

Now is the time for everyone involved in the hedge fund industry to re-address due diligence and to be mindful of corporate governance, says **Gavin Gray** of Phoenix Fund Services

# Corporate governance

**T**here are many factors to be considered by managers in choosing a hedge fund structure. Equally there are many factors to be considered by investors when choosing which hedge fund to ultimately invest in. Increasingly, investors have come to expect that the hedge funds they invest into adhere to sound principles of corporate governance. This is an expectation that will be only reinforced with news of an alleged fraud of US\$50bn, perpetrated by Bernard Madoff, the principal of Bernard L. Madoff Investment Securities, with respect to a hedge fund run by him.

It is therefore an opportune time for investors to revisit their due diligence with respect to the hedge funds they are invested, mindful of the principles of corporate governance. It is also a time for funds themselves and in particular their directors to ensure there exists a framework of corporate governance to reassure investors and counter the risk of fraud.

Central to the notion of corporate governance is the relationship between the board of the fund and the investors and the development of a system of internal control to serve the needs of both by directing and controlling management activities in a fair and transparent manner.

The complicating factor in the world of hedge funds is that the funds themselves are set up at the behest of the manager. What has led to the current alleged problems with Madoff, and famously before with the collapse of Long Term Capital Management (LTCM) some ten years ago, is the lack of information available to investors and the unavailability of genuine inde-

pendent third-party verification. It is this lack of transparency and accountability that corporate governance can act as a buffer to.

The following considerations can therefore mitigate some of the risks inherent in investment as thrown up by Madoff.

## The appointment of service providers

### The administrator

Hedge funds typically appoint independent third-party administrators to provide valuation, transfer agency and, in some cases, corporate secretarial services.

With the appointment of an independent third-party administrator, the board delegates valuation to the administrator and retains oversight of any valuation issues that might occur. It has become best practice for funds to adopt valuation policies which are a summary of "practical and workable valuation practices, procedures and controls" as referenced in AIMA's useful *Guide to Sound Practices for Hedge Fund Valuation*. Many administrators are separately using pricing policies which are then adopted by funds. These outline a framework within which the administrator can provide its valuation service.

The appointment of an independent third-party administrator will provide comfort to investors that, in particular, the valuation of the fund is being carried out by an independent entity. This is to mitigate against manager pricing. Oversight by the board of valuation, as well as the adoption of valuation and pricing policies as referenced above, all provide greater transparency and accountability for investors.



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However, while it is a requirement in offshore jurisdictions that a fund retains a separate administrator, this is not the case for US funds where the majority are established as limited partners with a general partner often being the manager which also values the fund. It is with this self administration as practised by many US managers that the potential risk lies for investors as borne out by the Madoff case.

### The auditors

The appointment of an experienced and reputable audit firm is essential. Clearly this extends beyond the bigger firms with smaller firms able to also offer experience in market and strategy. In the context of sign off of financials, delays in sign off can often be a red flag to any issues within the fund.

It is important for investors in their due diligence to identify and satisfy themselves as to the credentials of the auditor firm which will be ultimately signing off on the financials.

In the case of Madoff, there seems to be have been a mismatch between a company with three employees, such as Friehling & Horowitz, who were the auditors, and Madoff's high profile business. Reports are that Friehling & Horowitz consisted of one partner in his 70s who lived in Florida, a secretary and one active accountant.

### The prime broker

In some way this is where Madoff differs to similar scandals in the past in this sphere in that Madoff allegedly acted as prime broker/custodian and executed all trades through his broker/dealer. A reasonable due diligence process by investors should generally highlight the limited oversight implicit in such a structure.

### Board of directors

To avoid tax, most hedge funds managed by European managers are domiciled offshore in locations such as the Cayman Islands, Bermuda or BVI. In recent years there has been a concerted effort by European managers, which has been admittedly tax driven to ensure these offshore funds have

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regular board meetings with an increased use of independent directors, not connected to the manager or any of the service providers. By ensuring that "central management and control" remains offshore, any potential of a fund been brought onshore for tax purposes is mitigated. Increasingly though this has become less of a 'cosmetic' exercise and more an exercise in the practice of sound corporate governance with the benefits this brings for the fund itself and its investors.

It is important to note that the push towards corporate governance in the form of regular and substantive board meetings is not so typical in the US where the boards are more "manager-centric".

### Independent directors

As summarised by AIMA in its popular *Offshore Alternative Fund Directors Guide* most recently updated this year, "Best practice for any fund would be to have a majority of independent offshore directors and to avoid appointing directors who represent the advisors or service providers to the fund because of the potential for conflicts of interest".

It is the ability of directors to be objective and unbiased that is important for the protection of investors interests to whom they owe a fiduciary duty. It is times of crises such as now with funds experiencing liquidity problems and closure in certain instances that having directors with the ability, experience and independence necessary to tackle these issues is crucial. This proper oversight also mitigates the risk of fraud occurring.

### Board meetings

Board meetings should be held regularly and industry practice seems to

be at four meetings a year. Many funds will have at least one physical board meeting every year with the rest by telephone conference call. Certainly larger European managers have moved to three/four physical meetings a year to facilitate the more effective oversight of the fund. It is worth noting that some administrators and law firms act as corporate secretary to the funds to facilitate the smooth running of the meetings, preparation of board packs for participants and timely distribution of minutes after meetings have taken place.

We have, in summary, seen in recent years a general trend by European hedge fund managers with offshore funds towards increased self regulation. This self regulation has been tax driven to a degree but has resulted in a relatively healthy culture of corporate governance, whether it be the increased holding of regular and independent board meetings, the use of independent third-party service providers or the opening up to investor due diligence.

The concept of self regulation has been reinforced by hedge fund managers themselves recently it terms of "high quality best practice standards" as espoused by the UK Hedge Fund Working Group in its January 2008 report, entitled *Hedge Fund Standards and the US Presidents Working Group on Hedge Fund Standards*.

However, while the 'European manager offshore fund model' has embraced corporate governance, the lines remain blurred in the US with self administration and more manager remit over board functionality.

It is with this dichotomy in mind that investors need to demand more from the industry to counter the threat of fraud as has allegedly taken place in the Madoff case. It is ten years since LTCM and the question remains: what has the industry learnt in that time?

As long as there are investors willing to invest, there will be those who will seek to take advantage. Investors need to be more vigilant and heed the oft quoted line "Caveat Emptor".