SOUND FUND ADVISORS

Best Practice Series
February 2021

10-Year Anniversary Edition

Fund Governance Trends: 2020 Industry Data & Recommended Best Practices

EXECUTIVE SUMMARY

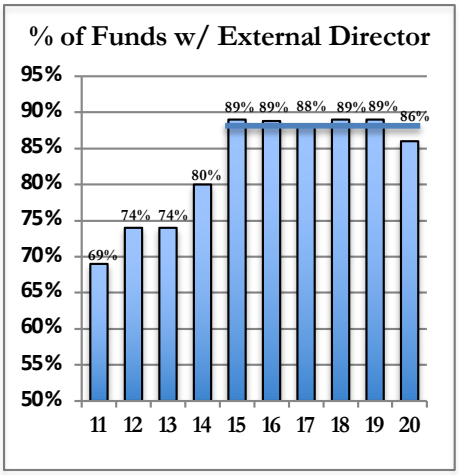
1. We started producing this white paper ten years ago in the shadow of the financial crisis of 2008-2009. It was clear then that the governance model that had prevailed in our industry wasn't working. We were committed, along with many others, to change that. We did that by entering the arena ourselves, pursuing a more engaged, value-added governance model. We also did that by providing managers, investors and directors with hard data on the movement toward better practices. It's ironic, that in this, our 10-year anniversary, the industry has just weathered another crisis in financial markets. That the hedge fund industry emerged mostly unscathed from the Spring of 2020 is a testimony to many factors (thank you, Federal Reserve), but at least one of them is a much-improved governance model.
2. It is important to not lose track of how much progress has been made over the past decade.
   a) In 2011, over 30% of funds did not have an external director. Now, nearly 90% of funds have have external directors.
   b) In 2011, only 43% of funds had a board with a majority of external directors. That number is now almost 80%, and for many UK/Commonwealth-based managers is over 90%.
   c) In 2011, only 26% of funds with two external board members had directors who worked for different companies ("split boards"). For 2020 and other more recent vintage funds, more than 60% of funds with two external directors have split boards.
3. This year we look at ESG (environmental, social and governance) and DEI (diversity, equity and inclusion) and what fund boards might do both formally and informally to fulfill their mandates and assist managers in these areas. But we also look at our own industry's ESG responsibilities. We started tracking gender diversity for external directors in 2018 and we continue that this year. Only 21% of external board seats were filled by women for funds started in 2020. That's up from 15% in older vintage funds, but not materially better than results from the last few years. Just as importantly, boards should be helping investment managers with ESG and DEI ideas and information.

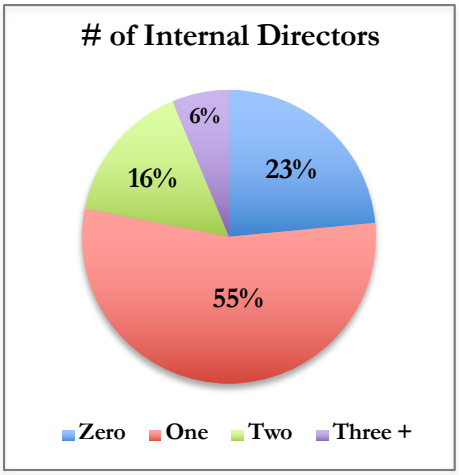
Index to Past White Paper Topics

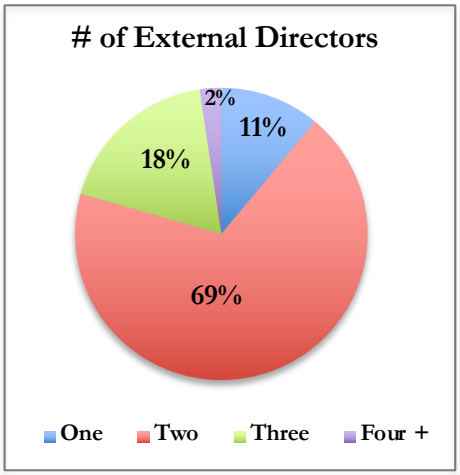
Over the years, Fund Governance Trends has reviewed many special topics. We thought it would be useful to provide readers with a historical index. Many of these topics retain their relevancy. The year below refers to the year in which the white paper was published. All papers are available on our website at https://soundfundadvisors.com/research

