

THE VITAL ROLE OF DIRECTORS

Directors play a central role in every stage of the life cycle of a hedge fund. Victor Murray of MG Management examines every aspect of the relationship between directors and their funds.



The board of directors plays a central role in any offshore hedge fund. The directors are involved at every stage of the life cycle of a hedge fund. The life cycle can roughly be determined as the fund formation stage, the post-launch operation and then the wind-down.

Hedge funds have evolved into very sophisticated investment vehicles, no two hedge funds being the same. The role of director cannot therefore be defined within narrow parameters. However, there are common issues that arise and can be addressed competently by an experienced hedge fund director.

Composition of the board

During the fund formation and planning stage the composition of the board of directors is one decision that the promoters/manager of new hedge fund must make. It is common for the manager to speak with a number of directors in order to assess their suitability for their particular fund.

Experience

One of the issues that was central to the widely reported *Weaving* case in the Cayman Islands was whether the directors



Directors should be asked if they are willing to show independent thought and that they fully understand directors' duties, including the interests of investors and be able to manage conflicts. The directors should also have a good working knowledge of corporate law and the mutual fund laws and regulations of the jurisdictions the hedge fund operates in, as well as a good grasp of international issues affecting hedge funds.

The hedge fund industry works on the basis of disclosure to investors to make informed choices, even though investors in these vehicles must be sophisticated. Careful consideration is required to ensure the offering documents are consistent with the constitutional documents and reflect the operation and investment strategy of the fund.

Information exchange

The US Foreign Account Tax Compliance Act (FATCA) and Common Reporting Standard (CRS) reporting has now bedded down. Most service providers are aware of the annual requirements to make the filings on the Cayman Islands Tax Information Authority's Automatic Exchange of Information (AEOI) portal.

Directors of hedge funds are charged with the responsibility to ensure that the relevant information is gathered from the shareholders and filed on the portal. Sometimes the directors themselves act as the principal points of contact (PPoCs) for the authority.

There is nothing to prevent a director acting as a PPoC, but depending on the complexity of the required reporting and the investor base, it is usually preferable that the administrator or manager can upload the required reports directly.

Beneficial ownership reporting

All hedge funds are required to document how and whether they are exempt from reporting their beneficial owners to the secure Cayman Islands government platform. Most funds rely on the exemptions provided for by their Cayman Islands Monetary Authority (CIMA) mutual fund registration and their regulated service providers. This is normally addressed in the first board meeting and recorded at the registered office.

The directors must ensure that the correct exemption has been selected and is appropriate for their fund.

Data protection

The Cayman Islands will shortly implement its own Data Protection Laws which are very similar to the EU General Data Protection Regulation (GDPR). A director's consideration for GDPR is whether the fund has any EU individual shareholders and whether there has been relevant notice provided to those shareholders on how their data will be handled.

Quite often for a new fund this can be addressed through amendment to the subscription document and disclosure in the offering document.

possessed sufficient experience. There were also other issues, including the relationships with the manager.

When selecting a hedge fund director experience is vital to ensuring that proper oversight is achieved, whether this be directors from different firms with complementary professional backgrounds or people from the same firm with different experience.

If the director has no relevant industry experience, this can be a red flag to investors and regulators that there is no proper oversight. Evidence of professional qualifications and experience should be sought from directors (such as being a qualified accountant or lawyer).

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Fund documents will have to be reviewed and updated for the Cayman Islands’ new data protection rules.

Anti-money laundering officers

There have been significant enhancements to the existing Anti-Money Laundering (AML) Cayman Islands Guidance Notes.

Fund directors are responsible for ensuring: (1) the suitability of the AML officers and making appointments; (2) that the fund complies with the updates to AML laws and regulations; (3) that an AML compliance programme is established; and (4) that the AML officers and all service providers are adhering to the regulatory AML requirements.

AML officers are responsible for periodically reporting to the funds directors on the implementation of the fund’s AML procedures and report the results of any testing.

Therefore, it is perhaps not advisable that fund directors themselves fulfil the AML officer role as they would essentially be reporting to themselves. The Guidance Notes envisage that the directors will have oversight and receive reporting from the AML officers of their fund.

Master feeder redemption terms

A master fund ordinarily would be established with identical articles of association to the feeder fund and this is especially important for redemption terms.

It was assumed in the Cayman Islands that there was an automatic back-to-back redemption process as between feeder and master funds. However, the recent Cayman Islands case of Arden Maroon decided that a redemption notice from the feeder permitted the administrator to process the redemption from the master fund notwithstanding a failure of the feeder fund to provide an actual redemption notice.

The impact of this decision is that existing funds should enter into a written agreement between the feeder fund and master fund outlining the mechanism used to process redemption from the master fund.

For newly established funds, they should imbed in their constitutional documents as to how the redemptions will be made from the master fund so that there is a written process in place. This is one of the key areas that directors should assess for existing and new funds.

Operation of the fund

One of the most-asked questions is about how often board meetings should be held and if any should be held in person.

In forming an opinion on frequency and format for the meetings there are a number of considerations, including how active the fund is, whether there are special issues needing oversight and the requirements of investors and other stakeholders. Board meetings will be held to approve audited financial statements and for most hedge funds quarterly or even more frequent meetings may be appropriate.

Any professional hedge fund director who is properly experienced, and has sufficient time to devote to his or her appointment, will make sure that board meetings are comprehensive and substantive and not merely “going through the motions”.

Hedge fund directors need to be able to weigh up legal advice, and the commercial aspects of a transaction and situation, and balance this with their duties to the hedge fund and investors. This may mean challenging advice or recommendations they do not agree with.

Directors should also request to see copies of any investor letters or complaints. As was shown in the *Weaving* case, the directors received the reports but failed to duly consider or question them.

Side letters

The majority of hedge funds will be asked to enter into a side letter. The side letter can be used to facilitate a large investment or to attract a strategic investor. Entering into a side letter will raise various fiduciary and other concerns that must be addressed by the director.

A director should not be afraid to raise questions when a side letter term is clearly incompatible with the fund’s articles or the rights of the investors.

Investor protection

Since the global financial crisis most hedge funds investors are conducting due diligence on the manager and its principals. The independence and quality of the directors should also be carefully evaluated as part of that process.

In particular investors will want to ensure that the director is sufficiently competent and experienced so that if they have to make difficult decisions they will do so independently in the best interests of all the investors, and not favour one group of investors over another.

Liquidation

A decision to liquidate the fund may be taken at some point. The directors will execute the declaration of solvency to commence the process in the most common winding-up: a voluntary liquidation (a solvent liquidation).

The directors will need to be satisfied as at that date that the fund is solvent for a certain period (usually 12 months). The directors will take personal liability in the event such declarations prove to be untrue so they should undertake to receive proper information from the administrator, manager and, in some cases, the auditor. ■



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