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This Article provides the first comprehensive scholarly analysis of the internal governance of hedge funds. Hedge fund governance consists of the funds' underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs. Hedge fund governance is important because better governance can improve investor returns and help managers raise and retain capital. I argue that hedge fund governance is best understood as a type of responsive managerialism. It is a type of managerialism because applicable law and contracting structures give managers uniquely wide-ranging control over the fund and its operations. Hedge fund governance is also uniquely responsive, however, because managers must continually satisfy investors, due to their ability to shut down a fund by withdrawing their capital.

In addition to their underlying legal regime, the primary components of hedge fund governance are investors with a strong propensity to exercise their short-term redemption rights, managers with high pay-performance sensitivity, investor demand for quality governance, and close monitoring by short-term creditors and derivatives counterparties. On balance, hedge fund governance devices seem to prevent managers from pursuing their own interests at the expense of investors. Nonetheless, there is still plenty of room for hedge fund governance to improve. Accordingly, this Article provides a normative framework and principles for improving hedge fund governance by striking a better balance between governance devices that are investor-friendly and those that empower managers. My analysis suggests that the areas in which hedge fund governance needs the most improvement are performance reporting (valuation) and the timing of performance-fee calculations. Importantly, my analysis also suggests that investors may benefit from less disclosure, higher fees, and less access to their capital.

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Introduction

Concerns about the internal governance of hedge funds have dramatically increased in recent years.[1] During the financial crisis of 2008, investors became frustrated when numerous hedge fund managers suddenly prevented them from withdrawing their capital yet nonetheless continued to charge them fees.[2] Since the financial crisis, concerns about hedge fund governance have centered on transparency, operational practices, and the growing view that fund directors do not effectively monitor fund managers. Exemplifying these governance concerns was the June 2012 enforcement action by the United States Securities and Exchange Commission (SEC) against the prominent hedge fund manager Phillip Falcone. The SEC alleged that Falcone misappropriated investor assets and granted favorable treatment to some investors without the knowledge of the fund's directors or other investors.[3] As a result of such developments, major institutions are increasingly refusing to invest in hedge funds that fail to meet their governance standards.

If hedge fund governance is not improved, investors may miss out on higher returns or suffer undue losses. Improved governance can also help managers raise and retain capital.[4] Due to disappointing hedge fund returns in the years following the financial crisis,[5] the new focus on governance, combined with an increasing number

[1] A hedge fund is a private investment vehicle that is not subject to the full range of restrictions on investment activities, disclosure obligations, and other regulations imposed by federal law on investment companies, that compensates management in part with a fee based on annual profits, and that typically engages in the active trading of financial instruments. Hedge funds are enabled by their underlying legal regime to use the trifecta of leverage, short sales, and derivatives in pursuit of an extremely wide variety of investment strategies. These strategies include investing in stocks and bonds, trading off of global interest rate and currency fluctuations, purchasing illiquid assets, such as distressed debt, and making asset-based loans. *See* Houman B. Shadab, *The Law and Economics of Hedge Funds*, 6 BERKELEY BUS. L.J. 240, 241 (2009). Hedge funds globally managed an estimated $2.19 trillion in assets as of the third quarter of 2012. ALEXANDER INEICHEN, ALT. INV. MGMT. ASS'N, AIMA'S ROADMAP TO HEDGE FUNDS 17, (12th ed. 2012).

[2] CASEY QUIRK & BANK OF N.Y. MELLON, THE HEDGE FUND OF TOMORROW: BUILDING AN ENDURING FIRM 11 (2009); Adam L. Aiken et al., Discretionary Liquidity: Hedge Funds, Side Pockets, and Gates 2 (Nov, 2012) (unpublished manuscript), *available at* http://warrington.ufl.edu/departments/fire/docs/seminar/2013Spring_ChrisClifford.pdf.

[3] Press Release, SEC, Philip A. Falcone and Harbinger Charged with Securities Fraud (June 27, 2012), http://www.sec.gov/news/press/2012/2012-122.htm.

[4] *See* ALT. INV. MGMT. ASS'N, A GUIDE TO INSTITUTIONAL INVESTORS' VIEWS AND PREFERENCES REGARDING HEDGE FUND OPERATIONAL INFRASTRUCTURES 7 (2011) ("Governance has become a 'make or break' area in the investment decision-making process."); ANASTASIA DONDE, INSTITUTIONAL INVESTOR'S ALPHA, THE HEDGE FUND REPORT CARD 2 (2013) ("[S]imply posting high returns is no longer enough to keep [hedge fund] investors happy.").

[5] SEI, SIX WAYS HEDGE FUNDS NEED TO ADAPT NOW 23 (2013), *available at*

of hedge funds competing for capital,[6] has resulted in bargaining power over fees and other governance devices permanently shifting in favor of investors.

This Article provides the first comprehensive scholarly analysis of the internal governance of hedge funds.[7] In doing so, this Article makes several contributions. First, this Article contributes to the literature on corporate governance by conceptualizing the unique way in which hedge funds are governed and situating their style of governance within established paradigms. I argue that hedge fund governance is a type of *responsive managerialism*. In general, managerialism is a descriptive theory of corporate governance referring to control of a business enterprise resting in the hands of managers, with equity holders and directors playing a passive role.[8] Managerialism is widely rejected as a descriptive account of public corporations by schol-

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http://www.seic.com/docs/IMS/SEI-HF-Paper-6-Ways-to-Adapt_US.pdf; Ellen Kelleher, *Hedge Funds Must Make 'Evolutionary Leap'*, FIN. TIMES (Mar. 24, 20130, http://www.ft.com/intl/cms/s/0/8f873208-92d3-11e2-9593-00144feabdc0.html.

[6] MANAGED FUNDS ASS'N, HEDGE FUNDS: TRENDS AND INSIGHT FROM THE INDUSTRY AND INVESTORS 4 (2012), *available at* https://www.managedfunds.org/wp-content/uploads/2012/05/MFA_HedgeFunds_Trends_and_Insight1.pdf (displaying historic growth in number of hedge funds from 1990 through the first quarter of 2012); *Hedge Fund Numbers, Assets Hit Record*, FINALTERNATIVES (Dec. 12, 2012), http://www.finalternatives.com/node/22347.

[7] This Article focuses on hedge funds managed in or from the United States. Legal scholarship has yet to focus on hedge fund governance. To date, the most governance-oriented work is an article by Wulf A. Kaal that discusses hedge fund manager compensation and conflicts of interest in the context of valuation issues. *See generally* Wulf A. Kaal, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28 ANN. REV. BANKING & FIN. L. 581 (2009). When legal scholarship focuses on hedge funds and governance, it focuses on the impact that hedge funds have on the governance of other companies as activist shareholders or bondholders. *See, e.g.*, William W. Bratton, *Hedge Funds and Governance Targets*, 95 GEO. L.J. 1375 (2007); Brian R. Cheffins & John Armour, *Past, Present, and Future of Shareholder Activism by Hedge Funds*, 37 J. CORP. L. 51 (2011); Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, COLUM. L. REV. (forthcoming 2013), *available at* http://ssrn.com/abstract=2206391; Robert C. Illig, *What Hedge Funds Can Teach Corporate America: A Roadmap for Achieving Institutional Investor Oversight*, 57 AM. U. L. REV. 225, 231–32 (2007); Marcel Kahan & Edward Rock, *Hedge Fund Activism in the Enforcement of Bondholder Rights*, 103 NW. U. L. REV. 281 (2009). Legal scholarship also focuses on the regulatory aspects of hedge funds. *See, e.g.*, Wulf A. Kaal, *Hedge Fund Manager Registration Under the Dodd-Frank Act*, 50 SAN DIEGO L. REV. (forthcoming 2013), *available at* http://ssrn.com/abstract=2150377; Anita K. Krug, *Institutionalization, Investment Adviser Regulation, and the Hedge Fund Problem*, 63 HASTINGS L.J. 1 (2011); Cary Martin, *Is Systemic Risk Prevention the New Paradigm? A Proposal to Expand Investor Protection Principles to the Hedge Fund Industry*, 86 ST. JOHN'S L. REV. 87 (2012); Dale A. Oesterle, *Regulating Hedge Funds*, 1 ENTREPRENEURIAL BUS. L.J. 1 (2006); Houman B. Shadab, *Fending for Themselves: Creating a U.S. Hedge Fund Market for Retail Investors*, 11 N.Y.U. J. LEGIS. & PUB. POL'Y 251(2008); J.W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, a Self-Regulation Proposal*, 32 DEL. J. CORP. L. 799 (2007).