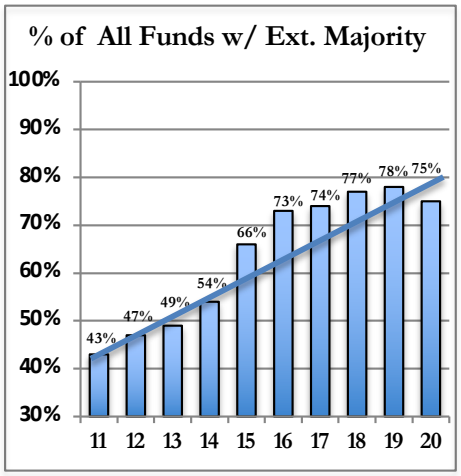
2020 – Fund Boards and ESG/DEI
2019 – Gender diversity on hedge fund boards
2019 – Questions investors can ask directors
2018 – Experience profile of external directors
2018 – Experience profile of externals: US vs Offshore
2018 – Is good governance related to survivorship?
2017 – Buy American: the trend towards local directors
2017 – Who is the internal director: CIO or CFO?
2016 – Market share of boutique director firms
2015 – How much activity is there on existing boards?
2015 – Changes boards are making to composition
2014 – Board independence as top investor concern
2014 – Board perception gap: managers vs investors
2013 – Should funds have split boards?
2013 – The most important skills for fund board
2013 – Status: US onshore governance
2012 – How does fund size impact governance?
2012 – How has the 2008 crisis affected governance?
2012 – How many assignments do directors have?
2012 – Who do external directors work for?

