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CURRENT TRENDS IN HEDGE FUNDS

In the aftermath of the 2008 financial crisis, and continuing today, hedge funds are facing new demands from investors and regulators. Using data, in part, from recently registered Cayman Islands funds, the authors discuss these trends with regard to management fees, incentive compensation, expense allocations, and liquidity terms. They then turn to the fiduciary duties of directors under English law and Cayman Islands precedents, and compare that with the U.S. They close with the disclosures required by the EU's AIFMD and notes on the SEC's recent concerns with conflicts of interest and cybersecurity.

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The hedge fund industry continues to evolve based on the balance of power between managers and investors, and the evolution of the legal and regulatory landscape. In particular, the industry has undergone significant change in the aftermath of the financial crisis that began in 2008, which brought additional new demands by investors and increased regulation of the industry. This article explores recent trends in hedge funds with respect to management fees, incentive compensation, expense provisions, liquidity terms, fund governance, and disclosure obligations.

MANAGEMENT FEE TERMS

Management fee rates have continued to experience downward pressure since the financial crisis that began in 2008. In the first half of 2014, "less than 15% of new funds [had] a 2% management fee".[1] Although the industry range for management fee rates is typically 1% to 2% for emerging managers, such rates are often less than 2% with many such managers offering founders' classes of shares to attract capital. Such special classes of shares are designed to attract early investors and permit them to invest on terms that include a discount to the standard management fee rate. For example, a new fund with a standard management fee rate of 1.5% may offer founder investors the opportunity to invest at a rate of 1.25% or 1%. Founders' classes are typically offered for a limited period of time and/or until a certain amount of capital is raised. Often investors investing in a founder class will seek such preferential terms for

[1] Maples and Calder, "Hedge Fund Trends 2010-2014 H1."

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IN THIS ISSUE

● **CURRENT TRENDS IN HEDGE FUNDS**

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subsequent capital contributions and, accordingly, there may be negotiation by such investors with fund managers as to whether such investors have the continued right indefinitely to invest on a preferential fee basis.

A more recent trend in the emerging manager space is to reduce the management fee rates as the firm reaches certain levels of assets under management ("AUM"). For example, the management fee rate with respect to a fund may be 1.5% until firm AUM reaches $1 billion and then the rate may be reduced to 1%. Certain complications with this newer formula can arise since firm AUM will fluctuate both up and down based on performance and capital activity (*i.e.,* subscriptions and redemptions) and, therefore, adjustments to management fee rates may happen frequently.

Management fee rates can also be tiered based on an investor's net subscriptions in a fund, allowing a reduction in the rate as certain thresholds are reached or permitting a reduction in the incremental net subscriptions over a certain threshold point. Net subscriptions are often defined as subscriptions less any redemptions for the period of time in which the management fee is being charged. Management fee rates also continue to be discounted in exchange for longer initial lock-up periods.

Existing managers organizing new funds are also experiencing investor pressure with respect to management fee rates and such new funds may not be launched at the high end of the management fee spectrum.

INCENTIVE COMPENSATION TERMS

Incentive fee/allocation rates have remained more consistent, with many fund managers continuing to receive 20% of the net realized and unrealized appreciation over a high water mark. For emerging managers launching funds with founders' classes, the incentive fee/allocation rates are often discounted. Such discounted rates are typically in the range of 15% to 18%, but can be as low as 10%. Incentive fee/allocation rates also are often discounted in exchange for longer initial lock-up periods.

Less prevalent in the market, but included in some new launches, are hurdles and preferred returns. Since the financial crisis, when such terms are included, they often do not provide a "catch-up" provision mechanism to the manager. A catch-up provision allows a manager to be paid incentive compensation for having made for the investors the hurdle or preferred return.[2] Catch-up provisions were more common pre-crisis for all types of hurdles and preferred returns (*i.e.,* t-bill rates, LIBOR rates and higher hurdle/preferred return rates), but currently are most often seen when the hurdle rate or preferred return is relatively high (*e.g.,* above 7%). In addition, although in the immediate aftermath of the financial crisis some investment managers explored utilizing multi-year formulas for calculating incentive allocations/fees with the implementation of clawback mechanisms, today there are fewer funds currently being offered with such terms.

