Best Practices in Fund Governance

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, operational, 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 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. Annually, the Board should meet with the Fund's AML officers to discuss their findings.
- 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 asymmetry in governance and a lack of 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.
- ✓ A board that is cognizant of the compliance and regulatory requirements of the fund.
- ✓ 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.

Sound Fund Advisors ("SFA") was founded in 2011 to provide focused and active directorship services to asset management firms and institutional hedge funds.

SFA was founded by Jonathan Morgan who has served as a hedge fund strategist, portfolio manager, principal and investor for more than 18 years. From 2002 until 2011, he was 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 three different hedge funds. He graduated from Princeton University in 1986, Harvard's John F. Kennedy School in 1990 and has a Master's of Divinity with a focus on ethics from Yale Divinity School in 2019. Jon is an FSA Credential Level II Candidate for the Sustainability Accounting Standards Board.

Ramona Bowry is a director of SFA. Prior to joining SFA she was Senior Vice President and Head of Operational Due Diligence at MaplesFS. Prior to joining MaplesFS in 2012, she was a founding partner, director and company secretary of A.R.C. Directors Ltd., a Cayman directorship services firm. Prior to that, Ramona was based in London where she worked at DPM Europe Ltd., an offshore hedge fund administrator which is now part of BNY Mellon. Ramona began as a risk analyst at Bright Capital, a hedge fund manager. Ramona is an FCA Securities & Financial Derivatives representative. She holds a BS in Economics and History from University College London. Ramona is an FSA Credential Level II Candidate for the Sustainability Accounting Standards Board. In addition to her role as a director, Ramona provides operational due diligence consulting services in the alternative investment space.