Sound Fund Advisors

Best Practice Series
February 2022

Fund Governance Trends: 2021 Industry Data With a Special Report on Governance For Digital Assets Funds

EXECUTIVE SUMMARY

1. We started noticing the emergence of digital assets funds in our data last year, but their growth over the past year now warrants closer examination. We define digital asset funds ("DAFs" hereafter) as funds that predominantly invest in cryptocurrencies, NFTs, decentralized finance or other digital assets. While existing funds, especially in the macro space, have made small allocations in digital assets such as Bitcoin these past few years, increasingly we are seeing funds that are wholly dedicated to digital assets and digital strategies. In this edition, we look at the special characteristics of governance for digital assets and DAFS.

2. There are four topics of special relevance for governance of DAFs that we will address in this paper.

    a) Governance practices at DAFs could still be described as "early cycle." The appointment of independent directors for DAFs, for example, is significantly below what we see in more traditional alternative asset funds. About 40% of digital funds don't have external directors vs 14% of the larger hedge fund universe. Digital funds with external directors are also more likely to have two externals coming from the same firm, another early cycle characteristic.
    b) The leading service providers to DAFs are not always the leading service providers we see with more traditional hedge funds. This may or may not be transitory, as traditional providers adjust to the new business environment.
    c) The nature of digital assets is that they are bearer instruments. This characteristic creates unique custody issues not faced by more traditional funds.
    d) The principals (CIO, CFO, COO, etc.) of DAFs are more likely to come from the technology industry as opposed to the financial industry. This means they bring fresh ideas and perspectives. It also can create differences in practices or expectations.

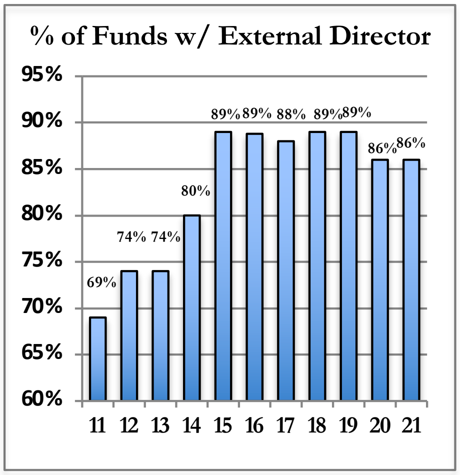
3. In addition to the topics above, this paper will also look at how boards themselves need to adapt to meet the needs of these new digital strategies and assets.

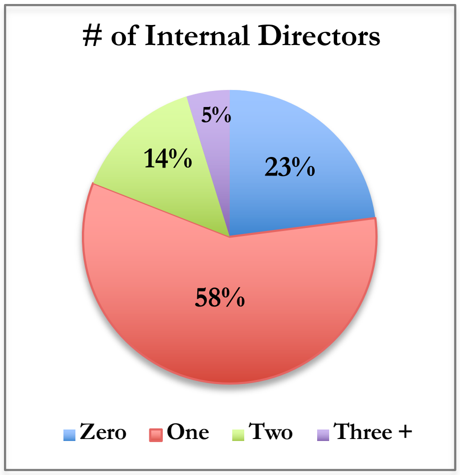
4. We also provide the proprietary, industry-leading benchmarking information on hedge fund boards and their composition and characteristics that have marked our whitepapers for the past ten years.

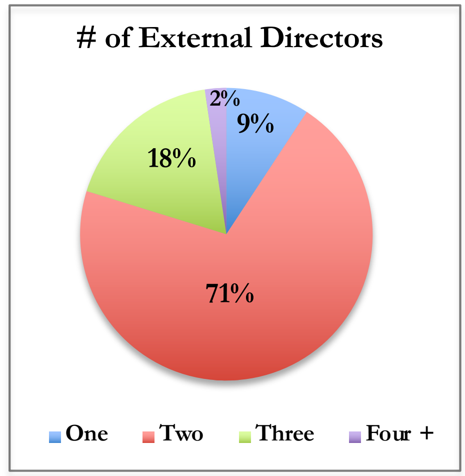
Index to Past White Paper Topics

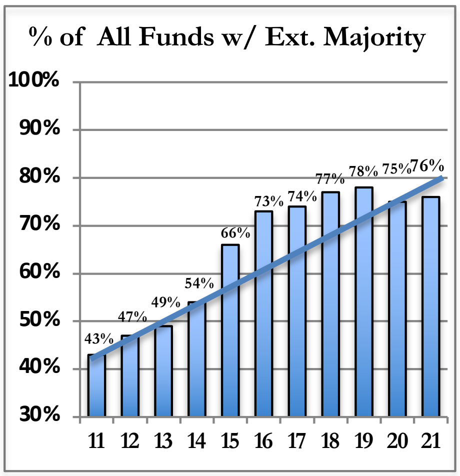
We thought it would be useful to provide readers with an historical index of the topics this whitepaper has discussed in past years. All papers are available on our website at https://soundfundadvisors.com/research