EXPENSE PROVISIONS

Expense provisions, as well as how expenses are allocated, have come under increased scrutiny from both investors and regulators.

On the investor side, post-financial crises, many institutional investors seek to negotiate expense provisions with the most scrutiny being placed on certain internal expenses of the manager that may be allocated to a fund (*e.g.,* salaries and bonuses of personnel performing accounting, legal, and compliance). Travel expenses associated with fund raising activities, and technology and infrastructure expenses are often scrutinized as well. With respect to all expenses, there has been a desire by investors for increased transparency to shed light on what expenses are being charged to the fund in order to assess the impact of such expenses on performance. If an expense is common to multiple funds managed by an investment manager, investors are often

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[2] For example, assume a fund starts with $100, has an 8% preferred return, and a 20% incentive compensation arrangement for the manager. If the fund makes a $10 gain in a year, without a catch-up provision the manager would receive 20% of the excess over $8 (*i.e.,* 40 cents). However, with a full catch-up provision the manager would receive $2 (*i.e.,* the manager gets paid for having made the $8 gain).

engaging in additional due diligence with respect to how such expense is allocated among funds. Negotiations with investors often involve either the elimination of certain line items contained in the fund's expense language to reduce the categories of expenses that can be charged to a fund and/or negotiating expense caps particularly with respect to allocations of a manager's internal overhead expenses.

The SEC has also placed an increased focus on expense provisions, in particular looking at disclosure deficiencies, conflicts in allocating expenses between the fund and manager, and issues involving misallocation of expenses among funds and accounts.[3] As a result, managers should pay particular attention to ensure there is adequate disclosure of the expenses being allocated to the funds, clear disclosure of how shared expenses are allocated among multiple funds (*e.g.,* based on relative net asset value, usage, or some other methodology), implementation and monitoring of expense allocation policies, and internal compliance reviews of expense allocation practices.

LIQUIDITY TERMS

In the aftermath of the 2008 financial crisis, preserving liquidity continues to be a major concern to investors, with the primary factor in structuring the redemption terms being the fund strategy and anticipated liquidity profile of the fund's portfolio. Investors are increasingly focused on ensuring that the liquidity offered (*i.e.*, the fund's redemption terms) matches the liquidity of the underlying portfolio. In structuring redemption terms, it is also important to balance investors' desire for liquidity against the ability to manage the portfolio in a liquidity crunch.

Lock-ups

In a competitive asset-raising environment, new managers are developing founders' and other share classes, typically with lower fees in exchange for longer lock-ups. Another option to the founders' class is the seeding route and, as with founder classes, seeding has become increasingly mainstream.[4] Typically, founders' classes and seed capital are subject to longer, hard lock-ups, with a three-year lock-up becoming a standard term. Less hard lock-ups are being employed on the main share class and, where a lock-up is used, generally it will be a soft lock-up, often for a year, with an early redemption fee of between 2% and 5%. Some funds have implemented the use of a rolling lock-up period. The initial lock-up period runs from the date of initial investment for a specified time, it expires and then starts over again, with the rolling lock-up period designed to match the life of the investment.

Gates

Following the collapse of Long Term Capital Management in 1998, fund documents were redrafted to provide mechanisms to deal with short-term illiquidity. Fund-level gates were introduced that were triggered where redemption requests exceeded a certain percentage of a fund's net asset value on any redemption date, typically 20%. Where the redemption threshold was met, redemption requests would be cut back automatically, so that redeeming investors could only redeem their *pro rata* portion of the gated amount. During the 2008 financial crisis, however, fund-level gates did not always work as managers and investors expected, and more often than not, added to confusion and increased precautionary redemption requests. Consequently, the tendency during the crisis was to restructure or make a distribution in-kind rather than implement any gate. Following on from these experiences, there has been a significant decrease in funds launching with fund-level gates, steadily decreasing from 36% of new funds launched in 2010 having a fund-level gate to just 19% of new funds having a fund-level gate in the first half of 2014.[5] The decrease in fund-level gates has been accompanied by an increase in investor-level gates over the same period, with each investor limited to redeeming a certain percentage of the value of its shares/interests on each redemption date. Typically, investor-level gates allow investors to redeem 25% of their net asset value over sequential redemption dates. In this scenario, the investor receives 25%, 33%, 50%, and then the balance over four consecutive redemption dates. The redeeming investor is required to notify the fund in each redemption period of its intended redemption, with a failure to do so restarting the percentage limits. "No-gate" funds have

