Understanding the Role and Duties of Hedge Fund Directors: A Discussion with Appleby Partner Alex Brainis

Investors and regulators have increased their focus on the quality of governance on hedge fund boards in recent years. As the composition of hedge fund allocators has shifted from high net worth investors to institutional investors, the latter have expanded the purview of traditional due diligence on hedge fund managers to encompass evaluation of board governance, as well as directors’ experience and oversight of risk management, valuations, operational controls, transparency and the investment process. According to some sources, the results of the heightened review have become almost as important as managers’ performance. Institutional investors, seeking to standardize governance practices across hedge funds, have also lobbied regulators for additional investor protections.

The Cayman Islands Monetary Authority, the primary financial regulator in the top offshore hedge fund domicile, in particular, has responded. CIMA has issued guidance on the roles and duties of hedge fund directors that sets forth best practices and establishes minimum governance standards for fund boards. In addition, in 2014, CIMA promulgated the Directors Registration and Licensing Law, which sets registration obligations for directors of most Cayman hedge funds and licensing requirements for “professional directors” appointed to 20 or more boards.

In light of investors’ and regulators’ attention on hedge fund boards and governance standards, The Hedge Fund Legal & Compliance Digest recently sat down with Alex Brainis, a partner in Appleby’s Cayman Islands-based funds group, to discuss the role of hedge fund directors, oversight, the duties directors owe to both funds and managers, decision-making models for boards and the regulatory standards applicable to hedge fund directors.

Duties of Hedge Fund Directors

What is the role of a hedge fund’s board of directors?

In general terms, if you look at the derivation of directors’ role, it arises as a consequence of the fiduciary relationship between the director and the fund. From a regulatory perspective, in its Statement of Guidance, the Cayman Islands Monetary Authority sets out specific elements detailing what constitutes management of certain business activities of funds. These include an oversight function component that sets out that the board of directors is ultimately responsible for overseeing and supervising the activities of the fund. The board of directors should regularly monitor and take steps to ensure that the fund and its service providers are conducting the affairs of the fund in accordance and compliance with the fund's defined investment criteria, investment strategy and restrictions, as well as with all applicable laws and regulations. The board of directors should receive regular reporting from the investment manager and service providers to ensure that they are able to make informed decisions and adequately oversee and supervise the fund.

Directors of funds must also ensure that the fund’s offering documents adequately and accurately disclose conflicts of interest.
What is the scope of boards of directors’ fiduciary duties, and are duties owed to the fund alone or to investors?

There are obviously fiduciary duties to act in the best interest of the fund and to exercise powers under the articles or constituted documents of the fund for the purposes for which they are conferred to avoid conflicts between the interests of the fund and the directors’ personal interests and duties. To the extent that any such conflicts exist, they must be properly disclosed to exercise powers as a director independently. Directors also have a duty to not make any secret profits from acting as a director of the fund.

There are also duties of skill and care, and there are statutory obligations. In terms of the duties of skill and care, directors must acquire and maintain a certain degree of knowledge concerning the business of the fund, on a continuing basis. They need to have a good grasp of what the fund does from an operational perspective in order to supervise and discharge the functions which have been delegated to other service providers.

There are also statutory obligations which go into maintaining the register of members or directors and officers; proper books and accounts for the fund; and a registered office in the Cayman Islands for the fund. In addition, there are statutory obligations to comply with any anti-money laundering regulations issued under local laws and regulations; to ensure the offering document issued by the fund describes all matters pertaining to the fund in all material respects and contains such other information necessary to enable an investor or prospective investor in the fund to make an informed decision as to whether or not to invest in that particular fund; and to update the offering documents to take into account any material changes. Also, from a statutory perspective, board directors need to ensure that the fund is audited on an annual basis and must comply with any reporting obligations, including notifying any regulators of any changes in the directors, officers or registered office of the fund.

These duties I’ve outlined are derived from English case law. They are ultimately owed to the fund but can, in particular circumstances, be owed to creditors or individual shareholders. In the ordinary course of business, the interests of the fund can be equated to acting in the best interest of the fund shareholders as a whole. However, once a fund becomes insolvent, a director must take into account the fund’s creditors when discharging their duties.