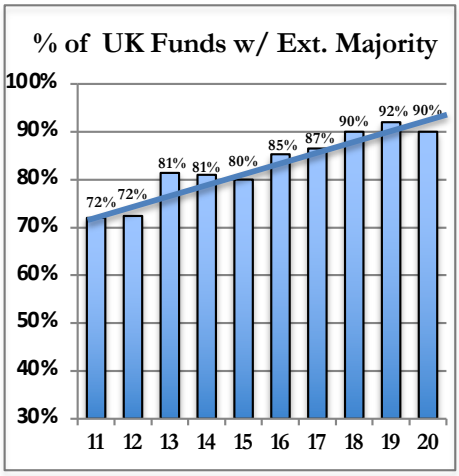
Chart Summary

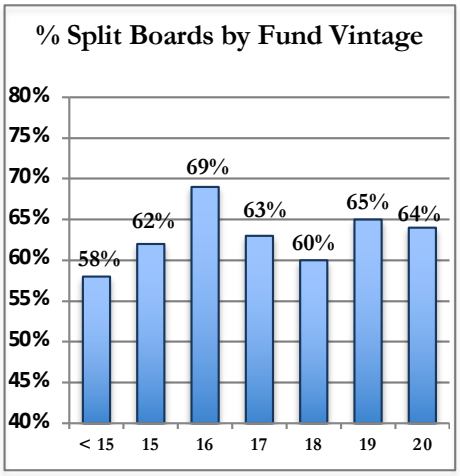


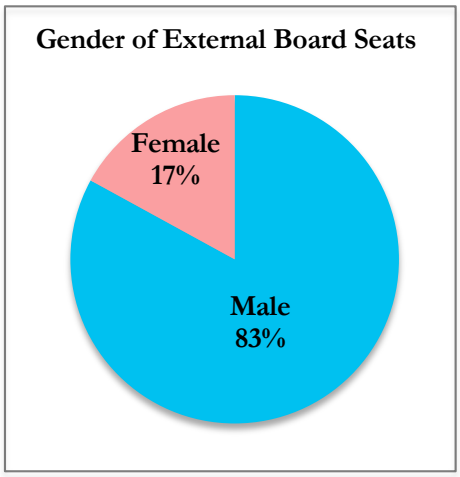


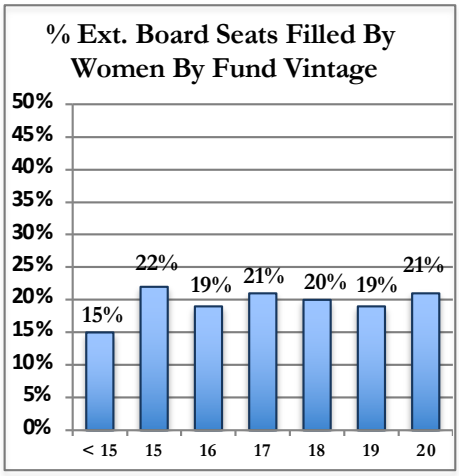


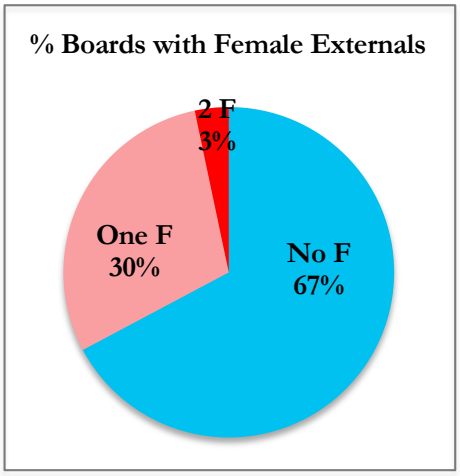












Special Topic: Fund Boards and ESG and DEI

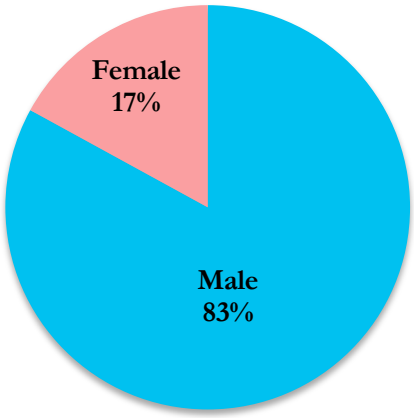
The investment management industry has hit a tipping point with regard to ESG and DEI issues. Boards of directors should be right at the center of that effort. This means the engagement of the boards of directors or advisory boards of the investment managers themselves on these issues. But there is also a value-add place for fund boards. We think the role and involvement of the fund board can have both formal and informal characteristics.

The Formal Role of the Fund Board

To put it plainly, fund boards themselves are an important part of the "G" in ESG. Investors and stakeholders want funds and their boards to be (i) transparent, (ii) operating in the best interest of shareholders, and (iii) navigating conflicts of interest. The most straightforward contribution a fund board can make to ESG is to operate as effectively as possible and follow best practices. But ESG entails more than just good board functioning. More and more frequently, investment managers have made commitments to include ESG criteria in their investment process. This means that boards should be checking in with managers at least annually on how that process is being effectively implemented. Fund directors themselves are urged to begin educating themselves on ESG risk factors and how these might impact the investment process. At SFA, our directors have completed SASB - Sustainability Accounting Standards Board credentialling. If ESG is to be more than a passing fad, it is because everybody holds the process accountable and there is effective oversight. We recognize that the tools for implementing ESG analysis are not nearly as mature and developed as the tools in other areas of the investment world. But this only restates that we are at the beginning of the ESG era, not the end.