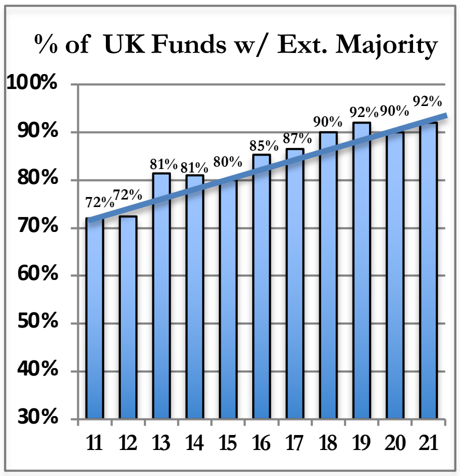
Chart Summary
(Hedge fund universe = 2,164 funds unless otherwise indicated)

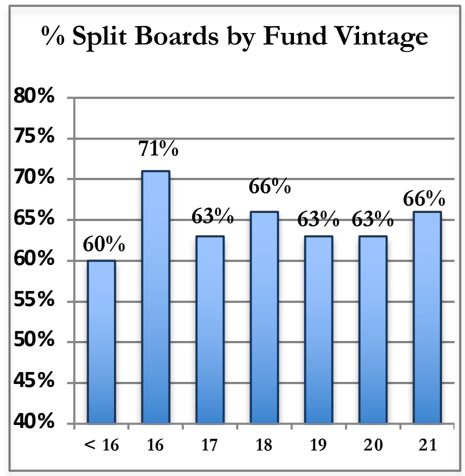


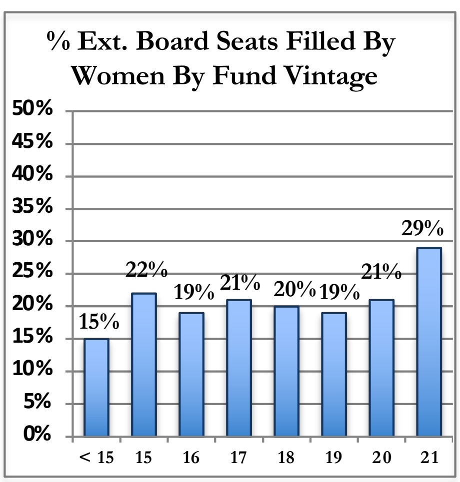


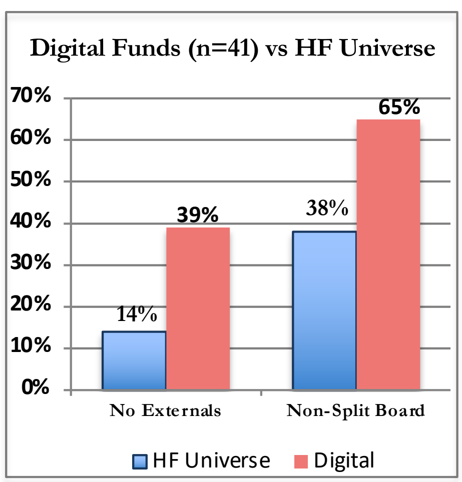


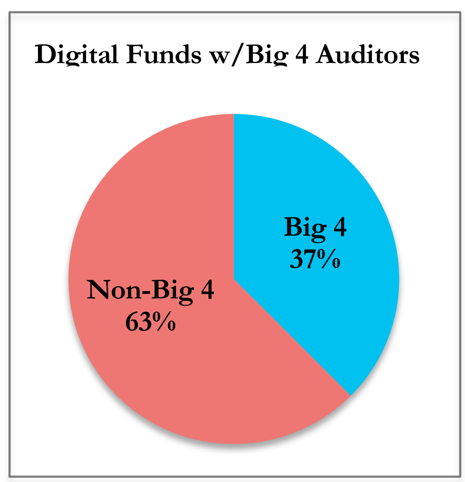












Special Topic: Governance and Digital Asset Funds

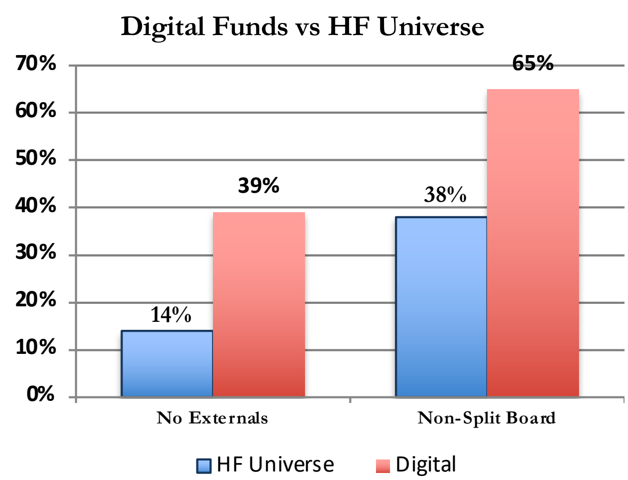
Financial markets by their nature are dynamic. The investment strategies that are dominant today are markedly different, if not in name, then certainly in implementation then they were ten or twenty years ago. Our whitepaper doesn't usually herald the beginning of a new strategy or a new era, and we don't attempt to do that today. But we are noting the growth in digital assets and digital strategies from something quite inconsequential a year or two ago to something more demanding of your attention. For those of us who are focused on governance, the introduction of digital assets, strategies and funds is particularly noteworthy because they present important differences compared to more traditional alternative strategies. We discuss below the four most important differences and then turn our attention to the role that an active board should play for DAFs. Finally, we talk about some of the important steps and decisions involved in setting up a digital fund.

Key Differences Between Digital Funds/Strategies and Legacy Alternative Strategies

As we sifted through our proprietary data set, we were able to identify four important trends in the emerging digital asset sector:

1. **The appointment of external directors by digital investment funds is significantly below what we see in the more traditional alternative asset segment.** One of most basic markers of good governance is the presence of external directors on fund boards. Since 2015, between 86% and 89% of all Cayman hedge funds have employed external directors. In contrast, in 2021 only 61% of digital funds had external directors, lagging the larger universe by 25%. To provide some context, even in 2011 when the majority of our sample were funds formed before the Global Financial Crisis, the percentage of funds with external directors was 69%. DAFs have a ways to go in this regard.

