operational complexity grow. The same should be true with our approach to governance. So, best practices may not be a fixed point but a continuum, and funds judged as much by their movement as by fixed standards. In each section of our discussion, we will talk about ideals, but we will also include a paragraph on what smaller funds may accomplish with more limited resources.

I. Board composition

The most important contributor to strong fund governance is an excellent board. The best governance procedures will be ineffectual in the hands of a group of disinterested or conflicted individuals. We believe that best practices in board composition involves the following:

① A board composed of representatives of the investment manager in addition to independent directors. Independent directors should be independent of both the investment manager and each other. This means that the directors, their firms or affiliates are not receiving fees from the investment manager for any other services. In addition, it is also our view that directors should not be either shareholders or LPs. While having a director who is also a shareholder may heighten their attention, it also creates situations where his/her personal interests may conflict with the interests of the broader group of shareholders.

② The investment managers' representatives on the board should include the CIO or the COO or comparable person in charge of non-investment activities. The perspective of the investment manager should be represented on the board. Additionally, including the CIO and COO on the board creates a personal legal responsibility for the fund's proper management.

③ The independent directors should have a majority of the votes on the board – or their approval should be required for certain actions such as suspending redemptions or changing the liquidity terms of the fund.

④ In order to provide meaningful oversight, the board – and especially its independent directors - should have a diversity of experience. The areas of functional insight should include: legal, regulatory, markets/investment strategies, audit, fund administration and risk management.

⑤ While professional independent directors will work for a number of funds, the capacity of a director should allow that director to devote significant time and attention even during periods of high market stress, like Q4 2008. There is not an exact science to the number

of funds or relationships a director can handle, but the director should be transparent about the number of assignments they have both to investors and the investment manager.

⑥ Director compensation should be reasonable for the amount of work involved in the assignment and may differ from director to director based on their level of experience and expertise.

⑦ Directors should be willing and able to travel to meet the investment manager and participate in face-to-face board meetings at least twice per year. There is no substitute for spending time and being with the manager and other board members.

Smaller Funds: Smaller funds are likely to start with a board primarily or entirely comprised of internal directors. There should be at least two internal directors covering investment and operational areas and the boards should be operating in a transparent, structured manner. Even with limited budgets, a third-party firm can be engaged to provide corporate secretarial services (compiling and distributing agendas and meeting materials, taking minutes, establishing follow-up schedules. etc.). This can be an important prod to keeping the trains running on time. As and when practical, firms would add their first independent director.

II. The role of the board

While the board will typically delegate many day-to-day responsibilities to third parties like the investment manager, administrator, auditors, etc., the board retains very important roles and responsibilities. These would include the following:

① *Monitoring Strategy, Risk and Liquidity Profile.* The Investment Management Agreement will specifically delegate the responsibilities for selecting investments, portfolio construction, risk management and trading/dealing to the investment manager. The board should be ensuring, however, that when the investment manager is exercising these responsibilities that he or she is doing so in a manner that is consistent with the prospectus and other materials that have been provided to investors.

Put simply, the board ensures that the manager adheres to investment, risk and liquidity restrictions. Independent directors should take the lead in this role because of the inherent conflict of interest for "inside" directors. While this can often seem relatively straightforward, many funds adapt and change with market conditions over time. The independent directors are charged with the responsibility to ensure that this change does not constitute wholesale strategy drift or a change in risk or investment profile that differs materially from what was described to investors. The directors may be helped in this regard by requesting that the administrator prepare reports for the board that would highlight changes in security types or strategy profile.

② *Monitoring Service Providers.* The investment manager will be responsible for daily interaction with third-party service providers such as prime brokers, auditors and legal counsel, but the board should supervise and approve the selection of these providers and interact with them at regular intervals. This provides shareholders with an important protection against either (i) conflicts of interest between the service providers and the investment manager, and (ii) fraud or misconduct – which typically would require some combination of misconduct and negligence by the investment manager and the fund's other service providers.

③ *Valuation.* One of the most important risks in governance today is the uncomfortable level of vagueness of exactly who is ultimately responsible for valuation of the fund's assets. It is clear that the directors perform a role in the valuation process, but that role may differ from fund to fund. What is important is that all roles be clearly defined and acknowledged, whether it be the directors, the investment manager, the administrator, the valuation agent or any other third party and that this be communicated properly to investors. With regard to the directors specifically, the board should do the following: (i) review Valuation Committee minutes on a monthly or quarterly basis, (ii) annually approve valuation procedures and processes, (iii) approve any exceptions to the agreed-upon procedures, (iv) be aware of valuations on hard-to-value or exotic securities, (v) sign off on any transactions that are done between

vehicles that are advised by the investment manager, and (vi) receive and review NAV packages on a monthly or quarterly basis.