What are the repercussions for breach of a director’s fiduciary duties?

The breach of the director’s duties is a fairly rare occurrence. However, there are different types of breaches, including breach of statutory duties. As I mentioned, there are various laws that impose certain duties upon a director of a fund, and some of these duties are sanctioned by criminal penalties, imposition of a fine and/or a custodial sentence. Many of these duties are imposed upon the directors, so if a fund is in breach of a duty or obligation, the relevant legislation may impose penalties on any officer of the fund, which includes a director, who is in default. Directors will be in default if they knowingly and willingly authorized or permitted the defaulted action.

There is also breach of fiduciary duties owed to the fund, and directors may be found personally liable to the fund in damages. If there are negligent misstatements or fraud—and there are a range of offenses relating to those—there are criminal and civil penalties that can be imposed. In the event of gross negligence, there is personal liability associated, and actions can be brought against directors by various parties, including the shareholders of the fund. But generally, the repercussions are very case-specific.

What is the decision-making process for directors when a hedge fund manager presents them with a conflict of interest or unexpected situation?

Directors do have obligations to oversee the fund and its operations. Typically, directors are in a position to determine, depending on the circumstances, what constitutes “in the best interest of the fund and investors.” It would obviously involve a fairly collaborative process between the manager and the directors. While very circumstance-specific, typically, the oversight duties and responsibilities are exercised by the directors first and foremost. An example is where there is a split board, and a director/principal of the manager is also on the board of the fund. The fiduciary duties of the directors may compete with or be different
from the interests of the manager. In such situations, the directors should have regard to their obligation to act in the best interest of the fund and seek to resolve the conflict fairly.

**What situations should be brought to directors for review and guidance?**

You would have to look at the stage in the lifecycle of the fund. Directors get involved at an earlier stage when it comes to establishing the fund. As part of that establishment stage, directors typically satisfy themselves that the overall structure of the fund and the terms of service provider contracts are reasonable and consistent with industry standards. They would conduct a review of all fund governing documents, which includes the offering document, the articles, the subscription agreements and any other material agreements that involve the launch of a particular fund, and provide extensive comments on those documents to make sure they’re consistent with what the directors have seen in the industry. Directors are also collectively responsible for the contents of the offering document, which is the main disclosure document of the fund. Directors have to make sure the offering document is accurate and not misleading upon launch and on an ongoing basis.

In the next stage, which is the ordinary course of business, directors typically perform a high-level supervisory role. They hold regular board meetings, and they request regular reports from specific service providers.

**What interaction do board directors have with fund counsel?**

At the launch stage, any interaction with counsel is really one of collaboration, in terms of document review and providing comments in connection with those documents. From an ongoing perspective, there may be some collective reviews or issues associated with side letters or other documents that are brought forth that may require review by both fund counsel and directors.

Where greater interaction is involved with counsel is crisis management. There are some issues—such as any pending or threatened litigation against the fund, any disputes with investors or counterparties, any outstanding redemption requests—that have significant impact on the NAV. In addition, any ERISA or pension-related matters, or any conflicts of interests that have not been identified previously may have an impact on existing investors. Any time the fund finds itself in particular difficulty, it is incumbent upon the directors to seek out and rely on the advice of counsel and suitable third parties.

**Do directors interact with fund service providers? If so, which ones and under what circumstances?**

Directors are responsible for the appointment, removal and contract terms of service providers, including notifying investors and CIMA of any changes to the service providers. They determine what service providers will and will not be doing for the fund and ensure that delegation of responsibilities to such service providers is appropriate. If the appointment of a service provider is approved, in certain resolutions, the directors should make sure the appointment actually happens and should review a copy of the appointment letter and service agreement.

**Qualifications of Directors**

**What qualifications must a hedge fund director have?**

There are no set qualifications that must be met, but there are bare minimum professional qualifications that are evident in this space, which are either a legal background, or an accounting or auditing background. Those are the main professional qualifications we see. You will also see former fund administrators or anyone who has significant experience with risk management or fund governance or a regulatory background. Those tend to align with fund directors in today’s environment.

