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## HEDGE FUND OVERSIGHT

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2007 will be remembered for the sub-prime/credit crisis and the impact of “cardboard collateral”.<sup>2</sup> 2008 looks to be just as unsettling. What does this portend for investors in hedge funds? How will the directors of the corporate, trustees of the unit trust or general partner of the limited partnership hedge fund respond?

Prospects ask many questions in due diligence questionnaires (DDQs) and meetings with promoters before investing and afterwards. One of these assumes paramount importance: *who is responsible for the hedge fund?* Responses to DDQs and replies given in interviews state that the directors, trustees or general partner (together, directors) are legally responsible for the hedge fund. This is true. It often does not take into account the roles of the investment manager and the prime broker and the powers granted to and exercised by them in their respective agreements with the hedge fund.

### What do these three parties do?

- The *directors* review matters, make decisions and sign agreements. They consider important issues such as changes to the investment objective, policies and restrictions, handle valuation and pricing queries, delegate activities to service providers (or add or change service providers) and review, approve and sign the audited financial statements. They also supervise and evaluate service providers.
- The *investment manager* manages the portfolio and is responsible for investment decisions and trading. When the directors are not available (and with their approval), he discusses with the administrator matters such as which prospects to admit or redeem. Also, the investment manager assembles board packs for the directors’ meetings, instructs lawyers to draft or negotiate documents such as ISDAs (he might negotiate these for and on behalf of the hedge fund), manages the preparation of shareholder communications and assists in the preparation of audited financial statements and annual reports.
- The *prime broker* is the source of credit. He lends securities and provides loans to engage in margin transactions. He is empowered to suspend lending or financing and may place the hedge fund in default in many situations and liquidate the portfolio - effectively shutting down the fund; (these issues may be amplified if there is more than one prime broker).

Thus, the directors assume legal responsibility for the hedge fund while the investment manager and the prime broker *operate* it. However, it is important to realise that, in terms of answering the question, *who is responsible for the hedge fund*, operating does not confer the right to exercise oversight or assume legal responsibility. Yet, in many ways, these service providers engage in aspects of oversight. Is this right? Does it matter?

The term “oversight” means to supervise, control or oversee. In the context of hedge funds, it means supervising service providers, gaining consistent complete information, making informed unbiased decisions and being legally responsible for the hedge fund on an independent and objective basis. It is hard for an investment manager to do this, because he owes fiduciary duties to his client, the hedge fund and to exercise oversight would breach this duty and give rise to conflicts of interest.

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<sup>1</sup> © 2008 Mark Berman. Portions of this article are excerpted from or based on materials contained in *An Introduction to Hedge Funds* (Risk Books, © 2007 Mark Berman).

<sup>2</sup> “Cardboard collateral” refers to illiquid securities and investments that are deposited as collateral by hedge funds with prime brokers and, in the first instance, not given a “haircut” commensurate with the nature of the instrument and the inability to gain a price or to sell it. In the opening phases of the sub-prime/credit crisis, prime brokers were forced to revalue downwards the value of illiquid instruments they held, resulting in margin calls and drops in hedge fund AUMs.

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### How could an investment manager oversee himself?

A prime brokerage agreement might contain provisions - broad definitions of "act of insolvency", "events of default" and others and give wide ranging powers - that effectively cede control to the prime broker.

Oversight rests with the directors.

Oversight matters to investors in hedge funds because it helps to ensure meaningful corporate governance and the proper carrying out of the duties that are owed to investors. It also helps to ensure that no service provider might, even inadvertently, control hedge fund activities, that the right amounts of fees are being paid and that investors are being protected. It helps secure the role of the directors as the sole entity responsible for the hedge fund. It ensures separation of powers and helps minimise or even, in certain cases, eliminate conflicts of interest.

Often, directors may not actively exercise oversight. They may leave this to the investment manager as "first among equals". On occasion, oversight is overlooked. This should not be the case. Directors must exercise oversight in a meaningful manner.

Proper oversight has benefits. The directors will receive all of the information that they require, on a timely and unbiased basis. This will permit them to review objectively how and whether the investment strategy is being achieved and the activities of the service providers. They will be able to assess provisions of key documents and have sufficient information to take proper, informed decisions. Information should come from service providers in a format that the *directors* establish. This means that the information will be clear and consistent and make it easier to assess transparency, operations, trading, profitability and proper and timely valuations. The directors will be able to assess, before signing, side letters (if they choose to issue them). They will be able to agree fees that are within acceptable market parameters understand and take steps to cut down on the number of non-settled or failed/DK'd trades, obtain information from investors that paint a clear picture of their needs and, most importantly, ensure that the information that they receive from the service providers is consistent, reconciled and complete.

### How should directors exercise oversight?

In the first instance, the directors should discuss oversight at a full directors meeting. Following this, they should consider and adopt a resolution establishing an oversight policy. This policy would include the following;

- how "oversight" is defined - what it means, includes and does not include;
- who will perform oversight - all of the directors, a committee of directors, an independent entity or even a service provider, always subject to strict internal controls, segregation of duties, information barriers, timely provision of information and supervision and, if necessary, removal;
- what elements, checks and information requirements comprise the "ongoing nature" of oversight;
- establishing "rules of the road" to ensure that any issues or disputes between or among service providers are resolved in a timely, objective manner;
- clarifying what information is required and in what format for directors meetings - an information template is a good starting point;
- adopting a resolution to ensure that, between meetings, one director is available to give any instruction, take any action, sign any document or address any issues as they arise;
- how often oversight audits will take place - these are checks, periodic and at least annually, of the oversight process. It is advisable that this should not be a part of the annual audit and preparation of financial statements.

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## What is an oversight audit?

An oversight audit is a review of the components of the oversight programme. It is conducted by at least one director and, as is usually the case, with assistance from an independent third party. The oversight audit:

- Considers each element of the oversight policy as a target to be achieved, much like an earnings forecast:
- Evaluates all information generated, provided, considered and all decisions and actions taken against this target:
- Measures whether or not the goal has been achieved and evaluates the effectiveness of the programme.

The following are examples of sections of an oversight audit:

**Goal:** Generate consistent information about failed/DK'd trades, report this to the directors and act to minimise the effects of these.

**Action:** Agree an information template and policy. The directors and service providers (administrator, investment manager and prime broker, or the department of the general partner that performs the administrator duties and the prime broker) agree upon what is a failed/DK'd trade, who generates and provides the information for the service providers and who addresses these issues between board meetings. The directors review activity between meetings and address outstanding issues.

**Goal:** Avoid paying excessive/unnecessary fees.

**Action:** The directors consider fee schedules of service providers and evaluate fees paid over a period of time to ascertain value for money (no excessive or tied fees, etc.). The directors receive fee schedules from service providers, review paid fees and decide whether negotiations for future fees are required (or whether changes to service providers are required).

There are many issues involving hedge funds before regulators. These include side letters, valuations, insider trading, market abuse, the registration of hedge funds, how to "look through" a hedge fund to protect investors, the "dark side" of collateral, easy credit and the risks of trading highly leveraged investments. Oversight is an issue that is "on the regulator's radar screen". By having a proper oversight policy, applying it and conducting an oversight audit, hedge fund directors will be able to return value to investors and operate in a proper manner, conducive to the best interests of all involved.