[3] *See* "Spreading Sunshine in Private Equity", speech by Andrew J. Bowden, Director, Office of Compliance Inspections and Examinations, May 6, 2014 for a discussion of concerns regarding expense practices *at* http://www.sec.gov/News/Speech/Detail/Speech/1370541735361.

[4] As opposed to founders' arrangements, seed arrangements typically provide that the seed capital provider shares in the management fees and incentive compensation earned by the manager.

[5] Between 2010 and 2014, 4,749 open-ended funds were registered in the Cayman Islands. In conjunction with onshore counsel, Maples and Calder has advised on the establishment and launch of 1,610 of those funds. The figures, trends, and insights in this section reflect the terms of the funds on which Maples and Calder has advised.

also increased dramatically, with 61% of new funds launched in the first half of 2014 having no gate.

Side Pockets and Co-Investments

A side pocket is a mechanism used to segregate less liquid or hard-to-value assets from a fund's liquid portfolio. The assets are segregated and generally only those investors who are invested in the fund at that time participate in the side pocketed investment. Investors are unable to redeem their side pocketed shares until the asset is realized, at which time the manager typically also takes its incentive compensation.

The use of side pockets grew considerably in the years leading up to the crisis, with some funds having the ability to allocate upwards of 30% of the fund's net asset value to side pocket investments. Managers also tended to have great flexibility as to what assets could be placed into side pockets, as well as the timing for designating a side pocket investment as such. Side pockets certainly helped in managing liquidity during the crisis by allowing managers to isolate illiquid assets whilst allowing investors to continue to redeem from the liquid portion of the fund's portfolio. In many cases, funds that had side pocket mechanics were able to navigate the liquidity crunch more successfully than funds that did not have such protections. Despite this, side pockets have fallen out of favor and investors continue to be concerned that side pockets have insufficient investor protections, as well as being open to abuse. There remains reluctance on the part of investors to invest in funds with side pockets. Consequently, for new funds launching in recent years, side pockets continue to be difficult to sell. Where side pockets are offered in new funds, there is usually some level of optionality for investors, with investors electing at the outset whether to opt-in or opt-out of any side pocket investments. Needless to say, opt-in classes have seen less interest than the opt-out classes.

Despite the decline in use of side pockets, the side pocket has not been completely stitched-up. There are certain strategies for which side pockets continue to be used, for example, distressed debt, but it appears that fewer managers are using them to take advantage of potentially attractive, but illiquid, investment opportunities.

An alternative option for funding illiquid opportunities is by way of co-investments, which have become a hot item in the hedge fund space. More managers are establishing co-investment funds and offering co-investment opportunities to expand their relationships with their existing investor base. Some are designed to take advantage of, or give access to, overflow capacity. In other instances, a co-investment fund may be created with a limited focus, such as a sub-strategy within a larger strategy of the manager's flagship fund. In addition, co-investment funds have also been established with a mandate to invest in any co-investment opportunity across a manager's entire suite of funds (*i.e.,* overflow to all their funds). For hedge fund managers, those most successful in raising capital for co-investments tend to be in strategies where the additional capital can be complementary to, rather than competitive with, the main fund. As with the opt-in side pocket class, the investor can designate a portion of its investment that will be included in any co-investment. Co-investment vehicles launched by hedge fund managers tend not to fit neatly within an open-ended hedge fund structure and, as a result, often are more negotiated products.

In-kind Payments

Dealing with investors' redemption requests in a liquidity crunch continues to be a common concern for managers and investors. Payments in-kind were used by many funds during the financial crisis and the ability to pay in-kind continues to be a popular tool when a fund is under redemption pressure. The principal advantage of making payments in-kind is that it allows the fund to redeem shares by reference to specific assets within the portfolio and, for many managers, enables them to ensure that the liquid to illiquid assets continue to be maintained in the same ratio after a redemption is processed for non-redeeming investors (compared to a gate where liquidity is drained to meet cash redemptions).[6] This means that, properly managed, all investors remain interested economically in the same proportion of liquid and illiquid assets held on the effective date, irrespective of whether they redeem immediately or at some future date.