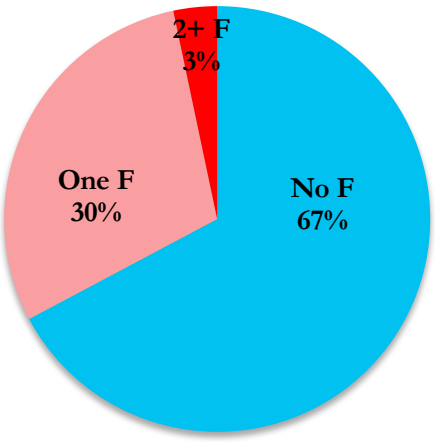
A third more formal contribution that fund boards can make involves both ESG and DEI. Namely, fund boards should emphasize a diversity of backgrounds, perspectives and experiences. Diversity has been one of the areas that SFA has stressed for the past ten years. Fund boards should have people with market and risk experience. Fund boards should have people with accounting and legal backgrounds. Fund boards should have people with administration backgrounds. Fund boards should have men and women. SFA was one of the first groups to highlight gender representation on fund boards in our special white paper in the summer of 2019. We do it again here. (We only track the gender of external directors on these boards.) In 2020, there were 1,693 funds that had external directors and where we were able to get information on the external directors' gender. On those 1,693 funds, there were 3,605 external board seats (i.e., on average, there are 2.13 externals per fund.) Of those 3,605 seats, 611 or 17% of them, were filled by women. And this despite the fact that there are many qualified women in areas that are especially relevant to fund governance.

Gender of External Board Seats



While women only account for 17% of total external board seats, this overstates the scarcity of women on boards. As noted, there are, on average, two external seats per board. There were 33% of funds that had at least one female external director. But very few funds (just over 3%) had two women on their boards, and no funds had more than two female external directors. The cause of the under-representation of "multiple female" boards may warrant further investigation.

% Boards with Female Externals



The Informal Role of Fund Boards

The smartest investment managers realize that if they hire knowledgeable, commercially savvy, and engaged directors, they can use those boards in value-added ways that are not directly related to their formal governance role. For example, managers should be asking their directors for benchmarking information and advice on industry practices with regards to ESG and DEI. The way for the industry to move forward more quickly in meeting the ESG and DEI challenge is for best practices to be shared and encouraged broadly. Because many fund directors work with a number of managers and would be involved in discussions on important ESG/DEI issues, they can be an important conduit for managers that are willing to share information to move the industry forward.

As an example of this, we have one relationship that wanted to improve the DEI performance of their recruiting efforts. The manager only engaged recruitment firms that would guarantee that they saw a 50:50 split of men and women for front office roles. The manager strongly believes that there are interesting female candidates in the market that they were missing because they were being filtered out (for lack of levels of experience or certain degrees). Often, these filters are not as meaningful as one might have expected in advance. This same firm also made sure that the people that interview the candidates had diverse backgrounds. Finally, the firm removed some identifying information from resumes (names, home addresses, etc.) that might result in unconscious pre-judgement.

We are aware of other clients that have taken steps downstream in the recruiting process. One has implemented a "buddy" system, which pairs a candidate with a person within the firm, so they are able to discuss firm culture and processes in a more relatable context. Other firms have implemented better maternity leave for their female staff members, with the goal of both attracting and retaining top talent. In addition, many of these firms have developed cross-training programs that allow women to fully utilize their maternity leave while others capably fill the gaps during the leave time. From a best practice standpoint, this type of cross-training is an important point for those performing operational due diligence on managers.

What else do we as informal advisors to our clients see on the ESG/DEI front? The most common trend is the breadth of investors that are starting to care and ask about these initiatives. The larger institutional investors get a lot of press for their commitment to ESG/DEI, but we observe it at the family office level as well. The next generation of wealth wants their money to match their personal commitments. Because of this, ESG and DEI are now standard parts of investment consultant's operational due diligence questionnaires. In an increasingly competitive landscape, ESG and DEI progress is one way for a firm to differentiate itself.

Hedge Fund Governance Trends: 2020 Industry Data

2020 was the first year in the past five where governance gains appeared to level off. Of course, it's important to remember how far we have come during these past years and that is, in part, the reason for headlining our tenth year of publishing this research report. For the most part, the industry has adopted the most important aspects of best practices with regard to board composition. Almost 90% of funds have external directors – and for those that do, almost 90% of them have a majority of external directors. The industry has also moved in the direction of splitting their boards. Despite offerings from several of the Cayman law firms to package their slate of directors, almost two-thirds of funds with two external directors have directors from different firms. The most common configuration remains two external directors and one internal director. But almost as prevalent is the number of funds where there are only external directors. While we see the benefit in having representation of the investment manager on the board, certainly this trend enhances the independence of external board members.