[8] STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 9 (2008).

ars, who correctly argue that directors have ultimate control over managers and other constituencies.[9]

I argue that in hedge fund context, by contrast, managerialism does provide substantial descriptive value. Hedge fund governance is a form of managerialism because the funds' underlying legal regime gives managers near complete authority over the structure and operations of the funds they manage. Hedge fund managerialism arises from the fact that hedge funds are organized as privately held limited partnerships (or their functional equivalents) that highly circumscribe equity investors' rights, issuing shares that have neither voting rights nor any mechanism to replace managers or directors. Hedge fund managerialism gives hedge fund managers more control and authority over their firms than managers of public companies, mutual funds, or other private investment funds (e.g., private equity).

However, hedge fund governance is also uniquely *responsive* in the sense that to obtain and retain investor capital, hedge fund managers must be highly responsive to the preferences of equity investors (the limited partners). This responsiveness arises from a fundamental dynamic of hedge fund governance — the propensity of investors to "pull the plug" and cash out of a fund if they are dissatisfied.[10] Although hedge fund investors usually face short-term redemption restrictions,[11] they typically can disrupt the operations of a fund, or even cause it to wind down in a few months to a year, by withdrawing their capital.[12] Indeed, even if a hedge fund is performing very well, *potential* governance problems may still cause the fund to become concerned about its survival. For example, in January 2013, the highly successful hedge fund SAC Capital reportedly had to "persuade investors to keep their money at

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[9] *Id.* at 10 ("Neither shareholders nor managers control corporations."); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 290-292 (1999). *But see* George W. Dent, Jr., *Corporate Governance: Still Broke, No Fix in Sight*, 31 J. CORP. L. 39, 42-45 (2005).

[10] *See* Itzak Ben-David et al., Hedge Fund Stock Trading in the Financial Crisis of 2007-2009 5 (July 2011) (unpublished manuscript), https://fisher.osu.edu/blogs/efa2011/files/APE_2_3.pdf (finding that "relative to mutual funds, [hedge fund investor] sensitivity to negative past performance is three times as large"); *infra* note 159 and accompanying text. Pressure from hedge fund creditors may also cause a collapse. *See* JPMORGAN ALT. ASSET MGMT., HEDGE FUNDS, LEVERAGE AND COUNTERPARTY NEGOTIATIONS 15 (2008).

[11] *See infra* Part I.A.2.

[12] *See* Harriet Agnew, *More Hedge Funds Shut Down*, WALL ST. J. (Dec. 6, 2012); Katherine Burton & Saijel Kishan, *Longacre to Close Some Funds After Redemption Requests*, BLOOMBERG BUS. WK. (Oct. 11, 2011); Steve Eder, *Hedge Funds Face Investor Pruning*, WALL ST. J. (Oct. 24, 2011); Richard Meryn, *Hedge Fund Diamondback Winds Down as Clients Withdraw Money*, INDUSTRY LEADERS MAG. (Dec. 7, 2012).

the fund" in response to an ongoing insider trading investigation that, at the time, had only implicated certain employees but not the firm itself or its manager.[13]

The uniqueness of hedge fund governance stems from the fact that the exit rights of hedge fund investors put hedge fund managers on a much shorter leash than managers of public corporations and other types of investment funds. Corporate scholars recognize that an essential feature of the corporate form is that it permits a firm to have access to permanent, "locked-in" capital from equity investors.[14] Private equity and venture capital funds likewise have access to long-term capital because investors in such funds are contractually bound to them for seven to ten years.[15] Managers with access to permanent or long-term capital do not have to be concerned about investors suddenly pulling the rug out from beneath them and causing their firms to shut down. Hedge fund managers do not have that luxury.[16]

In accordance with Larry Ribstein's seminal theory of business organizations, hedge funds adopt a unique set of "uncorporate" governance devices.[17] In addition to

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[13] Peter Lattman, *Beneath the Calm, SAC Works to Contain Fallout from Inquiry*, N.Y. TIMES DEALBOOK (Jan. 27, 2013).

[14] *See* Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003); Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 YALE L.J. 387 (2000). Hedge funds do not use the governance devices of public corporations, which include not only independent boards, the shareholder voting franchise, and non-waivable fiduciary duties but also a right of exit by selling shares in liquid stock markets.

[15] Darian M. Ibrahim, *The New Exit in Venture Capital*, 65 VAND. L. REV. 1, 9 (2012); Bob Zider, *How Venture Capital Works*, HARV. BUS. REV., Nov.-Dec. 1998, at 131, 1137; *A Fund By Any Other Name: The Convergence of Hedge Funds and Private Equity Funds*, PRIVATE EQUITY NEWSL. (Davis Polk & Wardwell) May 2006 at 1.

[16] To obtain permanent capital, some hedge funds have even gone so far as to establish reinsurance companies. Houman B. Shadab, *Permanent Hedge Fund Capital Through Reinsurance*, LAWBITRAGE (Sept. 10, 2011, 10:10 AM), http://lawbitrage.typepad.com/blog/2011/09/permanent-hedge-fund-capital-through-renisurance.html.

[17] LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION 1-2, 38 (2010). *See also* Joseph A. McCahery & Erik P.M. Vermeulen, *How Should We Regulate Private Equity and Hedge Funds?*, MAB, July-Aug. 2007 at 344, 348 ("One of the central features of the governance environment of [private equity and hedge] funds is the limited partnership structure . . . . Its popularity is due to its contractual nature which allows the internal and external participants to reduce opportunism and agency costs."), *available at* http://www.mab-online.nl/pdf/599/McCahery_Vermeulen.pdf. Hedge funds do share a fundamental similarity with mutual funds in that mutual funds are also subject to short-term redemptions. Hedge fund governance is nonetheless unique because mutual funds do not face the same level of ongoing collapse-risk as hedge funds, as hedge fund investors are more sophisticated and preemptively remove funds to avoid redemption restrictions. *See* Ben-David et al., *supra* note 10, at 3-6; William A. Birdthistle, *Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence*, 2010 U. Ill. L. REV. 61, 73-85 (2010) (discussing weaknesses in the ability of mutual fund investor exit rights to discipline managers). Mutual funds are also subject to a strict regime of federal regulation that makes the types of governance devices they must and may adopt very different from that of hedge funds.

their underlying legal regime, I argue that the primary components of hedge fund governance consist of:

- investors with a high propensity to exercise their short-term redemption rights;
- managers with high pay-performance sensitivity, due to being compensated with an annual performance-based fee and their own investment in the funds they manage;
- sophisticated investors demanding quality governance; and
- short-term creditors and derivatives counterparties providing close monitoring.

The hedge fund governance regime is also notable for what it lacks. Not only do hedge funds lack permanent or long-term capital but hedge fund managers are also not subject to stringent board oversight, removal by investors, or any market for corporate control.[18] Unlike private equity and venture capital funds, hedge funds are not organized as "closed-end" funds for a finite (e.g., ten year) duration and, hence, are not subject to the discipline of being required to return capital to investors at the end of a specified investment lifecycle.[19]

The governance regime that results from the interplay of hedge fund managerialism and investor responsiveness may benefit investors by providing them with sufficient transparency and liquidity and by empowering managers to successfully pursue their investment strategies. On the other hand, hedge fund governance may permit managers to impose agency costs on investors in the form of fraud, performance manipulation, misaligned compensation incentives, and redemption restrictions that unnecessarily keep investor capital locked inside a fund. Hedge fund governance thus consists of the funds' underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs.