The issue of in-kind redemption payments was considered by the Cayman Islands Court of Appeal ("CICA") in the recent case of *In re FIA Leveraged* Fund.[7] In that case, the CICA confirmed that the terms of a fund's governing documents determine the right of a fund to satisfy a redemption by payment in-kind. Although each case will turn on its own facts (*i.e.,* the specific contractual documents) in the absence of clear language to the contrary, the CICA has clarified that in order to constitute a valid in-kind payment, the asset being distributed must have been an asset in the fund's

[6] To accomplish this result most managers redeeming investors in-kind distribute a pro rata slice of every investment in a fund.

[7] [2013] (1) CILR 152.

portfolio at the time when the investor was entitled to be paid their redemption proceeds.

FUND GOVERNANCE

The numerous high-profile bank and fund collapses and Ponzi schemes uncovered in the wake of the 2008 financial crisis have pushed the issue of fund governance and directors' duties squarely into the limelight. Now, more than ever, it is vital to demonstrate a robust corporate governance structure to regulators, investors, and, if necessary, the courts, all of whom are becoming increasingly discerning in the conduct of their due diligence.

Below is a discussion of the general fiduciary duties that the director of an offshore fund will owe as a matter of common law (based on the English law position, which largely has been adopted in the most popular offshore fund jurisdictions) and a discussion of the current best practices that funds and their managers are adopting to ensure adequate corporate governance. This is contrasted with both industry practice and the regulatory requirements of the U.S. fund market, and the implications in the recent judgment of the Court of Appeal of the Cayman Islands in *Weavering Macro Fixed Income Fund Limited (in Liquidation) v. Stefan Peterson and Hans Ekstrom.*[8]

Duties Based on Common Law and Equitable Principles

Broadly speaking, the duties of an offshore fund director can be summarised as comprising (i) the fiduciary duty to act with loyalty, honesty, and in good faith and (ii) the common law duty to act with skill, care, and diligence. These duties have been developed over time by the English courts and are generally followed in the key offshore hedge fund jurisdictions (including the Cayman Islands, BVI, Bermuda, and the Channel Islands). The codification of these duties by the U.K. Companies Act 2008 has done little to diminish the importance of the common law rules and equitable principles, as the duties set out in the Companies Act are not exhaustive and should be interpreted in the same way as under the previous law.

Since the major offshore jurisdictions have not followed suit in setting directors' duties into statute (although, as a result of *Weavering*, the Cayman Islands Monetary Authority has now included many of them in its formal guidance on corporate governance, as explained in greater detail below), this discussion will focus on the position prior to the enactment of the Companies Act. The following is a summary of some of the key duties, which apply equally to directors who are principals or officers of the manager and independent directors, and with which any current or potential director should be comfortable before accepting an appointment.

Duty to act in good faith in the best interests of the company. This is a subjective duty, requiring a director to act in what he himself considers to be in the best interests of the company (notwithstanding that a court may reach a different conclusion based on the facts). Generally speaking, the "best interests" of the company are referrable to the interests of the company's shareholders (while the company is solvent) or its creditors (in cases of insolvency).

Duty not to fetter own discretion. It is important that a director is not restricted from exercising independent judgment on the company's behalf. This becomes particularly relevant in the hedge fund context when looking at side letters, as the directors cannot bind themselves to, for example, vote in a particular way (although there is an exception in cases where the director is satisfied that to do so is in the best interests of the company).

Duty to avoid conflicting interests and duties. This has become one of the most important duties for investors and regulators alike, and is a duty that continues even after the resignation of the director.[9]

Common law and equitable duty to act with skill, care, and diligence. The courts have found that this involves both objective and subjective elements, requiring the director to take such actions as would be taken by a "reasonably diligent person, having both: (i) the general knowledge, skill, and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company and (ii) the general knowledge, skill, and experience that that director has."[10]

Equitable duty of confidentiality. This duty overlaps with a number of other duties, particularly the duty to act in the best interests of the company and the duty to avoid conflicts. The key takeaway is that the duty is owed to the company rather than shareholders, meaning that confidential information pertaining to the company

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[8] Unreported, Court of Appeal, CICA 10 of 2011, 12 February 2015; https://www.judicial.ky/judgments/unreported-judgments.

