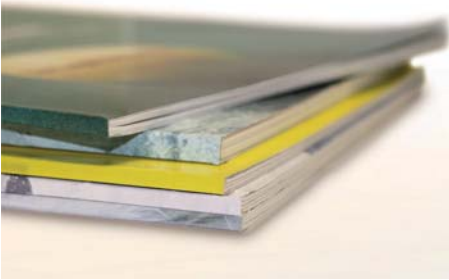


Corporate Governance of Funds – No Small Task for Directors



BY TANYA KOZAK

Corporate governance is a term that broadly refers to the rules, processes, policies and laws by which companies are directed and operated. Within any company the structure of its corporate governance is shaped by the laws and regulations of the jurisdiction in which it is incorporated.

Recent turmoil in the financial markets and fraud in the funds industry have resulted in investors paying closer attention to corporate governance issues and the role of directors on investment fund boards. Some institutional investors may even require that certain standards of governance be in place before they will invest in a fund.

Corporate governance of funds differs from managed portfolios and public companies in a number of ways. A primary difference is that the offering of interests in a fund is often restricted to qualified investors; (that being high net worth individuals, sophisticated investors or institutional investors). As a result, funds have reduced reporting requirements and disclose extensive risk factors to potential investors. The use of extensive leverage and arbitrage investment techniques are but two examples that distinguish hedge funds from mutual funds and other traditional investment structures. As a result of the foregoing, corporate governance issues and the role of a fund's directors raise unique issues that require consideration when

assessing whether a fund has appropriate corporate governance mechanisms in place.

Another aspect that makes corporate governance of a fund distinguishable from other corporate entities is that funds do not fit the traditional corporate model of having a centralised office from where all employees, directors and management collectively operate on a daily basis. The day to day business of a fund operates through the delegation of the majority of its operations by the board to various service providers. Generally, the day to day operations of a fund are delegated to the investment manager of the fund. Net asset value determinations and the acceptance of subscriptions and redemptions are most often delegated to an administrator. Auditors, prime brokers and advisors are also outsourced. This is done in part to create an effective, cost efficient corporate entity that utilises specialised skill and expertise of various financial service providers in the funds industry. However, it is far from reality to conclude that the role of a fund's director is diminished due to the extensive delegation of duties.

Pursuant to a fund's constitutional documents, directors may delegate most operational functions and roles and can rely upon the opinions and advice of others, but directors are not able to escape responsibility in respect of such delegation. Rather,

directors remain responsible to oversee and regulate the tasks that they have delegated to others. Their responsibility to do so is part of a director's overarching fiduciary duty. Under Cayman Islands law, directors are to consider the best interests of the fund as a whole and not the best interests of any one shareholder.

A director's duty to ensure corporate governance mechanisms are in place and the duty to act in the best interest of the fund is rooted in long standing principles of English common law. Accordingly, the duties of a director fall into two broad groups: the duties of loyalty, honesty and good faith (known as fiduciary duties), and the duties of care, skill and diligence. In practice, corporate governance for a fund requires the board of directors to be in close consultation with the investment manager. With the increasing institutionalisation of funds, the trend towards increased disclosure and more rigorous corporate governance is acknowledged by both directors and investment managers.

The role of directors of a Cayman Islands incorporated fund is of particular importance as many Cayman Islands funds engage professional service providers to act as non-executive directors. However, it is important to note that whether the directors are executive directors (having involvement in the day-to-day management of the fund) or non-executive directors (not being involved in the day-to-day management of the fund) there is no legal distinction under Cayman Islands law between executive and non-executive directors. Non-executive directors have the same legal duties, responsibilities and potential liabilities as their executive counterparts.

One of the unique features in fund corporate governance is the recent rise in activism from investors. Investors who have experienced illiquidity in their investments, material drops in net asset values and uncertainty in the markets have begun to take a more active stance in the funds in which they have invested. If the constitutional documents of a fund so permit, mainstream institutional investors may requisition to remove board members and place their individually selected members to sit on the board of directors.

Accordingly, the role of directors and the corporate governance principles in place have been under increased scrutiny.

A best practice approach for any fund would be to consider having independent directors and to avoid exclusively appointing directors who represent the service providers or financial advisors to the fund. This is due to real and potential conflicts of interest between a director's duty to the fund as a whole and the interests of the service providers that they are associated with. Increasingly investors are of the view that director independence is an essential and critical element of a fund's board of directors. At a minimum, directors should ensure that if any conflicts exist they are fully disclosed to the fund's investors and fellow board members and if necessary a director must excuse himself from any discussion or voting that may relate to a particular subject or issue that relates to the conflict of interest.

Investors are also taking notice of a fund's care and due diligence in selecting qualified directors. Good and effective directors are drawn from a variety of skills and experiences. The directors of a fund must have an accumulated collective expertise to understand the nature of the fund, the industry in which it invests, its risk profile and other relevant issues. Recently, investors have also questioned whether professional directors with extensive directorship portfolios have sufficient time, resources and attention in order to properly attend to the affairs of each individual fund.

In today's economic climate, acting as a director of a fund is not made easier by the fact that many responsibilities are delegated out of the hands of the directors. Good corporate governance helps to enhance a fund's reputation and credibility, making it more attractive to all interested parties. Potential investors and service providers undoubtedly prefer dealing with a fund that is well governed and well run. Funds that employ high standards of corporate governance, especially in the areas of transparency and disclosure, are more marketable and are likely to be more sustainable in the long run. It is not surprising that good corporate governance has become a hot-topic for investors because of the financial crisis and it

should now become the norm. Lessons learned will result in more attention to the importance of good governance and the important role directors have in watching over the complexities involved in the operations of a successful fund.

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