**Do investors look at the qualifications of directors? If so, what are they looking for?**

Investors are increasingly demanding more and more on the backgrounds of fund directors. Investors also look for someone with a legal background, an accounting background or a risk management background to oversee the fund in a suitable and effective manner and to add real value to the ongoing operations and viability of the fund. You'll see, as part of the operational due diligence that’s done by
institutional investors, every ODD questionnaire has a separate and robust questionnaire dealing with qualifications of directors, how many boards they sit on and their professional backgrounds.

**Regulatory Requirements**

Directors of CIMA-registered fund companies are required to be CIMA-registered or licensed. How do directors determine whether they need to be registered or licensed, and are there situations in which they need both registration and licensure?

The Directors Registration and Licensing Law basically imposes the obligation to register on directors of registered mutual funds and securities investment businesses that aren’t professional or corporate directors. The license is required for professional directors who conduct this type of endeavor on a full-time, regular basis, being natural persons appointed to the boards of 20 or more corporate directorships of covered entities. In a situation where you have a split board, and you have a director who is a member of the management team, they would only need to be registered. The licensing would apply to the independent directors who do this for a living.

CIMA has released a Statement of Guidance which establishes key principles of good governance and issues guidance on directors’ duties with respect to hedge funds in the Cayman Islands. Does the guidance require that directors have specific qualifications? Does it recommend who can and/or should serve on a hedge fund’s board of directors?

There are no specific qualifications. The Statement of Guidance sets up best practices and establishes minimum standards for boards and governing bodies of funds. It doesn’t impose a strict set of qualifications.

Are there limits to how many fund boards a director can serve on at one time?

There is no limit in our space, but it is being looked at closely by directors and consultants who want to make sure that directors have capacity and are exercising their duties in a manner that allows them to spend meaningful and significant time with each fund.

Does the guidance stipulate how often boards of directors should meet?

Fund boards should meet twice a year, and more often depending on the circumstances, the size, nature and complexity of the fund, and the service providers. They can meet in person or via telephone or video conference. Agendas and associated documents should be circulated before formal meetings with sufficient time to review. Directors should not approve resolutions or board minutes which they have not reviewed or discussions that have not been had.

Are directors supervised? If so, by whom?

There are a couple of components to that. If you are looking at statutory supervision, or regulatory supervision, there is the CIMA Statement of Guidance. CIMA’s Statement of Guidance was published in December 2013 and applies to investment funds regulated under the mutual fund law in the Cayman Islands. The supervision itself in many instances has to do with the type of director company you are dealing with, and how extensive and robust the direct company’s internal compliance and risk management infrastructure is. There are also external audits that are conducted on directorship shops by CIMA that ensure there is adherence to supervision standards and quality control.

In addition to that, the industry also sets a supervisory standard in connection with directorships. In today’s day and age, there are operational due diligence companies that come in on a regular basis prior to investing on behalf of institutional investors, endowments and pension funds. In these ODD questionnaires and due diligence sessions they make sure directors are well-equipped to take on the role. They look at the director’s track record and the number of directorships that they currently perform, so this acts as an additional check and balance to the suitability of directors to sit on the boards of certain funds.

Are there any other laws governing corporate governance?

There are various statutory duties associated with the conduct of directors. The Companies Law is one such key statutory source. The
Companies Law does not set out any fiduciary duties (these are derived from English case law), but it does set forth certain statutory obligations, such as the duty to maintain registers.

**Ending Directorships**

**Under what circumstances would a director end his/her membership on a hedge fund’s board?**

That could come about in a variety of circumstances. In practical terms, it may just be the end of the fund’s life cycle that would necessitate the end or a termination of the relationship with a manager. There are situations where there is continued deadlock at the board level, or there could be specific complaints that come about that contribute to an ongoing internal deadlock or dispute that may drive a director to end his or her relationship with the fund. Depending on certain factors, there may be reputational risk or the manager being sued that would necessitate the termination of the relationship.

**Under what circumstances would a manager want to remove a director?**

A manager, either directly or via investors, may feel a director is acting contrary to the best interests of the fund. Sometimes, over a prolonged period a director may not be providing advice or may not be responsive in a timely fashion, especially when a response is urgently needed. Sometimes directors miss board meetings. Anything to do with a perceived inability to perform a director’s function or duties may necessitate a manager seeking to remove a director from a fund.