[9] *Hunter Kane Limited v Watkins* [2003] EWHC 186 (Ch); *CMS Dolphin Limited v Simonet* [2001] EWHC 415 (Ch).

[10] D'Jan of London Limited [1993] BCC 646.

should not be disclosed to shareholders without the company's authority.

Good Practice in the Hedge Fund Industry

What do these duties, based on judgments dating back many years, mean in practice for today's offshore fund directors? Doubtless the list above, and the fact that it is merely a summary of some of the more pertinent duties, will be daunting to many. As former SEC Chairman, Arthur Levitt said:

"*Yours is a complex job that requires enormous diligence, skill, and responsibility. You must be prepared to step in at any time, you must know what to look for, and you must know when to act.*"[11]

Fortunately, while it is difficult to say that there is "standard" practice in an industry as diverse as the hedge fund world, the London asset management industry has developed a good body of common practices that are generally accepted as indicative of good practice and which some may consider to be the gold standard. While practices may vary to accommodate different structures and management styles, the extensive due diligence that is carried out by many investors, with many of the larger ticket investors often having a laundry list of governance prerequisites, means that funds not seen to conform to these practices may miss out in the asset-raising stakes, as well as leaving themselves more exposed to challenge by existing investors, and, in some cases, even regulatory interference.

In addition to these relatively well-developed industry standards, help for the uninitiated is also available from a number of industry bodies, including the Alternative Investment Management Association ("AIMA") and, although slightly less relevant for offshore hedge funds, the Association of Investment Companies ("AIC"), which have published guides for fund directors.

The following is a summary of some suggested approaches and practices that are commonly adopted and expected by boards of funds managed by London-based managers. There must naturally be some degree of flexibility in order to accommodate the vast range of different types of funds; however, *Weavering* essentially laid the groundwork for many of these to be seen as baseline requirements:

[11] "Mutual Fund Directors as Investor Advocates" – Remarks by Chairman Arthur Levitt, United States Securities and Exchange Commission, the Second Annual Symposium for Mutual Fund Trustees and Directors, Washington, D.C., April 11, 1995.

(i) For managers considering who should be a director, and for directors considering whether to accept an appointment, any conflicting interests that the director may have (*e.g.*, connection to the investment manager or a particular broker) should be carefully considered and properly disclosed. In many cases, the investment manager will be keen to retain some element of control over the fund by having a representative on the board (although a majority of connected directors would be best avoided) and this helps to demonstrate the manager's commitment to the fund. However, investors now appear to have an expectation for a more independent board. Majority independence is now the generally recommended approach. Directors should also ensure that they have sufficient time to devote to their role – good practice, and indeed a requirement in respect of Irish funds, would be to get an indication of the director's existing commitments to establish whether they have the time to commit.

(ii) While not expected to be an expert or professional in investment management (although industry backgrounds, whether investment management, legal, administrative, or accounting, certainly help and are common), a director should nonetheless have sufficient and relevant knowledge and experience to carry out his or her duties. Directors linked to the investment manager may be held to a higher standard when analyzing the execution of their duties, while other directors should take responsibility for acquiring appropriate knowledge in order to enable them to carry out their duties, taking advice from the fund's advisers where necessary. An understanding of financial statements and related documents is vital, as *Weavering* proved.

(iii) From the outset, the directors must be comfortable that they understand the structure and strategy of the fund, and the terms of all service provider contracts. The directors are responsible for the contents of the offering document, and should ensure that it is accurate, not misleading, and updated on a sufficiently frequent basis. In practice, while the directors are responsible for signing off on agreements and the offering document, many, if not all of these documents, will be prepared and/or negotiated by other parties, predominantly the investment manager and legal counsel. Directors should therefore make sure that they receive final documents in sufficient time for review and are given ample opportunity to ask any questions, comment, and conduct appropriate due diligence regarding the content.

