



POWER BEHIND THE SCENES: THE ROLE OF FUND DIRECTORS

Comments such as “there should be more or better oversight” are regularly heard, but what does this mean and what do fund directors actually do? Mark Cook of IMS provides some insights.

There has been much written about the governance of investment funds and the protection of the interests of investors in those funds, particularly in the context of independent directors—that is, where the funds do have independent directors.

By giving some insight into the activities of a fund director, it is hoped that investors and other interested parties gain a better understanding of what is being done behind the scenes and what is not.

It is also hoped that a recognition of perceived governance gaps leads to an enhancement and improvement of current practices.

At a fund’s inception

While it is not necessarily common for a fund’s independent directors to select the fund’s service providers, such as the investment manager, administrator or auditor, it is important that the directors review the service providers’ agreements and understand the implications for the fund in agreeing to the terms and conditions included in those agreements.

Experienced fund directors will be aware of best practices and industry trends and should ensure that key terms are included or excluded as appropriate to ensure the fund’s interests (and by extension its investors’ interests) are sufficiently protected and the directors’ discretion is not unduly fettered. In other words, the directors should retain sufficient options to respond and deal with potentially controversial future events and not have a predetermined course of action laid out.

The directors should look to strike a balance between enabling the fund’s day-to-day activities to be properly conducted by the investment

“Directors for their part should embrace this dialogue as it is in all parties’ best interests to ensure that a fund is operated in the manner expected.”

manager and administrator, while retaining sufficient authority to decide requests for actions that may be outside the standard terms included in the fund’s offering document.

Operational areas of focus may include ensuring there are adequate controls over cash movements at the investment manager and the administrator, and specifying who has ultimate authority for valuation of the fund’s investment portfolio and determination for the net asset value. While there may be good and valid reasons for accepting different outcomes to these issues for different funds, an understanding of the implications of delegating authority to one party or another will enable the directors to put in place checks and balances to reduce the risk of error or wrongdoing.

Taking this process further, the directors should ensure that the fund’s anticipated activities are appropriately outlined in its offering document. The offering document should obviously include details around the investment strategy the manager will undertake and describe the various parties involved in operating and managing the fund.

Perhaps as important, the directors should ensure that the offering document includes sufficient and accurate disclosures around any conflicts of interest, preferences that may exist for strategic investors and allocation of expenses, for example. In essence, prospective investors should be informed of what they are committed to and exposed to as a result of making an investment in the fund.

Day-to-day activities

Once a fund is operating, the directors’ activities broadly fall into routine matters or dealing with ad hoc requests.

Routine matters may include reviewing the fund’s performance, reviewing the investment manager’s correspondence to investors, reviewing the annual audited financial statements and of course, preparing for and attending board meetings.

Ad hoc matters may include requests to waive certain terms of the fund’s offering which would typically involve liaison with the investment manager, administrator and legal counsel, consideration of side letters, responding to investor inquiries and potentially responding to litigation matters or regulatory issues.

What does attending to routine matters entail?

A review of the fund’s performance may involve obtaining financial statements and portfolio details, ideally directly from the administrator, and cross-checking against any investment restrictions outlined in the offering document as well as checking for style drift and generally understanding the liquidity profile and concentrations within the fund’s portfolio.

Directors should also check for any unusual or unusually high expenses and any otherwise unusual transactions. Anomalies would then be raised and discussed with the investment manager and other service providers.

In the context of a board meeting, these matters would also be considered. A routine board meeting provides an opportunity for the directors to formally engage with the investment manager and

administrator regarding the operation and affairs of the fund as well as the fund’s auditor and legal counsel as appropriate. Other matters that may be addressed and discussed during a board meeting include conflicts of interest, the investment manager’s risk management procedures, counterparty exposure, regulatory compliance and cybersecurity preparedness.

Ad hoc requests by their nature are unpredictable in relation to their level of complexity. Fund directors assess any ad hoc request through a lens of what is in the best interests of the fund as a whole. While it is obvious that independent directors can assist with protecting the interests of investors against the interests of the investment manager, it may not be so obvious that the directors can and should be mindful of the interests of certain investors against the interests of other investors.

This issue is often manifested by way of side letters requested by particular investors. Experienced directors will ensure that undue advantage is not granted to the investor requesting the side letter. This may be by refusing certain terms or ensuring that other terms are offered to all investors in order to maintain parity. An example could be the provision of enhanced information to all investors.

What directors don’t do

A word of caution: it is becoming more common to have independent directors appointed to the board of an offshore feeder fund within a master/feeder structure but to have the investment manager or one of its affiliates controlling the master fund within the structure.

While the independent directors will often enquire regarding the activities of the master fund and its portfolio, their function is limited without the specific authority or mandate to oversee the master fund’s affairs. Investors that are uncomfortable with this scenario are encouraged to advocate for independent oversight of the master fund as well.

Many independent directors would also prefer to have a governance role at the master fund when they are already appointed to the offshore feeder fund.

Ongoing dialogue

The examples given here are not exhaustive and each fund has different circumstances that require different perspectives and specific activities. Investors should feel that there is merit in engaging with the fund’s directors to gain an understanding of activity levels and involvement and also to set expectations wherever there are points of sensitivity or perceived governance gaps.

Directors for their part should embrace this dialogue as it is in all parties’ best interests to ensure that a fund is operated in the manner expected and material issues are circumvented or quickly identified and appropriately dealt with. The points made here are intended to be an overview of what fund directors do, but there is always an opportunity to do more. ■

Mark Cook is a fund director at IMS. He can be contacted at: mcook@ims.ky