The second primary contribution of this Article is to examine and assess hedge fund agency costs and the governance mechanisms used to reduce them. Although financial economists have studied numerous discrete aspects of hedge fund governance, this Article is the first to integrate their findings to provide a general as-

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[18] *See* Paul Gompers & Josh Lerner, *An Analysis of Compensation in the U.S. Venture Capital Partnership*, 51 J. FIN. ECON. 3, 4 (1999) (noting that "[i]nvestors in venture [capital] funds, the limited partners, cannot utilize many of the methods of disciplining managers found in corporations, such as dismissal, the active involvement of boards of directors, and the market for corporate control").

[19] *Structural Distinctions Between Private Equity and Hedge Funds*, INV. LAW GRP, http://www.investmentlawgroup.com/structural-distinctions-between-private-equity-funds-and-hedge-funds (last visited Jan. 165, 2014).

sessment of the relative significance of hedge fund agency costs.[20] Overall, it seems that hedge fund managers are not systematically ripping off investors. This is because empirical studies do not find that fraud or other types of agency costs are pervasive or significant.[21] In addition, empirical studies strongly suggest that hedge funds outperform stock and bond markets on a risk-adjusted basis even after managers are paid their fees.[22] In other words, the market for hedge fund managers seems relatively competitive and well-priced.[23]

Thus, in contrast to the argument that investor exit rights in mutual funds undermine good governance (made in the *Yale Law Journal* by John Morley and Quinn Curtis),[24] I view the exit rights of hedge fund investors as the primary reason why hedge fund agency costs are low. And in contrast to prominent commentators, such as Simon Lack, who argue that the benefits of investing in hedge funds are a "mirage,"[25] this Article undermines the view that the overwhelming majority of hedge fund investors would be better off investing elsewhere.[26]

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[20] A related governance and agency cost literature exists in the study of private equity firms and venture capital funds. *See* Harry Cendrowski & Adam Wadecki, *The Private Equity Governance Model*, *in* PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS 117 (2d ed. 2012); Douglas Cumming, Grant Flemming & Armin Schwienbacher, *The Structure of Venture Capital Funds*, *in* HANDBOOK OF RESEARCH ON VENTURE CAPITAL 155-176 (2007); William A. Sahlman, *The Structure and Governance of Venture Capital Organizations*, 27 J. FIN. ECON. 473 (1990). Although industry analysis is increasingly focusing on hedge fund governance, its value is limited because it is typically not informed by academic research.

[21] *See infra* Part II.

[22] *See infra* Part III.D.

[23] Whether and to what extent the market for mutual fund managers is competitive is a subject of substantial debate and attention. *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 Yale L.J. 84, 98-100 (2010).

[24] *See id.* at 84 (arguing that "the net effect of exit on many [mutual fund] investors is ambiguous, because investors who do not use their rights to leave underperforming funds cannot expect activism by other investors to improve the funds").

[25] *See generally* SIMON LACK, THE HEDGE FUND MIRAGE (2012) (arguing that hedge funds significantly underperform risk-free U.S. treasury bonds and that the overwhelming majority of hedge fund profits go to managers).

[26] While much of Lack's analysis and recommendations are sound, his approach to measuring hedge fund returns and how hedge fund managers and investors share profits is fundamentally flawed. The most important errors of Lack's analysis are basic mathematical errors, using flawed indices to estimate average returns, overgeneralizing based upon the performance of the "average" hedge fund, and confusing gross manager profits with net profits. *See* CTR. FOR HEDGE FUND RESEARCH, THE VALUE OF THE HEDGE FUND INDUSTRY TO INVESTORS, MARKETS, AND THE BROADER ECONOMY 5 (2012) ("hedge fund investors earn around 72 percent of the profits, while the managers' proportion is significantly lower being 28 percent of total returns"); Robert G. Ibbotson & Peng Chen, *Sources of Hedge Fund Returns: Alphas, Betas, and Costs* 2 (Yale Int'l Ctr. Fin., Working Paper No. 05-17, 2005), *available at* http://www.hedgeindex.com/hedgeindex/documents/sourceofhedgefundreturns.pdf ("[E]xcess returns were almost equally shared between hedge fund managers and their investors."); Andrew Beer, *A Lack of Rigor in the Hedge Fund Mirage*, ALLABOUTALPHA.COM (Nov. 15, 2012), allaboutal-

Nonetheless, hedge fund governance still has plenty of room for improvement. The third contribution of this Article is to provide hedge fund investors and managers with a normative framework and principles to improve hedge fund governance. In doing so, this Article follows the tradition of legal scholarship pioneered by Harvard Law School professors Lucian Bebchuk and Jesse Fried. That tradition establishes principles for investors to consider when making decisions about financial contracting in the organizational context, with public company compensation arrangements serving as the focus of Bebchuk and Fried's work.[27]

In the hedge fund context, my analysis suggests that the areas in which hedge fund governance needs the most improvement are performance reporting (valuation) and the timing of performance-fee calculations. I also argue, however, that investors should be careful of what they wish for when choosing or negotiating governance structures. Although investors generally benefit from low fees and significant transparency and liquidity, if investor-friendly governance devices are improperly structured or taken too far, investors run the risk of undermining the unique performance-based incentives and other governance mechanisms that enable hedge funds to produce superior returns in the first place. Importantly, investors may benefit from less disclosure, higher fees, and less access to their capital.

This Article proceeds as follows. Part I examines hedge fund managerialism and its legal origins. Part II discusses the most important hedge fund agency costs, and Part III details important hedge fund governance devices. Part IV contains my framework and principles for improving hedge fund governance. The final Part of this Article concludes.

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pha.com/blog/2012/11/15/a-lack-of-rigor-in-the-hedge-fund-mirage/; Aaron Brown, *Are Hedge Funds Worthwhile Investments?*, MINYANVILLE (Feb. 1, 2012), http://www.minyanville.com/businessmarkets/articles/hedge-funds-what-are-hedge-funds/2/1/2012/id/39152; Christopher Faille, *A Fresh Look at Track Records and Risk*, ALLABOUTALPHA.COM (Nov. 29, 2012), allaboutalpha.com/blog/2012/11/29/a-fresh-look-at-track-records-and-risk/; Thomas Schneeweis & Hossein Kazemi, An Academic Response to the "Hedge Fund Mirage" (Sept. 30, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2228851; Aaron Brown, *Customer Review*, AMAZON (JAN. 12, 2012), http://www.amazon.com/review/R19QAFVYCJM5P0/ref=cm_cr_pr_perm?ie=UTF8&ASIN=1118164318&linkCode=&nodeID=&tag=; Gaetan Lion, *Customer Review*, AMAZON (April 19, 2012), http://www.amazon.com/review/R3MZ4RX0BJY3W3/ref=cm_cr_pr_perm?ie=UTF8&ASIN=1118.

[27] *See* Lucian A. Bebchuk & Jesse M. Fried, *Paying for Long-Term Performance*, 158 U. PA. L. REV. 1915, 1922 (2010).

I. Managerialism

A "hedge fund" consists of three basic entities: the fund itself, the fund's management company, and the fund's equity investors. Organizing the fund either as a U.S. limited partnership or offshore corporation affords the hedge fund manager overwhelming flexibility in managing its operational practices and carrying out its investment strategy. The general partner of a hedge fund limited partnership is responsible for managing all aspects of the fund's business, including its investment portfolio.[28] The hedge fund legal regime is best understood as a regime of managerialism due to the wide ranging discretion that applicable law and organizational structures give to managers. My analysis reveals that hedge fund managers have a greater level of control and authority than that of corporate managers and managers of most other of types of investment funds.

