



Best Practice Series

March 2023



Fund Governance Trends:
Introducing the 3.0 Director



The 3.0 Director

In previous papers, we have identified data driven trends in governance for the alternative investment industry over the past 12 years. In this Special Topic paper, we have turned the spotlight to ourselves, as directors, and discuss the evolution of the professional director model from the pre “GFC years” to the present. In doing so, we have identified three different iterations of the professional director and discuss some of the key changes that have occurred as both the approach to governance and the fund industry has matured. Finally, we discuss how the composition of the Board can be strengthened by including directors not only from different firms (the traditional split board) but also from these different models.

Below, we broadly define each of the models:

1.0 Directors: Prior to 2008, these directors were largely based in the offshore jurisdiction of the fund and were often affiliated with law firms or administrators. Director services were typically provided at low cost, as an add-on service to meet regulatory requirements. A director might have, what would be considered today, a very large book—possibly up to 100 manager relationships.

2.0 Directors: In the post GFC world, the number of experienced directors entering the industry increased significantly, as managers sought input from directors who fulfilled more than just an administrative function (i.e., the 1.0 Director). These directors often had varied backgrounds, including some with direct hedge fund experience. Both knowledgeable and skillful, the entrance of these directors to the governance landscape helped raise the bar across the industry. These directors were also generally full-time directors, focused solely on their role. Many would be part of a professional director firm specializing in governance and would typically have a medium to large-sized book, with approximately 15-40 manager relationships.

3.0 Directors: These are what we consider a multi-disciplinary director, as their sole role is not to serve as a professional director; rather, it is part of a portfolio of roles in the alternative investment industry that allows them to bring added experience and current perspectives to their role as a director. Such roles could include, for example, providing operational due diligence (“ODD”) services to institutional investors, or providing fund formation consulting to investment managers. Their involvement in complementary and active roles, combined with their fund governance experience, is their unique “value-add.” These 3.0 Directors typically have a smaller portfolio (in the range of 10 to 15 manager relationships), where they offer more of a consultative governance approach to the Funds they serve.

Benefits of the 3.0 Director Model

Given the increased role we expect 3.0 Directors to play in the industry going forward, the following is a discussion of some of the key benefits they provide:



1. Leverage of current and evolving industry knowledge and networks.

The 3.0 Director's diverse work experience, external to governance, often gives them a unique vantage into the forefront of operational best practice in the alternative investment industry. Their work entails detailed inspection of operational processes such as the compliance function, cash controls, cybersecurity policies and procedures, culture, staffing, service providers, mitigation of conflicts and other operational issues. Drawing from their present-day experience, the 3.0 Director can assist the manager in identifying and proposing actionable solutions to problems that might exist or arise (e.g., tightening inadequate cash controls, mitigating poor segregation of duties, or advising on technical expense allocation issues).

2. An increasingly collaborative and consultative approach

The 3.0 Director can enhance value to the board by creating a more collaborative partnership with the manager than might traditionally exist. The manager can consider 3.0 Director as a valuable resource to be called upon regarding any concerns relating to their wider operational ecosystem, not just shareholder issues.

An example could be the 3.0 Director leveraging their understanding of what systems, policy and procedures, and governance framework are most appropriate for each size and stage of the manager. These factors tend to change as the manager grows and a 3.0 Director is well positioned to advise the manager of what would be "best fit" in the current marketplace.

Another area of potential value would be a 3.0 Director's guidance to the manager in the service provider identification, evaluation, selection and ongoing diligence phase. Traditionally, prime broker consulting teams or lawyers might provide introductions to a standard set of industry vendors, typically legal, audit and fund administrators. As a 3.0 Director is still fully "plugged in" and may have undertaken detailed RFPs on a range of service providers for clients, they can be helpful in the identification and evaluation of more specialized vendors (e.g., outsourced back office/CFO services, cybersecurity firms, PB contract management specialists).

3. Commercial insights from the Investors' perspective

The 3.0 Director can help the Board and manager understand the evolving interests of investors in a variety of cultural and policy initiatives. For instance, they may note that an increasing number of investors want to see that managers have implemented sincere, effective ESG and DEI policies. A 3.0 Director, who reviews such policies on regular basis and is communicating with investors and other industry participants on these topics, is well-placed to help a Board and manager understand these evolving policies and how to structure and improve them in a way that keeps up with the rapidly changing marketplace.



Questions for the 3.0 Director Model

SFA believes in the value of having a 3.0 Director serve along side a 2.0 Director for most hedge fund boards, and we have organized our professional service offerings accordingly. That said, we recognize that certain questions ought to be addressed regarding the business model of the 3.0 Director.

1. Experience: Large portfolio vs. small portfolio?

A manager might question how the experience gained from sitting on a large portfolio of boards (1.0 and 2.0 Directors) compares to that of the 3.0 Directors who maintain a smaller book. It is undoubtedly true that the broad view gained from sitting on a large variety of boards is of great value, lending those directors good insight into a range of funds and strategies. However, one of the 3.0 Director's key strengths is the marriage of their governance experience from their select boards combined with the deep and current knowledge gained from being an active industry practitioner. An example of this knowledge gap could be the difference between a director who reviews the compliance review at a Board meeting to one who is actively involved in examining a manager's compliance function. The ability for the manager to access that level of detail and expertise on a current issue is what is inherently valuable about the 3.0 Director.

2. Conflicts: Is independence compromised?

Another area of focus for a manager might be management of conflicts between the Fund and other parties with whom the 3.0 Director has working relationships. It should be emphasized that independence remains top-of-mind for the 3.0 Director. At the initial onboarding, the 3.0 Director will identify any relationships it has with firms and then seek to mitigate the conflict by excusing themselves from the board appointment if there is an existing relationship in place with the Fund or manager.

3. Balancing Act: Is the 3.0 Director spread too thin?

There might be some question as to how 3.0 Directors manage or balance their commitments between their directorships and their other work practices. Managing capacity is an issue that all directors face, but having work in different areas helps clarify the importance of those commitments. We believe that effective 3.0 Directors will need to prioritize their commitment to governance. Fortunately, since many of these external roles are by nature, part time, it allows the 3.0 Director to balance those professional commitments with great care.

Conclusion

3.0 Directors engaged in complementary endeavors/roles can be more consultative in their approach, providing the manager with the most up-to-date, essential industry knowledge and best practice. We believe the path forward to developing a stronger and more established Fund governance framework includes the leverage of a 3.0 Director—in conjunction with the experience of the 2.0 Director—to help guide the funds through an ever-changing path.



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).