(iv) Clear delineation of responsibilities will be key – ensuring that all parties understand their responsibilities from day one will help to avoid oversights or missed information. In a European context, the implementation of the Alternative Investment Fund Managers Directive ("AIFMD") makes this more important than ever, particularly with respect to calculation of net asset value, but also anti-money laundering, compliance, and maintenance of accounts and records. Ultimately, notwithstanding any delegation, responsibility rests with the directors, who are required to perform a high-level supervisory role, and delegation must not result in a dereliction of directors' duties or abrogation of responsibilities.

(v) The directors should meet on a regular basis (at least quarterly), ideally in person in a jurisdiction that does not in itself give rise to tax or regulatory issues. They should meet with a representative of the investment manager, in order to review the fund's investment activities and performance, and to verify that the investment manager is adhering to the investment objectives, policies, and restrictions. Reports from the investment manager, the administrator, and any other key service providers should be provided in advance, together with the meeting agenda. Directors should be given the opportunity to review and ask questions. For more exceptional items, such as the execution of a new side letter or changes to material agreements and offering documents, the preferred option would be for another physical meeting to be held (occasional telephonic attendance by a minority of directors is acceptable, but should not become the norm). Approval by written resolution, where permitted in the articles of association, would be legally sufficient, but may cast doubt upon the extent to which the directors are carrying out their functions. All meetings should be properly minuted. There is no need for conversations to be transcribed verbatim, but an inspection of the minute book should yield enough information to understand the directors' process of consideration and approval. Of course, physical meetings can rarely be scheduled on short notice and in the dynamic life of a fund, it is often the case that issues arise that need swift resolution or an agreement is approved in principle but a period of time elapses before it is ready for execution. The use of committees of directors that have the authority of the board in a given area can, in certain circumstances, help to balance practicality with good governance.

(vi) It would be unusual for a hedge fund to be operated without at some point experiencing some form of crisis or extraordinary situation requiring the input of the board. Directors should be sure that the investment manager or other service providers are clear on when they should require board involvement, but neither should they shy away from proactively inquiring. The fund's constitutive documents will often set out numerous situations which may require the board to be involved, including (a) suspension of redemptions and/or determination of net asset value, (b) the imposition of gates and other liquidity management tools, (c) issues affecting the liquidity or risk profile of the fund, (d) legal and regulatory changes affecting the operation of the fund, (e) the exercise of discretionary waivers, (f) the execution of side letters, and (g) ultimately winding up the fund. The directors should be prepared to gain a thorough understanding of the relevant facts and circumstances, and should not be pushed into making decisions without adequate information to enable them to act in the best interests of the fund.

How does this compare with the US?

Thus far, we have focused on practices commensurate with the role of a director from the eyes of a London-based manager of an offshore fund. By contrast, the U.S. asset management industry, which unsurprisingly outstrips Europe in terms of size, operates in a strikingly bifurcated manner when it comes to governance. On the one hand, the private fund sector generally takes a rather more relaxed approach than its London counterpart, most likely as a result of historical sensitivities to the tax implications of funds being seen to be operated from London. Decisions are more frequently taken by written resolution (again, this is in accordance with the constitutional documents), but the lack of frequent, face-to-face meetings, where the activities of the fund and its service providers are scrutinized and held to account, naturally limits the extent to which directors can fulfil their supervisory and oversight duties. The impact of *Weavering* and the introduction of stricter requirements in the Cayman Islands (with others possibly following suit) may go some way to change this.

However, it is curious that such a practice has grown up in one-half of the U.S. industry when the other half, the regulated fund industry, applies such stringent practice to fund governance. Like all directors, the directors of a U.S. mutual fund (a registered investment company, under the Investment Company Act of 1940)

have overall responsibility for the management of the affairs of the fund. However, the legislative and regulatory requirements are such that board oversight is intended to eliminate or reduce the perceived conflicts of interest inherent in the U.S. investment company structure, where the sponsor of the fund is often its affiliated investment adviser. The Investment Company Act requires that each registered investment company appoints a corporate form of governance (*i.e.,* board), of which no more than 60% of the members can be "interested persons." The Act goes on to impose specific responsibilities on independent directors and requires them to monitor potential conflicts of interest between the fund and its adviser. Independent directors have a duty annually to evaluate and approve the fund's advisory contract (approval from a majority of disinterested directors is necessary), approve certain distribution plans, oversee fund valuation, proxy voting, compliance, and fund disclosure, as well as select and nominate other independent directors. State law imposes an additional layer of duties on directors. It is not surprising to learn that agenda and minutes for registered fund board meetings can run to many pages.