A. Hedge Fund Limited Partnerships

1. Governance of the Management Company

The general partner of a hedge fund limited partnership is the fund's portfolio manager and investment adviser. The general partner bears unlimited liability for any debts the partnership itself cannot satisfy.[29] Accordingly, the general partner of a hedge fund is organized as a limited liability entity to prevent the manager from being subject to personal liability for the fund's debts.[30]

The general partner, or management company, is governed by its operating agreement, which determines, among other issues, how the manager's profits and losses are allocated, partner capital contributions, and terms of withdrawal or expulsion.[31] The hedge fund management company's operating agreement and company

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[28] DOUGLAS L. HAMMER ET AL., SHARTSIS FRIESE LLP, U.S. REGULATION OF HEDGE FUNDS 89, 94 (2005). For the purposes of this Article, the phrases hedge fund "manager" and "investment adviser" are used interchangeably to refer to the same business entity.

[29] *See* DEL. CODE ANN. tit. 6, § 17-403 (West 2012); HAMMER ET AL., *supra* note 28, at 92.

[30] HAMMER ET AL., *supra* note 28, at 88 n.4, 91-92. As control persons of the general-partner entity, its owners may be personally liable for actions of the general partner as manager of the fund. *Id.* at 92. Organizing the fund as a limited partnership, and the general partner as a limited-liability entity, is crucial to the fund, its investors, and the manager in minimizing tax burdens. As a limited partnership and limited liability company (LLC), respectively, neither the fund nor the general partner-manager would be taxed at the entity level. All income, gains, losses, and deductions "pass through" to the general and limited partners, who report such items on their personal income tax returns. *Id.* at 88-89, 92.

[31] *Id.* at 93-94; NAVENDU P. VASAVADA, TAXATION OF U.S. INVESTMENT PARTNERSHIPS AND HEDGE

policies and practices must determine who may act for the manager and the extent to which owner approval may be required.[32] In practice, hedge fund management companies typically establish a senior management structure that includes a chief executive officer, chief financial officer, chief compliance officer, and committees that oversee risk and valuation.[33] Hedge fund management companies typically do not have an independent board of directors or equivalent supervisory body.

Fiduciary duties imposed on the management company stem from two sources. First, as investment advisers, federal law imposes fiduciary duties of loyalty and care on hedge fund management companies to the funds they advise but generally not to the fund's own investors.[34] These duties include providing independent investment advice that is suitable for the fund, putting the fund's interests above the adviser's own, and disclosing any potential conflicts of interest between the adviser and the fund including the general nature of any preferential treatment to some investors.[35] Second, state-level limited partnership law typically imposes default fiduciary duties upon managers.[36] Although fiduciary duties are generally viewed as contractual in nature and may be eliminated entirely in the fund's operating agreement,[37] in practice, hedge funds typically do not entirely eliminate the fiduciary duties the management company (general partner) owes to the limited partners.[38] When fiduciary

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FUNDS: ACCOUNTING POLICIES, TAX ALLOCATIONS, AND PERFORMANCE PRESENTATION 7 (2010).

32 HAMMER ET AL., *supra* note 28, at 93.

33 ASSET MANAGERS' COMM. TO PRESIDENT'S WORKING GRP. ON FIN. MKTS., BEST PRACTICES FOR THE HEDGE FUND INDUSTRY 14, 24, 50 (2009), *available at* http://www.amaicmte.org/Public/AMC%20Report%20-%20Final.pdf.

34 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963); SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 22 (2011). Only under limited circumstances have hedge fund managers been found to owe a duty to investors directly. United States v Lay, 612 F.3d 440, 445 (6th Cir. 2010); Retirement Program for Employees of Fairfield v. Madoff, No. X05CV0950115618, 2010 WL 2106654 (Conn. Super. Ct. Apr. 16, 2010).

35 SEC, *supra* note 34, at 22-28.

36 *See* Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC, No. 5502-CS, 2011 WL 3505355, at *31 (Del. Ch. Aug. 8, 2011) ("As a matter of default law, Paige General Partner clearly owes fiduciary duties to the limited partners in the Hedge Fund."). *See generally* Robert H. Sitkoff, *The Fiduciary Obligations of Financial Advisors Under the Law of Agency* (Harvard Pub. Law, Working Paper No. 13-16, 2013), *available at* http://ssrn.com/abstract=2234830. By contrast, whether managers of limited liability companies owe default fiduciary duties to members is not clear. *See* Gatz Properties LLC v. Auriga Capital Corp., 59 A.3d 1206, 1218 (Del. 2012).

37 For example, Delaware's limited partnership statute seeks "to give maximum effect to the principle of freedom of contract" by permitting the partnership agreement to eliminate the fiduciary duties of general partners to limited partners. DEL. CODE ANN. tit. 6, § 17-1101(c)-(d) (West 2012). The equivalent provisions allowing statutory waiver for the member of an LLC are located in section 18-1101(b)-(e).

38 *See* Paige Capital Mgmt., 2011 WL 3505355, at *1 (noting that the partnership agreement provided an investor with the right of withdrawal if the manager breaches a fiduciary duty). An empirical study

duties are so eliminated, investors' claims against the manager are limited to breach of the limited partnership agreement or violation of the implied covenant of good faith and fair dealing.[39]

Under the terms of the manager's agreement with the fund it advises, the management company is compensated in part by a management fee. The management fee ranges from 1% to 2% of the fund's net asset value and is calculated monthly or quarterly.[40] The management fee generally covers expenses for operating and administering the fund — such as for overhead, personnel salary, office leases, and physical capital costs.[41] The manager is also compensated with a performance fee averaging approximately 18% of the annual profits of the fund.[42]

2. Limited Investor Rights

Under limited partnership law, the hedge fund manager (general partner) has the exclusive right to manage the company,[43] except with respect to a few extraordinary issues.[44] In addition, a hedge fund's limited partnership operating agreement contractually defines the rights and duties between the fund manager and the limited partner investors. The agreement empowers the management company with wide-ranging authority to manage all aspects of the hedge fund's business, including its investment portfolio.[45]

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of publicly traded limited partnerships and limited liability companies did find, however, that an overwhelming majority either eliminated fiduciary duties or waived manager liability arising from their breach. Mohsen Manesh, *Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 574 (2012).

[39] *See* Lonergan v. EPE Holdings, LLC, 5 A.3d 1008, 1017 (Del. Ch. 2010) (noting that plaintiff's "complaint frames each of these theories using the implied covenant of good faith and fair dealing because the . . . LP Agreement eliminates default fiduciary duties").

[40] PREQIN, HEDGE FUNDS: THE FEE DEBATE, AN END TO "2 & 20"? 1 (2010), *available at* http://www.preqin.com/docs/reports/Preqin_HF_T&C_April_2010.pdf?rid=24.

[41] SAM KIRSCHNER ET AL., THE INVESTOR'S GUIDE TO HEDGE FUNDS 307-308 (2006). *See also What Expenses Does a Hedge Fund Pay For?*, HEDGE FUND L. BLOG (Aug. 17, 2008), http://www.hedgefundlawblog.com/what-expenses-does-a-hedge-fund-pay-for.html.

[42] *See infra* Part III.B. For a more detailed explanation of hedge fund employee compensation structures see GLOCAP SEARCH, INC. & HEDGE FUND RESEARCH, INC., 2011 GLOCAP HEDGE FUND COMPENSATION REPORT.

[43] UNIF. LTD. P'SHIP ACT § 406(a) (2001).

[44] These extraordinary matters over which limited partners have consent rights include amending the partnership agreement and sale of at least substantially all of the partnership's assets outside the ordinary course of business. § 406(b).

[45] HAMMER ET AL., *supra* note 28.