   A second proxy that we use for the maturity of governance is the prevalence of split boards. By split boards, we mean that funds have external directors that work for different firms; that is, the external directors are independent of each other. Our observation about the industry is that early in the hedge fund life cycle, funds add external directors but are also looking to save on costs. Hiring directors from the same firm is a way to economize since many directorship service firms will charge a lower price for a package of directors. However, as funds and the industry have matured and institutional investors demanded split boards, it became difficult even for smaller funds to avoid splitting their boards. Because DAFs have started out with more of a high-net-worth clientele, this pressure has to-date been less acute. We expect as more institutional investors get involved in DAFs that the pressure to split boards will increase.



2. **The leading service providers for DAFS are not always the leading service providers we see with traditional or legacy hedge funds**. This trend is most notable in the independent auditor and fund administrator segments. The Big Four audit firms as a group have been more cautious in embracing DAFs, creating the space for more niche audit providers such as Cohen & Co. or Richey May & Co. to gain a foothold. In the audit space, for example, only 37% of funds in our digital data set are using one of the Big Four (E&Y, PwC, Deloitte

or KPMG). Our data highlights a similar trend in the fund administrator segment, where we see names like Sudrania, MG Stover, and Trident more often than legacy administrators. This is considerably lower than our overall hedge fund universe. These observations may change over time as the larger, legacy players adapt to new assets and new entrants or this could be the beginning of a shift in what is considered institutional for DAFs. In the short-run, these new service providers present institutional investors with an additional due diligence hurdle.