What have we learned from Weavering*?*

Weavering Macro Fixed Income Fund was a Cayman Islands fund which collapsed soon after it was discovered that a significant proportion of the assets on its balance sheet were fictitious. The Grand Court of the Cayman Islands held that the fund's directors (both of whom were relatives of the fund's principal investment manager) were guilty of willful neglect or default in the exercise of their duties, due to their failure to adequately supervise the operating of the fund and were liable for damages in the sum of $111 million. Throughout the life of the fund, the directors had failed properly to review reports and statements provided by the administrator, minutes and other records had been embellished, and it became clear that the directors had effectively adopted a policy of rubber stamping the actions of the investment manager.

The verdict was overturned by the Cayman Islands Court of Appeal in February 2015 on the basis that, while the directors had breached their duties, the exculpatory provisions in the fund's articles of association excused them from liability, and would do so unless it could be established that the directors knew that they were acting negligently or intended to do so. It remains to be seen if this point will be further explored by the Privy Council, but in the meantime, the Grand Court's judgment provides us with a neat encapsulation (with which the Court of Appeal did not disagree) of what is expected of a modern offshore hedge fund director.

In addition to the majority of the duties discussed above, the Grand Court held that directors are required to exercise their powers independently, without subordinating those powers to the will of others, except to the extent that they have properly delegated their powers, and to act in a professional, businesslike manner. The judge's assertion that directors "are not entitled to assume the posture of automatons" but rather should "apply their minds and exercise an independent judgement" and "review in an inquisitorial manner" is a pithy reminder of the responsibilities that directors undertake when accepting directorships.[12]

As noted above, in response to the Grand Court's original findings, the Cayman Islands Monetary Authority ("CIMA") gave many of the points raised in the judgment regulatory approval, issuing its Statement of Guidance on Corporate Governance for Regulated Mutual Funds in January 2014.[13] This guidance sets out the minimum standards to be observed by fund directors when performing their duties, and CIMA has since gone further by imposing an additional registration requirement for directors (upgraded to licensing for professional directors of more than 20 "covered" funds). Most other major offshore fund jurisdictions are also looking at taking similar steps. It is therefore clear that the emphasis on good governance is greater than ever.

Weavering was not the first case to examine directors' duties and it is unlikely to be the last.[14] However, the $111 million price tag that, if it weren't for broad exculpatory provisions, would have been attached to the directors' egregiously lax approach to fund governance, should serve as a good indication of what is at stake.

DISCLOSURE OBLIGATIONS

Recent trends in hedge fund disclosure generally have reflected areas of increased regulatory requirements or scrutiny. The recent adoption and implementation of the AIFMD imposes specific disclosure requirements on hedge fund managers marketing in the European Union. The focus by the SEC on compliance areas, such as conflicts of interest and cybersecurity, has resulted in

[12] *Weavering Macro Fixed Income Fund Limited (In Liquidation) v. Stefan Peterson and Hans Ekstrom*, Cause No. FSD 113 of 2010.

[13] http://www.cimoney.com.ky/WorkArea/DownloadAsset.aspx?id=2147484189.

[14] Press comments suggest that this may be further appealed.

increased disclosure by hedge fund managers' practices, policies, and procedures in those areas.

AIFMD

The EU Alternative Investment Fund Managers Directive (Directive 2011/61/EU) was required to be implemented by the EU Member States by July 22, 2013. AIFMD began applying to hedge fund managers that actively market a hedge fund into one or more Member States of the EU that has implemented the AIFMD.

AIFMD requires that, among other things, hedge fund managers make available to investors certain information, set forth in Article 23 of the AIFMD, prior to such investor's investment in the hedge fund. In addition to these disclosures required prior to an investment, Article 23 also requires that a hedge fund manager disclose certain information on a periodic or regular basis.