The limited partners provide capital as the fund's equity investors.[46] Limited partner investors are not liable for the fund's debts, although they are subject to losing all of their investment capital and any undistributed profits.[47] To avoid losing their limited liability and interfering with managerial control, hedge fund limited partners do not participate in investment decisions, and the fund operating agreement does not empower them to do so.[48] Although limited partnership statutes permit a partnership agreement to grant voting rights to limited partners,[49] hedge fund limited partnerships do not typically grant limited partners any voting rights or the ability to nominate directors.[50] The hedge fund management company directly or indirectly owns all of the fund's voting shares in a separate class with no economic rights.[51] Hedge fund investors thus do not have the right to vote for, or ultimately remove, management, which is inherent in corporate shares and typically available to shareholders in other types of investment funds.[52] The limited partners of a hedge fund are

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[46] *See, e.g.*, Allen v. Amber Manor Apartments P'ship, 420 N.E.2d 440, 495 (Ill. App. Ct. 1981) (holding that limited partnership status is obtained by making a capital contribution).

[47] *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-303 (West 2012). Hedge funds typically only accept capital contributions at the beginning of each month and may close themselves off to new contributions if managers determine that additional capital may undermine their ability to carry out their investment strategies.

[48] *See id.* § 17-303(a).

[49] *See, e.g.*, *id.* § 17-302(b) ("[T]he partnership agreement may grant to all or certain identified limited partners o a specified class or group of limited the partners the right to vote separately or with all or any call or group of the limited partners or the general partners, on any matter.").

[50] MANAGED FUNDS ASS'N, SOUND PRACTICES FOR HEDGE FUND MANAGERS 11 (2009). Partnership statutes expressly allow for a partnership agreement to completely eliminate any voting powers of limited partners. *See, e.g.*, DEL. CODE ANN. tit. 6, § 17-302(f) ("A partnership agreement may provide that any limited partner or class or group of limited partners shall have no voting rights."). Those hedge fund investors that hold voting shares will be able to vote on material events such as "the appointment and removal of the investment manager; the election of directors; approval of directors' fees; variation of shareholder rights; or a winding up of the fund at annual or extraordinary general meetings." ALT. INV. MGMT. ASS'N, *supra* note 4, at 8.

[51] *See* ALT. INV. MGMT. ASS'N, *supra* note 4, at 8; JAMES D. SPELLMAN, COAL. OF PRIVATE INV. COS., HEDGE FUNDS: HOW THEY SERVE INVESTORS IN U.S. AND GLOBAL MARKETS 10 (2009), *available at* http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf.

[52] *See* Investment Company Act of 1940 § 16(a), 15 U.S.C. § 80a-16(a) (2012) (providing for mutual fund shareholders to elect the fund's board of directors); PHYLLIS A. SCHWARTZ & STEPHANIE R. BRESLOW, PRIVATE EQUITY FUNDS: FORMATION AND OPERATION, § 2:1.7, 2-10 (2012) (noting that a main objective of private equity fund investors is to negotiate "an escape hatch from unsatisfactory management through use of for-cause (and in some cases also no-fault) general partner removal clauses"); Sahlman, *supra* note 20, at 490; Jamie Sklar, *Schulte Partner Stephanie Breslow Discusses Hedge Fund Liquidity Management Tools in Practising Law Institute Seminar*, 5 HEDGE FUND L. REP., no. 43, Nov. 15, 2008, at 7 ("In contrast to private equity fund investors, hedge fund investors have not, in the majority of cases, pushed for the contractual right to remove the fund manager.").

extremely passive investors, whose decision making is limited to deciding when and how much capital to contribute or redeem.[53]

Hedge funds also place significant short-term restrictions on investors' ability to redeem their capital and to resell or otherwise transfer their shares.[54] A fund operating agreement typically restricts investors' ability to withdraw capital to a periodic basis, such as monthly, quarterly, or semi-annually,[55] and may permit the manager to completely bar withdrawals at its discretion.[56] In addition, investors must typically give thirty to ninety days' notice before withdrawing capital.[57] Hedge funds may also implement an initial lockup period that prohibits the withdrawal of a capital contribution after it is first invested in the fund.[58] Lockup periods range from less than one quarter to one year.[59] A 2012 industry study found the average hedge fund redemption period to be thirty-five days and the average lockup period to be 5.85 months.[60] Hedge funds may also use a contractual provision known as a "gate" to limit how much capital can be withdrawn on a given date. Gates usually limit investor redemptions to 10% to 25% of the value of the fund, but they may also (or in the alternative) limit redemptions to a portion of the investor's own capital.[61] Hedge funds may also segregate a portion of an investor's capital into an illiquid "side pocket" that prevents the investor from withdrawing its capital until the manager actually exits the investment.[62]

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[53] MANAGED FUNDS ASS'N, *supra* note 50; Bruce N. Lehmann, *Corporate Governance and Hedge Fund Management*, FED. RES. BANK ATLANTA ECON. REV., 4th Quarter 2006, at 81, 86 ("[T]he limited partners in hedge funds are glorified creditors, not active participants in the day-to-day operations of the business.").

[54] Share resale restrictions are generally required for a hedge fund to make a private offering under federal law. *See infra* Part I.C.2. Hedge funds also place restrictions on the trading of their shares so as to not be deemed a publicly traded partnership and to avoid its associated higher tax burden.

[55] HAMMER ET AL., *supra* note 28, at 3; *Credit Hedge Funds Will Continue to Demand Appropriate Liquidity Terms From Investors*, SOBER LOOK (Jan. 19, 2013), http://soberlook.com/2013/01/credit-hedge-funds-will-continue-to.html. By comparison, publicly registered mutual funds are required to redeem shares to investors daily. 15 U.S.C. § 80a-22(e).

[56] *See* FRANCOIS-SERGE LHABITANT, HANDBOOK ON HEDGE FUNDS 29 (2006).

[57] MARK J.P. ANSON, HANDBOOK OF ALTERNATIVE ASSETS 125 (2008).

[58] *Id.*

[59] JAMES R. BARTH ET AL., MILKEN INST., HEDGE FUNDS: RISKS AND RETURNS IN GLOBAL CAPITAL MARKETS 38-41 (2006) (finding that a majority of hedge funds have a lock-up period of less than one quarter). Hedge funds may also use "soft" lockups that allow investors to redeem during their lockup period by paying the fund a penalty fee for doing so. *Credit Hedge Funds Will Continue to Demand Appropriate Liquidity Terms from Investors*, *supra* note 55.

[60] Ross Ford et al., *Liquidity*, 4 HEDGE FUND SPOTLIGHT, Dec. 2012, at 2.

[61] *See generally* David J. Lestz, *Gates, A Primer*, 5 BLOOMBERG L. REP., nos. 34 & 35, 2011.

[62] Steven J. Tsimbinos & Scott H. Moss, *Using Side Pockets for Illiquid and Hard to Value Securities*, MFA REPORTER, May/June 2005, at 1, 1-2.

Limiting the ability of investors to withdraw capital is the primary hedge fund governance device that arises in response to investors' ability and propensity to withdraw their funds. Redemption restrictions empower managers because redemptions may interfere with the manager's investment strategy, destabilize the fund's liquidity, or otherwise disrupt the fund's operations.[63] Fiduciary principles, however, may limit the ability to exercise discretionary redemption restrictions. For example, a fund manager's refusal to permit investors to withdraw capital pursuant to a contractually negotiated gate may violate its fiduciary duty of loyalty if done solely to earn additional fees and not protect the fund or other investors.[64]

B. Hedge Fund Corporations

1. Offshore Funds

Two-thirds of hedge funds globally are organized outside of the United States in an "offshore" jurisdiction, such as the Cayman Islands; and they are typically organized as corporations.[65] U.S.-managed hedge funds are organized in offshore jurisdictions primarily to appeal to non-U.S. investors seeking confidentiality, to permit U.S. tax exempt investors (e.g., pensions and charitable organizations) to take advantage of potentially beneficial tax treatment from investing offshore, and to afford greater flexibility via exclusion from U.S. investment company regulation.[66]

From a governance perspective, management companies enjoy the same general plenary powers over offshore funds' investments and other operations as they do with onshore funds.[67] However, in response to tax disadvantages and restrictions on marketing, U.S.-based onshore funds impose significantly greater restrictions on investor redemptions, including longer lockups and redemption notice periods.[68]

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63 *See infra* Part II.B.2.