3. **The bearer instrument nature of digital investments creates unique custody issues**. For the active digital investment manager, the trade-off between the safekeeping of assets and the speed/ease of access to assets is more acute than in the traditional alternative strategies. Digital coins, for example, might be kept in cold storage vaults that require multiple steps to make them accessible for live trading. While the industry has rapidly developed custodial arrangements and technology-based solutions to address these issues, the risk of loss in digital investments is particularly acute since transactions once done can't be undone; that is a feature, not a bug in the digital ecosystem. However, the institutions and technology securing digital investments are not as tested as that of traditional investment. For that reason, redundancy and security are significantly larger issues and key focus areas during the due diligence process.

4. **The key principals of digital investment funds are more likely to come from the technology industry as opposed to the financial industry.** Said differently, the leadership of a digital fund is more likely to have been trained in coding than on Wall Street. In many ways this is refreshing. But it also suggests that the principals of digital investment funds may not have experience with the demands of institutional investors. We have noted a desire by these new leaders for guidance and understanding of best practices in order to attract investors. The directors should help play an important role in bridging that gap.

The Role of an Active Board for Digital Funds

The analysis of our proprietary data in combination with our conversations across the digital investment universe suggests that best practices for governance in the digital arena requires a slightly different approach. This approach should be tailored to digital assets and their unique challenges and opportunities. Specifically, we believe an active board can have important responsibilities in the following areas:

Monitoring Strategy, Risk and Liquidity Profile of the Fund – Because the world of digital assets is changing so rapidly, the potential for material changes in investment strategies is significant. At this nascent stage in the evolution of digital assets, this again might be viewed as more of a feature than a bug. But boards will need to work with managers to make sure that material changes are disclosed and transparent to investors. The board of directors will help guide the manager to find the right balance between communicating to investors how the strategy is evolving without unduly limiting the investment program.

Monitoring Service Providers – The investment manager is responsible for daily interaction with third-party service providers such as prime brokers, auditors and legal counsel, but the board will supervise and approve the selection of these providers and interact with them at board meetings as needed. Because many of these service providers may not have extensive experience with institutional clients or institutional-quality boards, the directors will need to work with them to create the infrastructure and reporting necessary for proper oversight. Special attention will be paid to service provider cyber security resources as some DAF providers may be working with smaller IT security budgets.

Valuation – Digital assets can trade 24 hours a day/7 days a week across various exchanges. This creates the potential for complexity in the process of valuing portfolio of digital investments. A properly governed digital fund should have a valuation policy where all roles are 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. The board should do the following: (i) review and approve the Valuation Policy on an annual basis, (ii) confirm on a regular basis with the Administrator that the Valuation Policy is being properly implemented, (iii) review Valuation Committee minutes on a quarterly basis, (iv) approve any exceptions to the agreed-upon valuation procedures, and (v) be aware of valuations on hard-to-value investments.

Audit – The regulatory, tax and accounting standards for digital assets remains remarkably uncertain and largely untested. To manage through this uncertainty, it will be essential for the manager and the board to have an active dialog with the auditors throughout the year. 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.

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Investor Communication - An experienced board can help support a new investment managers' interactions with institutional investors and their consultants. These client conversations are important to foster client retention, especially in strategies where performance volatility may be high. The Board would help interpret and discuss key PPM terms and conditions, service provider performance, redemption and subscription mechanics, conflict management and valuation considerations.

Cybersecurity – Cybersecurity is a threat for any investment fund. While the bearer nature of fund assets poses increased risk, we also note that most funds will custody a significant portion of their assets in cold storage, safe from cyber attack. A more realistic issue might be the emerging tier of service providers to DAFs and their resources and commitment to providing highest level cybersecurity. The board should work with the manager to create and implement institutional level cash controls around the fund and require providers to safeguard both fund assets and client data.

Benefit of Quality Directors Early in a DAF's Life

As funds are preparing to launch, an experienced director can assist the manager with the development of the fund's critical infrastructure. Specifically, the director can help with the areas below.

Service Provider Due Diligence & Selection

The assessment of service providers should be forward looking, especially in the case of the newer service providers serving DAFs. The manager and board should consider the skills of the provider's management, their commitment to controlled growth as well as the skills of the team responsible for the fund. Turnover is a constant issue in the hedge fund industry and should be monitored carefully. Important service provider considerations are listed below.

