

Residency of independent directors more important in current market

Q&A with Karl O'Reilly

Change is always happening and as we near the end of the current investment cycle the world is learning to deal with increased and persistent market volatility. With this market backdrop, the role of independent directors remains as important as ever. Institutional investors are taking a more proactive approach in reviewing the directors of hedge funds, so it is essential that investment managers take the appointment of directors seriously.

Karl O'Reilly, Fund Director at IMS, outlines some of the key considerations that investment managers should be discussing when selecting independent directors of Cayman Islands hedge funds.



Karl O'Reilly is a fund director at International Management Services Ltd ('IMS'), one of the leading providers of governance and directorship services to the investment fund industry in the Cayman Islands

What are the key considerations that investment managers should be thinking about when appointing independent directors?

- *Experience* – the director should have sufficient experience with the fund's investment strategy, be experienced in serving on fund boards and have dealt with important issues throughout the various stages of a fund's life cycle. The more wide-ranging a director's portfolio, the better he or she is likely to be able to give sound guidance on governance issues and then apply that experience to the new hedge funds.
- *Qualifications* – the director should be suitably qualified with either an accounting, investment, legal, compliance or other relevant qualification.
- *Independence* – the majority of a fund's directors should be free from any conflicts of interest. The investment manager will naturally have a conflict of interest that will be clearly disclosed. However, best practice dictates that employees of the

investment manager should not have the majority of votes at a board meeting to make any decisions that are not in the best interest of all investors and to help prevent/manage potential conflicts.

- *Litigation* – ask if the individuals are/have been involved in any threatened/actual litigation issues. If they have, ask some detailed/probing questions regarding the cases and adopt a standard risk/reward analysis.
- *Investor confidence* – it is important for investors to gain confidence that the director clearly understands the hedge fund's investment strategy, its operations and fund documentation. Investors want to have confidence in the independent directors, who are not afraid to voice their opinions, particularly in important sensitive, perhaps distressed, situations.
- *Capacity* – capacity levels are always an important area of discussion. My advice would be to always focus on more than a single client/fund number and look at the composition of the individual's portfolio and his or her ability to manage that portfolio effectively. Generally, the industry has moved on from purely focusing on client/fund numbers and has focused more on the composition of an individual's portfolio.
- *Residency* – the residency of the directors is a key consideration that has surprisingly received little to no attention from the market in recent years.

Why do you think the residency of a director should now be regarded as a key consideration when appointing a director and how would you advise on structuring the board?

In my opinion, it may be important for the



majority of a hedge fund's directors to be resident in the Cayman Islands. We must focus on the critical point here that a hedge fund should be clearly able to demonstrate that the mind, management and control of the hedge fund is directed from the Cayman Islands and it is not directed from the investment managers jurisdiction. As we are keenly aware in offshore jurisdictions, the governments of larger countries directly and indirectly have attempted to exert greater pressure on offshore jurisdictions regarding such issues in recent times as beneficial ownership, appointment of AML Officers, FATCA/CRS and economic substance requirements. We should be mindful of any potential shortfalls with the current fund and board structure and always be proactive to ensure the fund's tax status is never jeopardised.

I do not wish for the funds industry to

lobby CIMA, the Cayman Islands regulator, to mandate a director residency rule for regulated hedge funds, as I believe that market participants are well capable of reviewing the director residency issue based on currently available information and global practices. We should be equally mindful of the director residency issue for unregulated funds to ensure their tax status is also never jeopardised. It should be noted that other jurisdictions have gone so far as to mandate that a certain number of a fund's directors are resident in the country of incorporation.

CIMA has more oversight on a Cayman Islands resident director than a director that is resident in a foreign jurisdiction. The local resident directors and CIMA are both very aware of this key point and it ensures that the appropriate level of skill and care is brought to the role. Certain jurisdictions have found it a persuasive argument to have a majority of local resident directors when funds become distressed.

Cayman Islands resident directors have direct access to an experienced local knowledge base. They attend legal updates presented by the local law firms that provides the directors with the opportunity for a thorough and thoughtful Q&A session afterwards to discuss the important issues from a new piece of legislation or recent case law. The local law firms are highly professional, deliver quality work on tight deadlines, provide active partner involvement and also have the experience of dealing with the sheer number of hedge funds domiciled in the jurisdiction. The strong working relationship between the local resident directors, the local law firms and CIMA has enabled the Cayman Islands to maintain its position as the domicile of choice for offshore hedge funds.

My advice to investment managers would be to take the appropriate amount of time to speak with the individuals that will serve as directors and who will be working with them for many years. Ask thoughtful and challenging questions, keeping the above points in mind regarding their experience, qualifications, independence, litigation, investor confidence, capacity and residency. And finally, ensure the individuals are engaged and are available at all reasonable times. ■