64 *See* Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC, No. 5502-CS, 2011 WL 3505355, at *2 (Del. Ch. Aug. 8, 2011) ("The discretion granted to the hedge fund manager to determine whether to waive the Gates is a fiduciary authority that must be used for the benefit of those whom the Hedge Fund is intended to benefit, and not for the selfish interest of the manager.").

65 ALT. INV. MGMT. ASS'N, *supra* note 4, at 21. For differences that may be relevant to U.S. and Cayman Island hedge funds structured as limited partnerships, see Andrea L. Cohen, *Differences Between Cayman Islands and Delaware Limited Partnerships*, PRIVATE EQUITY NEWSL. (Nixon Peabody), Jan. 22, 2007, http://www.nixonpeabody.com/118168.

66 HAMMER ET AL., *supra* note 28, at 99-101; *Focus on Offshore Funds*, HFMWEEK (June 9, 2011), http://www.mourantozannes.com/media/45571O/focus_on_offshore_funds.pdf.

67 HAMMER ET AL., *supra* note 28, at 104.

68 Bing Liang et al., Onshore and Offshore Hedge Funds: Are They Twins? 4 (Dec. 21, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=2014402.

2. Offshore Hedge Fund Directors

From a governance point of view, the most distinguishing aspect of offshore hedge funds is that, unlike most of their U.S.-based peers, offshore hedge funds typically have a board of directors.[69] This is because offshore funds are typically organized as corporations (which must have boards as a matter of basic corporate law) or are located in jurisdictions, such as the Cayman Islands, that require funds organized in their jurisdiction to have boards.[70] Offshore hedge funds also sometimes list their shares on stock exchanges that mandate independent directors as part of their listing requirements.[71]

At a high level, the duties of hedge fund directors are similar to those of public company directors.[72] Hedge fund directors have a duty to act in the best interests of the fund without any conflicts. They must also independently "exercise reasonable care, skill, and diligence" in furthering the fund's interests, which requires proactive supervision and information gathering. This oversight role includes monitoring the manager's investment performance and adherence to its investment policy, the fund's compliance with applicable laws and regulations, and disclosures to and treatment of the fund's investors and overseeing third-party administrators responsible for preparing financial statements and determining the fund's net asset value. In the 2011 decision in *Weavering Macro Fixed Income Fund Limited v. Peterson*, the Grand Court of the Cayman Islands found two hedge fund directors liable to investors for abdicating their oversight role in deference to the interests of the fund manager.[73]

In practice, the oversight role hedge fund directors play is likely not substantial. This is because directors are appointed by managers (as opposed to investors), typically sit on the boards of numerous funds, or lack the requisite financial expertise

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[69] RATAN ENGINEER & ARTHUR F. TULLY, ERNST & YOUNG, COMING OF AGE: GLOBAL HEDGE FUND SURVEY 13 (2011) (noting that less than 15% of North American hedge funds have boards).

[70] *See, e.g.*, WALKERS GLOBAL, WALKER, BVI, CAYMAN AND JERSEY HEDGE FUNDS 20 (2012) (The Cayman Islands Monetary Authority "requires a minimum of 2 individual directors for registered funds."); Jonathan Fitzgibbons, *Cayman Islands: Starting a Cayman Islands Hedge Fund*, MONDAQ (May 9, 2012), http://www.mondaq.com/x/131154/Banking/So+You+Want+To+Start+A+Hedge+Fund (In the Cayman Islands "[t]ypical hedge funds will be regulated funds and must therefore comply with the [Cayman Islands] Mutual Funds Law provisions.").

[71] Mark Beames, *The Role of Independent Directors in Offshore Hedge Funds*, EUREKAHEDGE,(July 2004), http://www.eurekahedge.com/news/04july_archive_news_beames.asp.

[72] *See* LHABITANT, *supra* note 56, at 91-92.

[73] Judgment of Aug. 26, 2011, Weavering Macro Fixed Income Fund Ltd. (In Liquidation) v. Peterson, Grand Court, Cayman Islands (Cause No. FSD 113 of 2010).

or independence from fund managers to provide independent oversight.[74] And because hedge fund investors usually do not have voting shares, they do not have the ability to replace directors.[75] Accordingly, hedge fund boards do not provide the same level of oversight and responsiveness to investors as do boards of public corporations.

C. Federal Law

In the United States, federal law indirectly impacts how hedge funds are governed by providing assurance to investors against fraud and by mandating certain disclosures and business conduct standards. The primary federal statutes that apply to hedge funds are the Investment Advisers Act of 1940 (Advisers Act),[76] the Securities Act of 1933 (Securities Act),[77] and the Securities and Exchange Act of 1934 (Exchange Act).[78] Although hedge funds' investing and trading activities are subject to the Investment Company Act of 1940,[79] hedge funds limit their investor base by number and wealth-qualifications so as to be exempt from its regulation.[80] The In-

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[74] *See generally* SOUND FUND ADVISORS, FUND GOVERNANCE AT A CROSSROADS: CURRENT INDUSTRY DATA AND RECOMMENDED BEST PRACTICES 1 (2012) ("There are few external hedge fund directors with the requisite experience to effectively monitor changes in investment strategy or fund risk."); Frances Denmark, *Directors Wanted*, ALPHA MAG., June 2008; Frances Denmark, *Hedge Fund Directors Still Veiled in Secrecy*, INSTITUTIONAL INVESTOR, June 3, 2011; Frances Denmark, *Hedge Fund Investors Doubt Director Support*, ALPHA MAG., May 15, 2009; Press Release, Fundgov, SEC Filings: Hedge Funds Far Behind Mutual Funds in Governance Practices (Jan. 7, 2013) (finding that "100 individuals hold 5,000 of the 9,000 board positions . . . of 2,800 different hedge funds"), *available at* http://fundgov.org/home/wp-content/uploads/2013/01/Press-release-from-Foundation-for-Fund-Governance-Jan-7-2013.pdf.

[75] *See generally* M. Corey Goldman, *Mutiny? Good Luck*, INSTITUTIONAL INVESTOR, Feb. 24, 2009 (reporting that hedge fund boards typically are not involved in monitoring management and that "the fine print in a hedge fund charter usually makes it almost impossible" for investors to replace directors or otherwise influence management decisions); Frances Denmark, *Hedge Fund Investors Doubt Director Support*, *supra* note 74 (noting that only in rare occasions can hedge fund investors replace directors); *supra* note 50 and accompanying text.

[76] Investment Advisers Act of 1940, 15 U.S.C. §§ 80b-1-80b-21 (2012).

[77] Securities Act of 1933, 15 U.S.C. §§ 77a-77bbbb (2012).

[78] Securities and Exchange Act of 1934, 15 U.S.C. §§ 78a-78pp (2012).

[79] Investment Company Act of 1940, 15 U.S.C. §§ 80a-1-80a-64 (2012).