Fund Administrators - The fund administrator maintains the fund's official books & records, and processes investor NAV statements, subscription and redemptions. Critical steps in selection include:

- Assessing the administrator's experience and systems for the accounting of digital assets. Identify the exchanges, wallets and protocols that the fund administrator can support.
- Reviewing the fund administrator's current SOC report. Take note as to how often the SOC report is produced, and the auditor publishing the SOC report.
- For offshore funds, confirming that the fund's administrator is approved by or registered with the relevant regulator in that jurisdiction.
- Deciding whether to accept fund subscriptions in crypto (in-kind) versus accepting only USD and discussing this issue with the fund's administrator.
- Discussing the AML and KYC procedures performed by the fund's administrator and assessing the quality of the AML officer offering. Understanding the issues associated with portfolio level AML. For example, how is the fund applying AML to the bitcoin it holds?

Custodians – Safeguarding the fund's digital assets (fund private keys) is a critical issue for any DAF. Critical issues include:

- Deciding whether use of a self-custody technology solution, such as Ledger, will be employed. At this point, the industry seems to be moving away from self-custody and towards a full-service custodian model such as Coinbase Custody in the US or HexTrust in Asia, or a multi-party computation (MPC) solution such as Fireblocks or Copper.
- Using a full-service digital custodian may provide comfort to clients more accustomed to investing in more traditional hedge funds but adds to the operational complexities (omnibus vs. named account, SOC Reporting) and counterparty risk.
- For managers expecting to become a Registered Investment Adviser in the US, SEC Custody Rules may impact custody arrangements.

Audit/Tax – Audit and tax treatment are areas of significant uncertainty for digital assets. It is vital to select firms that are well acquainted with the myriad of issues.

- Identify the audit providers that bring digital experience and knowledge that are also respected by sophisticated clients. There may be some flexibility in early periods for audit firms outside the Big 4, but already the market is creating a tier of digital audit firms.
- Managers need to understand the tax issues associated with their strategy. For example, there may be ECI or UBTI issues for some investors and in some digital strategies.

Legal – The creation of the fund's organizational documents, such as the PPM, LPA and Articles, by a law firm (and often by offshore counsel as well) is likely the largest expense incurred when launching a digital fund.

- Interview law firms that have experience with both digital investment funds and traditional institutional hedge funds.
- Staying organized and efficient when working with your legal provider can help the fund launch stay on time and on-budget
- An experienced independent director can work through legal documents and can help you navigate the key sections of your PPM and the digital investment management agreements.

Creation of Key Policy & Procedures Documents

Before making an investment, institutional investors may perform an operational due diligence (ODD) review. A key part of the ODD will be a focused review of the Fund's organizational documentation. An experienced director with a background in operations can assist the investment manager in the design and documentation of the control environment and review the PPM help to identify and solve for any potential conflicts.

Control Environment: The core documents that form the foundation the operational controls can include:

- Due Diligence Questionnaire (DDQ)
- Valuation Policy
- Cash Movement Policy
- Private Key Custody Policy

Conflict Identification and Management: Getting the fund's key PPM investment terms right and identifying potential conflict areas early is critical. Areas to be addressed are:

- The fees and rights for share class offered;
- The potential need for side pocket language for illiquid investments; determine if the target investor can invest in a fund with the ability to side pocket;
- Scenario analysis around fund gate mechanics and contrast against using an investor level gate; and
- A side letter policy and a tracking protocol to ensure compliance.

Best in Class Board Composition

An institutional, best-in-class DAF will be anchored by a properly constructed board of directors. Even the best governance policies and procedures will be ineffectual in the hands of a group of disinterested or conflicted board members. We believe that best practices in board composition for a digital investment fund involves the following:

- A board composed of representatives of the digital investment manager AND unaffiliated, independent directors. Independent directors, by definition, should be independent of the digital investment manager and optimally other directors.
- The digital 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 digital investment manager should be represented on the board.
- In order to provide meaningful oversight, the independent directors should have relevant experience related to the core operations of an investment fund. The fund board of directors is not the place for the digital investment manager's close industry or developer network; that is better suited for an advisor role to the investment manager. As for the independent directors of the fund, their areas of functional insight should be focused and oriented toward experience in operations, investment risk management, operational due diligence, audit, legal, regulatory or fund administration.
- 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.
- Director compensation should be set relative to the amount of work involved in the assignment and may differ from director to director based on their level of experience and expertise. As with most things in life, you get what you pay for. Be skeptical of directors charging below market fees; they are likely compensating for their low fee carrying an excessive load of clients. While rates can vary, a good benchmark rate for a high-quality independent director is $25,000 to $30,000 per annum.
- While professional independent directors are non-exclusive and will work with a number of funds, the capacity of a director should allow them to devote significant time and attention to your DAF, especially during periods of market or business volatility. The independent directors should be transparent about the number of assignments they have both to the digital investment manager and investors.
- While Zoom meetings have become ubiquitous in our lives today, independent directors should be willing and able to travel to meet the digital investment manager and participate in face-to-face board meetings at least once per year. There is no substitute for spending time and being with the manager and other board members.