SEC Director Data

In our description of the current state of governance, we will be relying on calendar-year 2020 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 7,535 funds registered in Cayman Islands as of December 31, 2020 (excluding Master Funds), while our Form D dataset includes 1,963 Cayman funds filing a Form D. Therefore, we are capturing approximately 26% 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 is available in Appendix I.

Board Composition Distribution

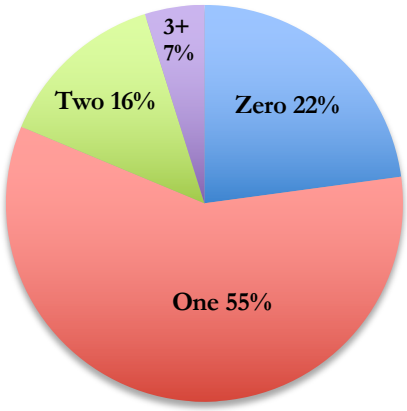
Based on our data, we were able to identify individuals as either internal or external directors. To put it briefly, an internal director either works for the investment manager/advisor or for an organization with an ownership interest in the investment manager/advisor. An external director is anybody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

Number of External Directors	Number of Internal Directors				
	0	1	2	3+	Sum
0		2%	8%	4%	14%
1	1%	5%	3%	1%	10%
2	12%	44%	2%	1%	59%
3+	11%	4%	3%	0%	18%
Sum	23%	55%	16%	7%	

How Many Internal Directors?

Having a single internal director is the most common configuration, though there are still a range of configurations. Boards without any internals has been more common with European and Commonwealth-based managers, but increasingly that model is migrating to US managers. Almost one-quarter of funds now have that configuration. Multiple internals are rare outside of larger asset management firms.

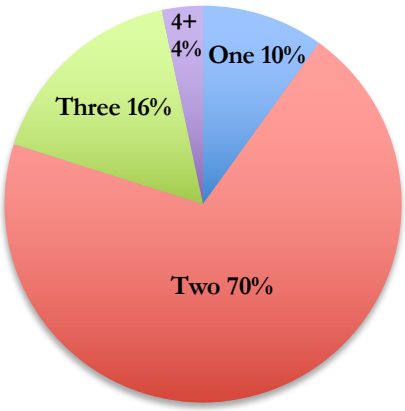
# of Internal Directors



How Many External Directors?

The majority of funds have two external directors. With the appropriate director profiles, this is sufficient for most funds.

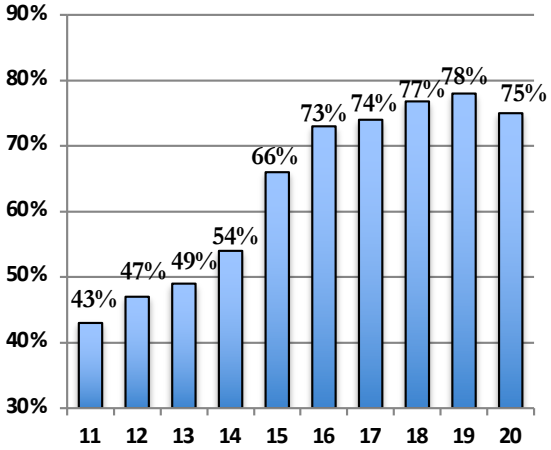
# of External Directors



Do External Directors Have Control?

A very evident trend has been the move toward a majority of external directors. Currently, more than three-quarters of funds have an external majority. This is consistent with practices in Europe and Commonwealth countries which have a much longer history of majority-external boards. UK-managed funds, for example, have external majorities in 90% of cases.