[80] Hedge funds operate so as to qualify for at least one of two exclusions from the definition of an investment company. Under section 3(c)(1) of the Investment Company Act, hedge funds are excluded from the definition of investment company so long as they have no more than 100 investors and sell their securities only through a private sale. § 80a-3(c)(1). Under section 3(c)(7), hedge funds are excluded from the definition of investment company so long as they only sell securities to "qualified purchasers" through a private sale. § 80a-3(c)(7). Nonpublic offerings for the purposes of being exempted from the Act are generally interpreted to be the same as those as under section 4(2) of the Securities Act. SEC, IMPLICATION OF THE GROWTH OF HEDGE FUNDS 12 n.36 (2003) [hereinafter SEC STAFF REPORT].

vestment Company Act subjects regulated funds to wide-ranging and detailed regulation,[81] including substantial limitations on a fund's use of leverage and ability to engage in short sales and derivatives transactions.[82]

A hedge fund manager meets the Advisers Act's definition of an "investment adviser," which is defined as any person in the business of advising others about whether to purchase or sell certain securities.[83] All U.S.-based hedge fund managers must register under the Advisers Act, unless they fall within an exemption, such as

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Qualified purchasers include both natural persons owning at least $5 million in investments and certain companies with at least $100 million in securities investments. § 80a-2(a)(51)(A)(i); 17 C.F.R. § 270.2a51-1(g)(2) (2005).

[81] *See* 15 U.S.C. § 80a-1(b)(1); SEC, Form N-1A Items 3, 5, 10, 14-15 (requiring disclosure of information including contact information of the fund's investment advisers and portfolio managers, the history of the fund, its risk/return profile and investment objectives, the fund's organization, and how the fees it charges to investors are calculated). Registered investment companies must also quarterly disclose portfolio holdings to the SEC and semiannually to investors. 15 U.S.C. § 80a-30(a)-(b), (e); 17 C.F.R. §§ 270.30b1-1, b1-5, e-1. Open-end registered investment companies must also daily calculate net asset value and allow investors to redeem shares within seven days at that value. 15 U.S.C § 80a-22(e); 17 C.F.R. § 270.22c-1(a) (requiring registered investment companies to sell, redeem, or repurchase shares at net asset value); 17 C.F.R. § 270.22c-1(b) (requiring registered investment companies to calculate net asset value at least daily).

[82] For example, to use leverage in the form of borrowing bank funds, a registered investment company must cover the debt by retaining assets equivalent to at least 300% of the borrowings. 15 U.S.C. § 80a-18(c) (debt restriction for closed-end investment companies);§ 80a-18(f) (debt restriction for open-end investment companies). In addition, under the Act an investment company that engages in a short sale or certain derivatives transactions must effectively hedge the investment position with an offsetting trade or hold liquid securities of an equivalent value in a segregated account. *See* Audrey Talley & James L. Love, *Restrictions on Investments*, *in* MUTUAL FUND REGULATION, §§ 3:3.1[B][3], 3.7–3.11 (Clifford E. Kirsch ed., 2d ed. 2007). Although the SEC has authority under section 12(a) to prohibit registered investment companies from undertaking short sales or purchasing securities on the "margin" (which is a form of borrowing), it has not exercised that authority. The Act also imposes additional restrictions on open-end investment companies available to retail investors, commonly known as "mutual funds." Mutual funds are prohibited from investing greater than 15% of the net value of their assets in illiquid securities, including the privately placed securities issued by hedge funds. Revisions of Guidelines to Form N-1A, Investment Company Act Release. No. 18,612, 57 Fed. Reg. 9828 (Mar. 12, 1992). The SEC defines "illiquid" securities as those that cannot be sold at or near their net asset value within seven days. Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Release No. 14,983, 51 Fed. Reg. 9,773 (Mar. 12, 1986); Statement Regarding "Restricted Securities," Investment Company Act Rel. No. 5,947, 35 Fed. Reg. 19,989 (Oct. 21, 1969). Mutual funds also may not utilize lock-ups because open-end investment companies must return capital to investors within seven days of a redemption request. 15 U.S.C. § 80a-22(e). In addition, mutual funds holding themselves out as "diversified" funds are prohibited, with respect to 75% of their assets, from holding more than 10% of the voting securities of any single issuer, or having the securities of an issuer constitute more than 5% of the mutual fund's net asset value. 15 U.S.C. § 80a-5(b)(1). To minimize their tax liability, mutual funds must also comply with the diversification rule of the Internal Revenue Code, which requires mutual funds to meet the same diversification rule with respect to 50% of its assets. *See* I.R.C. § 851(b)(3) (2012).

[83] 15 U.S.C. § 80b-2(a)(11).

advising funds with less than $150 million in assets under management or qualifying as a foreign private adviser.[84] Hedge funds also raise capital privately, so as not to be subject to the Securities Act's mandatory registration and disclosure obligations required of companies making a public offering of securities.[85]

1. Prohibitions Against Fraud

Registered and unregistered hedge fund managers are subject to the provisions of the Advisers Act prohibiting material misstatements to, misleading omissions to, and other fraudulent practices against investors or prospective investors.[86] The Advisers Act prohibits any fund manager from making false or misleading statements regarding investment strategies, experience and credentials, risks associated with the fund, or valuation of the fund's assets.[87]

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[84] Advisers Act §§ 80b-3(b), 80b-3(l), 80b-3(m); Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111, 75 Fed. Reg. 77,190 (Nov. 19, 2010). Although registered managers are prohibited from charging a performance fee to clients based solely upon the client's capital gains (i.e., the fund's profits), a registered adviser may charge a profit-based performance fee if advising a fund which is excluded from the Investment Company Act under section 3(c)(7), or if all investors in the fund meet the definition of a "qualified client." 15 U.S.C. § 80b-5(a)(1) (prohibiting a registered adviser from being paid compensation "on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client"); § 80b-5(b)(4); 17 C.F.R. § 275.205-3(d)(1). In addition, a registered adviser is permitted to charge a performance fee if the fee symmetrically increases or decreases in proportion to the performance of the fund averaged over a specified period or relative to an external benchmark of performance. 15 U.S.C. § 80b-5(b)(1)-(2). Symmetric performance-based fees, also known as "fulcrum fees," are only utilized by approximately 2% of U.S. mutual funds, in part due to accepted commercial practice, as well as the incentives fulcrum fees create for investors to exit early or to not join well-performing funds. Marcel Kahan & Edward B. Rock, *Hedge Funds in Corporate Governance and Corporate Control*, 155 U. PENN. L. REV. 1021, 1050 (2006-2007); Sophia Grene, *A Cautious Embrace of Performance Fees*, FIN. TIMES, Jan. 7, 2008..

[85] To qualify for a private offering, hedge funds generally limit their investor base almost exclusively to accredited investors, which include institutions with at least $5,000,000 in assets and natural persons whose net worth (or whose joint net worth with a spouse) exceeds $1,000,000 or that have an annual income for the last two years of at least $200,000 (or $300,000 in joint spousal income). 17 C.F.R. § 230.501(a). The definition of accredited investor was amended on Dec. 21, 2011 to exclude an investor's primary residence in the net worth calculation. Press Release, SEC, SEC Adopts Net Worth Standard for Accredited Investors Under Dodd-Frank Act (Dec. 21, 2011), *available at* http://sec.gov/news/press/2011/2011-274.htm. When an offering is made pursuant to the "safe harbor" of Rule 506, the offering is deemed in accordance with section 4(2) and hence exempt from the registration requirements of section 5 of the Securities Act.

[86] 17 C.F.R. § 275.206(4)-(8).