④ *Audit*. The directors are directly responsible for approving the annual audit for the fund. In practice, this means the directors hire and supervise the audit firm, engage the auditor in active dialogue to understand the financial compliance environment, and satisfy themselves that the accounts are accurate.

⑤ *Accuracy of Fund Information*. The directors are responsible for the accuracy, completeness and timeliness of official communications by the fund to investors and potential investors. This includes the offering memorandum, constitutional documents, subscription documents, and periodic valuations. This information should be reviewed on an annual basis to make sure that it remains accurate. In cases where the board is relying on third parties such as the administrator or investment manager to send this information, it should receive positive assurance that this has been done on a timely basis. Of course, the directors should also be aware of and conversant with communication directly between the investment manager and shareholders or potential shareholders (monthly or quarterly updates, risk information, marketing materials, etc.).

⑥ *Side Letters*. The board should be actively involved in the granting of any special terms and conditions that are codified in a "side letter".

⑦ *Discretionary Powers*. The board ultimately exercises the discretionary powers granted to it by the prospectus. This includes more mundane items like the ability to waive sales fees, minimum investment amounts, redemption fees or subscription cut-off times/dates. But it also includes the very substantial discretion to impose or waive gates, suspend redemptions and the calculation of the NAV. These discretionary powers are often fraught with potential conflicts for directors who also work for the investment manager. Therefore it is important that independent directors play a substantial role in the application of most discretionary powers.

⑧ *Shareholder Communication*. The board should be well acquainted with efforts undertaken to market the funds as well as shareholder relations. This would include understanding the target client base, the current mix and needs of shareholders, redemption and subscription requests or schedules, the capacity of the investment strategies, shareholder correspondence and shareholder events. Individual directors should be available to meet or listen to shareholders who have concerns or issues with the funds. These efforts generally will enhance shareholder retention.

Smaller Funds: It is especially important for smaller funds without independent directors that the internal directors provide ample documentation of their activities as directors, distinct from their corresponding role as members of the the investment manager. For example, the exercise of discretionary powers or over-riding of valuation procedures should be done in the context of board meetings and not during the normal course of duty as the investment manager.

III. Director Interaction/Board Meetings

In order to fulfill the responsibilities discussed above, the director will need to spend a material amount of time upfront familiarizing him or herself with the investment manager and other service providers. In effect, the director should be engaging in a due diligence process that would be akin to that conducted by a thorough professional investor. As one simple test, a director should know as much about a fund and its manager as its investors. Subsequent to this assessment, directors will typically interact with other board members and the investment manager through a schedule of board meetings. We recommend the following:

① The schedule of board meetings should be determined in advance and should be conducted with a frequency no less than 3 times per year. In many cases, board meetings should take place quarterly. In addition, the Board will meet (typically telephonically) to review the final audit results with the auditor at the end of Q1. At least two meetings a year should occur with all board members physically present.

② The agenda for board meetings should be provided in advance and materials supporting items to be discussed should be provided with sufficient time for directors to properly consider them.

③ Third party servicer providers such as administrators and auditors should be invited to participate during part of these meetings to report out on their areas of relevance.

④ While formal meetings are important, board members should be ready and prepared to meet formally or informally at any time as issues or market conditions dictate.

The agenda for Board meetings may vary from meeting to meeting depending on time of year and the issues at hand. But a typical agenda should include the following:

- Review of investment performance, risk and liquidity profile.
- Review of upcoming subscriptions and redemptions.
- Discussion of marketing efforts and shareholders issues or communication.
- Review of staffing or infrastructure changes at the investment manager.
- Review of new account openings/counterparties and counterparty exposure.
- Discussion of legal, regulatory or compliance issues or communication.
- Presentation by Valuation Committee of results, exceptions, procedures.
- Presentation by Administrator of NAV package, ASC 820 leveling, asset verification.
- Presentation by Administrator of AML procedures/issues, non-standard subscriptions or redemptions.
- Presentation by Auditor of annual accounts and approval as required (annually).
- Review of side letters.
- Review of any requests for discretionary powers/waivers.
- ERISA issues.
- Review appointment of service providers and engagement of auditor (annually)
- Approve renewal of D&O insurance (annually).

Smaller Funds: Smaller fund boards should meet at least twice per year, and it would be good for at least one of those meetings to be with all directors physically present. While the agenda for a board meeting with only internal directors may be abridged, it should demonstrate that all important roles have been discussed and minuted.