Hedge Fund Governance Trends: 2021 Industry Data

The governance landscape has been relatively stable for the past several years. If anything, we notice a slight degradation in our quality metrics. This seems likely driven by two factors. The first is the increasing prevalence of funds in Cayman that are sponsored by high-net-worth RIAs. These funds almost by definition don't have institutional clients and therefore tend to have non-institutional set-ups. The second reason, as discussed in detail in this paper, is the emergence of digital funds that are still early in their life cycles. As this segment becomes more institutionalized (as seems inevitable), we expect practices to improve. As it stands, 85+% 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 also 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

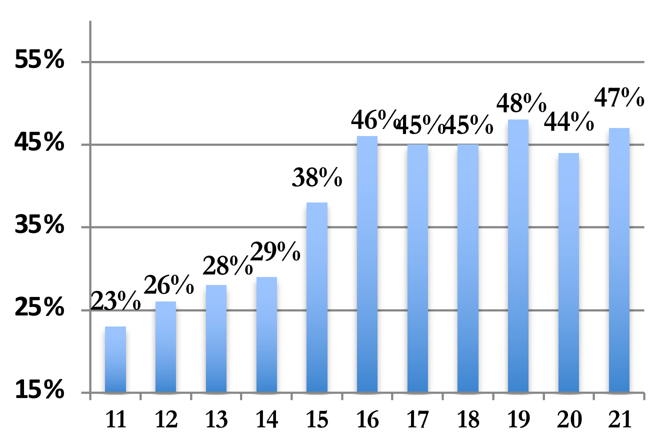
In our description of the current state of governance, we will be relying on calendar-year 2021 data made available by the US Securities and Exchange Commission ("SEC"). Some offshore funds file a Form D or D/A (an amended Form D) with the SEC -- typically to allow them to issue securities exempt from 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 8,499 funds registered in Cayman Islands as of December 31, 2020 (excluding Master Funds), while our Form D dataset includes 2,164 Cayman funds filing a Form D. Therefore, we are capturing approximately 25% of all Cayman funds. We should also note that our data may be overestimating the quality of hedge 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 Internal Directors				
		0	1	2	3+	Sum
Number of External Directors	0		3%	8%	3%	14%
	1	1%	4%	2%	1%	8%
	2	11%	47%	1%	1%	61%
	3+	11%	4%	3%	0%	17%
	Sum	23%	58%	14%	4%	

% Funds: 2 External, 1 Internal



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.

Ed Littmann is a director of SFA. Ed has spent nearly 15 years in the alternative investment industry, serving in senior roles as a hedge fund chief operating officer as well as a professional hedge fund investor. Ed was a Founder and the Chief Operating Officer of a hedge fund based in Hong Kong, serving in this role from 2017 to 2021. Ed built and managed all aspects of the hedge fund operations including the day-to-day fund and management company operations, compliance and investor relations. From 2006 to 2017, Ed was an Investment Strategy Head for Mesirow Advanced Strategies, a global fund of hedge funds, in both the United States and Hong Kong. His responsibilities included manager investment and operational due diligence, strategy analysis and manager monitoring. Ed previously worked in the equity research department at William Blair & Company and as an investment professional in family office, having started his career as a financial statement auditor at a Pricewaterhouse Coopers (PWC). He received a B.S. in Accounting from Purdue University and a M.B.A. from the University of Chicago. In addition, Ed was a CFA charter holder and a Certified Public Accountant (CPA).

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 2021 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 2,164 unique funds that met these criteria. There are 2,210 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: 1,454 persons

External Directors: 767 persons

Manager Location

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.

Digital Funds

The digital funds in our database were originally identified by screening for common terms (e.g., digital, crypto, bitcoin, etc.) and then verified through publicly available information, including Form ADVs.