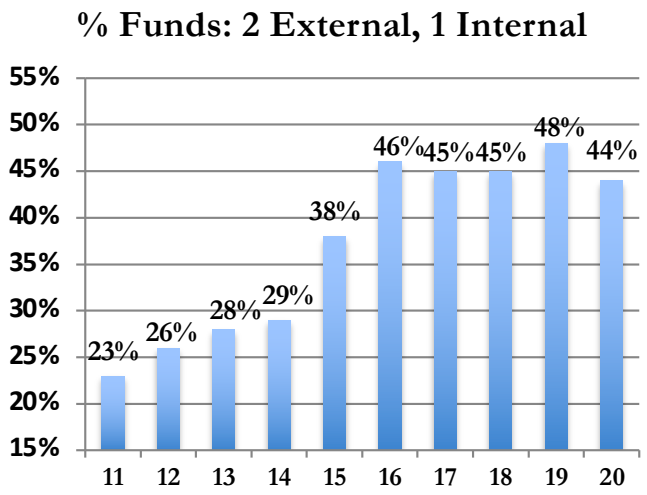
% of Funds w/ External Majority



The Preferred Model

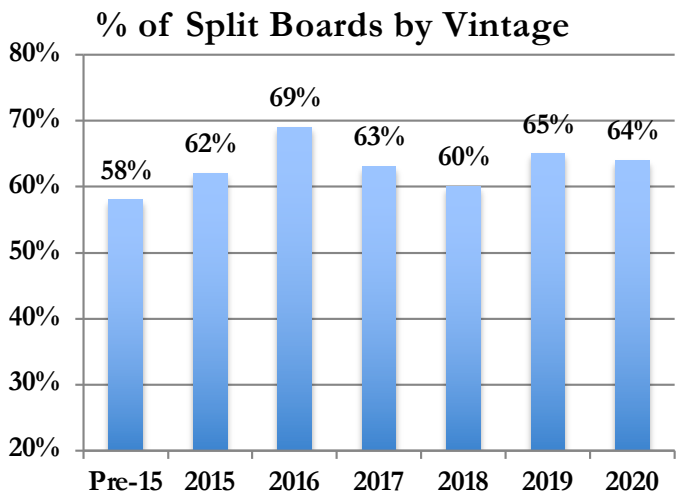
The data for 2020 confirm the continued dominance of a particular fund board profile, namely, funds with two external directors and one internal director. While this has always been a popular profile, currently almost half of existing funds have moved to this configuration. There are a number of possible reasons why this model is increasingly accepted as the new norm. First, the two external, one internal configuration situates the board to tackle conflict of interest issues that may arise regarding the manager and the fund. Second, a three-member board is likely to have several of the important competencies or experience sets essential for good governance (e.g. audit, investments, legal, operations, etc.) While larger funds would benefit from the added diversification of more board members, three members seems like a minimum. Third, with three members, the board can be relatively efficient. Whether it is a realistic concern or not, some managers worry about the board being a procedural impediment to timely decision-making. These concerns are relatively

trivial with three board members. Finally, having two external members is appropriately mindful of the costs of governance. If investors want quality board members (as they should), then funds will need to pay appropriate compensation. Having two externals strikes a good balance between cost and benefit, especially in a fund's earlier years.



External Directors and Split Boards

The quality of the fund board is entirely related to the quality of its people. The best credentials and structure are meaningless with the wrong people. But there are structural factors that can help improve governance. One increasingly accepted method is to have external directors coming from different firms ("split boards"). Having two external directors from the same firm 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 may 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. But the data suggest that managers and investors are recognizing the value of split boards. The chart below shows the percentage of split boards (where there are two external directors) by the year in which the fund was formed. The percentage of funds with split boards has been relatively consistent at 60% or more for the past five years, with 2019 hitting a record high rate of 68%. We expect this number to continue to go higher.



SFA's View on Governance Best Practices

Our website (www. soundfundadvisors.com) features a Research section with our past industry surveys as well as a white paper on Best Practices in Fund Governance. We encourage readers to review this document for a more comprehensive treatment of board practices.

About Sound Fund Advisors

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.

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 2020 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 1,963 unique funds that met these criteria. There are 1,962 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: 1,265 persons
External Directors: 697 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.