IV. Shareholder interaction

We believe that directors should be sensitive to the needs and interests of shareholders. This means that directors should provide transparency on the work they have done for the fund, the specifics of their interaction with other directors and how decisions were made, and issues that were considered. But this transparency needs to be coordinated with the investment manager and directors should be careful to provide equivalent levels of information to all investors. While minutes of board meetings are typically not provided, detailed board agendas should be available to all shareholders.

During normal times, directors should participate in shareholder events. During periods of market or fund stress, directors should be available to shareholders to understand their concerns and issues. Ultimately this communication will help the fund (and the investment manager) by making sure that investor concerns are heard.

What about Master Fund LP Governance?

Increasingly, master funds have been organized as limited partnerships. This creates a significant loophole for the governance and oversight of funds even if there are external directors at the offshore feeder level. In a more normal environment, the external directors would have transparency into the master fund in order to fulfill their responsibilities at the feeder level. But some investors are sensitive to the fact that directors wouldn't

be directly involved if the fund exercised discretionary authority to suspend redemptions or other extraordinary measures. To alleviate these concerns, some master funds have created advisory or governance committees whose approval is required for the GP to take certain actions. The actions would typically be outlined in the limited partnership agreement and the advisory committees would typically have the same members as a fund's offshore board of directors. We expect the presence of advisory committees to become more common as best practices in fund governance evolve.

Best Practices Checklist

✓ A board with 3-5 individuals, a voting majority of which are independent, external directors.

✓ External board directors that have diverse skill sets and include markets and strategy knowledge, legal/regulatory experience, risk and operations.

✓ External board directors with the appropriate number of assignments and focus to provide significant time, attention and oversight even during periods of market stress.

✓ Board meetings at least three or four times per year, of which two are face-to-face with all board members present.

✓ External board directors who spend significant time upfront becoming familiar with the fund and its operations.

✓ A board that is actively involved in monitoring the fund's valuation process.

✓ A board that interacts regularly with the fund's service providers and asks them to participate in board meetings.

✓ A board that interacts with shareholders and is transparent and available to them, especially during periods of stress.

✓ An advisory board at the master level if the master is organized as a limited partnership that would approve certain actions as outlined in the limited partnership agreement.

About Sound Fund Advisors

Sound Fund Advisors ("SFA") was founded by Jonathan Morgan in 2011 to provide focused and active directorship services to asset management firms and institutional hedge funds. The firm's approach brings market, risk and hedge fund investing experience to a small number of firms that are interested in best practices in fund governance. Prior to founding SFA, Jonathan Morgan was a hedge fund strategist, portfolio manager, principal and investor for more than 18 years. Over the past 9 years, he has been the head of hedge fund research and manager selection at Julius Baer Alternatives (2002-2005), Barclays Global Investors (2005-2009) and UBP Asset Management (2009-2011). Prior to that, Mr. Morgan was a markets strategist at Caxton Corporation and Croesus Capital Management and a portfolio manager at Parallax Capital Management. He graduated from Princeton University in 1986 and Harvard's John F. Kennedy School in 1990.

Appendix I – SEC Data Treatment

This analysis is based on information included in Form D and Form D/As filed with the SEC during calendar-year 2015 for hedge funds domiciled in the Cayman Islands. Funds that self-designated as "Master Funds" in their name have been excluded to mitigate the possibility of double-counting unless it could be verified that this was not the case. Limited partnerships were also excluded. In total, there were 2,251 unique funds that met these criteria. There are 2,484 people associated with these funds who serve as directors. A person is an Internal director if they self-designate as an "Executive" of the fund on their Form D, or if we associated them with the fund through publically available information. A person is also considered to be an Internal director if they work for either the investment advisor/manager of the fund, or they work for an entity which controls or has an equity stake in the investment manager. In cases where a fund is on a hedge fund platform, employees of the platform provider are considered Internals. External directors have no direct ties to the fund and this term is interchangeable with independent director or non-executive director. In cases where directors serve as independent directors for the investment manager itself and for the underlying fund, the director is considered an external director despite the potential for some conflict. The universe of External directors is derived from publically available information, including information provided by service providers themselves. In order to be conservative in our analysis, we have assumed that directors that cannot otherwise be identified are External directors. The number in each category are as follows:

Internal Directors: 1,817 persons

External Directors: 667 persons

Manager Location and Size

In addition to the data collected from SEC records, we have associated each fund with an investment advisor. The location of the investment advisor was obtained from publically available sources. We also survey industry information to identify managers with more than $1 billion in total strategy assets. These managers are considered "Large" for the purposes of examining how size impacts governance practices.