Some examples of the AIFMD required disclosures are: (i) investment strategy, objective, and details of how any changes may be implemented; (ii) information on where any master fund is established and in the case of fund-of-fund structures where the underlying funds are established; (iii) the main legal implications of the investment contracts; (iv) intended leverage and collateral arrangements; (v) the identity of the service providers (*e.g.,* hedge fund manager, depositary, valuer, auditor, prime broker, *etc.*, their obligations, including depositary liability and investors' rights); (vi) description of how the hedge fund manager complies with the capitalization requirements; (vii) valuation procedures; (viii) fees and expenses to be borne by investors; (ix) provisions to ensure fair treatment of investors, together with details of any preferential treatment; (x) the latest net asset value and historical performance information where available; (xi) latest audited annual reports within six months of the year end date; and (xii) liquidity management procedures, including how subscriptions and redemptions are processed.

Examples of ongoing disclosure requirements under the AIFMD include: (i) the percentage of its assets subject to special arrangements arising from their illiquid nature (for example, side pocket arrangements); (ii) any new liquidity management arrangements; (iii) the current risk profile; and (iv) the risk management systems employed to manage those risks. In addition, if it employs leverage, it must on a regular basis disclose any change to the maximum level of leverage permitted, as well as any rehypothecation rights or any guarantee granted under the leveraging arrangement, and the total amount of leverage that it employs.

Offering Memoranda in use prior to the adoption of AIFMD contained many of the AIFMD required disclosures described above. Many hedge fund managers that are marketing or plan to market a hedge fund in Europe are preparing supplements to the fund's offering memorandum containing the AIFMD required disclosures. Because each EU Member State has its own idiosyncratic disclosure requirements, the supplements have additional appendices to cover specific disclosure requirements in specific member states.

Conflicts of Interest

The SEC has emphasized publicly its focus on investment adviser conflicts of interest. Julie M. Riewe, the Co-Chief, Asset Management Unit of the Division of Enforcement recently gave a speech entitled *Conflicts, Conflicts Everywhere*.[15] In connection with the increased regulatory concern and scrutiny, hedge fund managers are providing enhanced conflicts of interest disclosure. This disclosure includes more robust disclosure on management of other accounts and allocation policies, co-investment opportunities for select investors, expense allocations, fees received by the hedge fund manager from portfolio companies, outside activities of hedge fund manager personnel, and allocation of internal resources.

Cybersecurity

Another area of increased regulatory concern has been cybersecurity for investment advisers, and, thus, for hedge fund managers. Last year, the SEC's Office of Compliance Inspections and Examinations conducted a compliance examination sweep on compliance issues associated with cybersecurity.[16] In response to the SEC's focus on cybersecurity, hedge fund managers have added to their offering documents disclosure on the manager's cybersecurity policies. This increased disclosure has included a description of the hedge fund manager's cybersecurity policies and procedures, enhanced risk disclosure, and additional procedures for communicating with the hedge fund manager or the

[15] Julie M. Riewe, Conflicts, *Conflicts Everywhere – Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View* (February 26, 2015), *available at* http://www.sec.gov/news/speech/conflicts-everywhere-full-360-view.html#.VRAN-Z3n8dU.

[16] OCIE, *OCIE Cybersecurity Initiative* (April 15, 2014), *available at* http://www.sec.gov/ocie/announcement/Cybersecurity+Risk+Alert++%2526+Appendix+-+4.15.14.pdf.

applicable fund's administrator, particularly regarding capital contributions, or share purchases and withdrawals or redemptions.

CONCLUSION

The 2008 financial crisis has had a lasting impact on the industry. First, investors gained significantly more negotiating power that has been harnessed to establish more favorable terms for investment, and create additional checks and balances in fund governance. An additional by-product of such investor influence has been the "institutionalization" of the industry resulting in many managers making significant investments in infrastructure to meet the needs of both investors and regulators. The second major impact has been a substantial increase in regulation worldwide, resulting in increased barriers to entry for new managers as a significant amount of start-up capital is required to build out the necessary systems and processes to meet these obligations. ■