[87] Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756, 44759 (Aug. 9, 2007) (to be codified at 17 C.F.R. pt. 275). *See also* SEC, *supra* note 34, at 29-32. Under the Advisers Act, fraudulent or misleading statements or omissions need not be willful to be unlawful; negligence is sufficient for liability. 72 Fed. Reg. at 44,759-60 (noting that negligent misstatements are

In raising capital from limited partner-investors, hedge funds are subject to the antifraud provisions of the Securities Act and the Exchange Act.[88] Under section 17(a) of the Securities Act, it is unlawful for any issuer to make an untrue statement of material fact or to omit any fact so as to make a statement misleading.[89] Under section 10(b) and Rule 10b-5 of the Exchange Act, material omissions in connection with the sale of any security are likewise prohibited.[90] Rule 10b-5-1 prohibits hedge fund managers from using material nonpublic information to purchase or sell securities (insider trading).[91] In addition, under various provisions of the Exchange Act and Securities Act, hedge funds are prohibited from manipulating the prices of publicly or privately held securities.[92]

2. Disclosure and Business Conduct Requirements

The Advisers Act requires registered hedge fund managers to electronically file and keep current Form ADV with the SEC.[93] All parts of Form ADV, except for an investment brochure, must also be made available to the public on the Investment Adviser Public Disclosure website.[94] The brochure must be written in "plain English" and be provided to prospective clients and annually to existing clients.[95] Part 1 of Form ADV requires managers to disclose basic information relating to the firm and its business, so as to assist regulators with oversight. Part 2 of Form ADV requires a manager to disclose information relating to potential conflicts of interest and other issues, including fees and how they are calculated, client referrals, disciplinary history, and the manager's supervision of personnel.[96] For the purposes of assisting regulatory authorities in preserving financial stability, registered hedge fund advisers with

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prohibited under the Advisers Act).

[88] Notwithstanding the fact that hedge funds privately raise capital in reliance upon Regulation D of the Securities Act, such an offering is fully subject to the Act's antifraud provisions. Landreth Timber Co. v. Landreth, 471 U.S. 681, 692 (1985); Regulation D Preliminary Note 1, 17 C.F.R. § 230.501.

[89] 15 U.S.C. § 77q(a).

[90] 15 U.S.C. § 78j; Rule 10b-5, 17 C.F.R. § 240.10b-5. Furthermore, under the Securities Act mere negligence is sufficient to be liable for fraud. Aaron v. SEC, 446 U.S. 680, 701-02 (1980).

[91] *See* Selective Disclosure and Insider Trading, Securities Act Release No. 7881, Exchange Act Release No. 43,154, Investment Company Act Release No. 24,559, 65 Fed. Reg. 51716, 51737 (Aug. 24, 2000).

[92] LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS § 14:5 (4th ed. 2004).

[93] 17 C.F.R. §§ 275.203.1, 275.204-1.

[94] The Investment Adviser Public Disclosure website is located at http://www.adviserinfo.sec.gov (last visited Jan. 15, 2014).

[95] SEC, *supra* note 34, at 18-20.

[96] *See* SEC, Form ADV pt. 2.

at least $150 million in assets under management must also disclose details about their funds' investment positions, counterparties, and other information on Form PF to the SEC, who makes the form available to the Financial Stability Oversight Council.[97] Hedge funds must also comply with other disclosure requirements under the Exchange Act arising out of any large equity investments in public companies.[98]

The Advisers Act also requires hedge fund managers to keep specific business and accounting records, to protect any client assets over which the fund has legal custody, and ensure that their own personnel comply with federal securities law and regulation.[99] Rule 206(4)-7 of the Advisers Act requires fund managers to establish a compliance program that includes written policies and procedures and a designated chief compliance officer.[100] These requirements have spurred a renewed focus on compliance and best practices by market participants.[101]

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[97] SEC, Form PF, *available at* http://www.sec.gov/rules/final/2011/ia-3308-formpf.pdf; Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308, 76 Fed. Reg. 71,128 (Oct. 31, 2011).

[98] First, hedge funds must disclose large shareholdings of public companies. To regulate the market for control of public companies, sections 13(d) and 13(g) of the Exchange Act require that hedge funds or their advisers disclose beneficial ownership of greater than 5% in a class of voting shares of securities registered under the Act and disclose whether the purpose of such ownership is to acquire or influence the issuer. 15 U.S.C. § 78m(d), (g); 17 C.F.R. § 240.13d-1(a). In connection with preventing insider trading, section 16(a) requires that hedge funds, upon acquiring a 10% ownership stake in any issuer's class of voting equity securities registered pursuant to the Exchange Act, must disclose such ownership, any other equity ownership in the company, and any subsequent changes in such ownership. 15 U.S.C. § 78(p)(3)(B); 17 C.F.R. §§ 240.16a-1, 240.16a-2. In addition, under section 13(f) hedge funds owning more than $100 million in stock traded on a national exchange are required to quarterly disclose to the public all of their equity holdings. 17 C.F.R. § 240.13f-1(b); Disclosure of Short Sales and Short Positions by Institutional Investment Managers, Exchange Act Release No. 58,785, 73 Fed. Reg. 61,678 (Oct. 17, 2008).

[99] SEC, *supra* note 34, at 32-38.

[100] Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204, Investment Company Act Release No. 26,299, 68 Fed. Reg. 74714 (Dec. 24, 2003). The SEC's adopting release reviews specific issues that a fund manager's compliance program should address. *Id.* Industry participants have also identified compliance best practices for hedge funds. *See, e.g.*, ADVENT SOFTWARE & FOCUS 1 ASSOCS., THE IMPACT OF DODD-FRANK ON YOUR FRONT OFFICE: THE FIVE KEY SEC ALARMS AND BEST PRACTICES TO AVOID TRIGGERING THEM (2011), http://www.focus1associates.com/library/doddfrank.pdf; CITI PRIME FIN., DODD-FRANK PRIVATE FUND MANAGER REGULATION: A NEW ERA OF COMPLIANCE (2011).

[101] *See* AKIN GUMP STRAUSS HAUER & FELD LLP, ANNUAL COMPLIANCE OBLIGATIONS OF INVESTMENT MANAGER AFTER DODD FRANK (2012); CITI PRIME FINANCE, *supra* note 100, at 13.

II. Hedge Fund Agency Costs

Hedge fund managers are the agents of their investors. However, the wide-ranging powers that managerialism bestows upon hedge fund managers potentially allow them to impose significant agency costs on investors in the form of losses and inefficiencies. Investors bear agency costs due to misaligned incentives between managers and investors and from managers acting opportunistically when they are better informed.[102] Agency costs have the effect of reducing investors' risk-adjusted returns, either through losses or by depriving investors of better returns.[103] Hedge fund agency costs arise from five primary sources: fraud or misreporting with respect to a fund's performance and other characteristics, incentive misalignments due to how hedge fund managers are compensated, overly long redemption restrictions, managers appropriating fund profits, and managers favoring certain investors or service providers. Empirical studies suggest that the most significant source of agency costs is the subtle manipulation of performance returns (valuation) by managers when it suits their interests.[104]

A. Fraud and Misreporting

The most basic type of hedge fund agency cost is manager fraud through misreporting some aspect of the fund's returns, asset values, risk taking, or investment activities. This accords with agency theory, which predicts that agents may try to manipulate the performance measures used by their principals.[105] Hedge fund investors may potentially be subject to higher agency costs from misreporting than investors in government-registered investment companies. This is because hedge funds

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[102] *See* D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 12-14 (2009). *See generally* Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980); Eugene Fama & Michael C. Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101 (1985); Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991); Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Capital Structure*, 3 J. FIN. ECON. 305 (1976).

[103] Hedge fund agency costs may also be exacerbated by adverse selection: investors may find it difficult to accurately determine how skilled a manager is, or how exposed they are to risky investment strategies. *See generally* Dean P. Foster & H. Peyton Young, The Hedge Fund Game: Incentives, Excess Returns, and Piggy-Backing (Mar. 2, 2008) (unpublished manuscript), *available at* http://knowledge.wharton.upenn.edu/papers/1352.pdf.

[104] *See infra* notes 122-128 and accompanying text.

[105] *See, e.g.*, Joel S. Demski et al., *Efficient Manipulation in a Repeated Setting*, 42 J. ACCT. RES. 31, 31-32 (2004).

are not required by regulation to value their assets according to SEC guidelines.[106] Unlike public companies, there is no market for hedge fund short sellers actively attempting to uncover and profit from hedge fund fraud.[107]

Hedge fund managers' compensation and desire to attract investors gives them several incentives to misreport their returns. Hedge fund managers have an incentive to overstate performance to increase their performance-based compensation, to be able to charge higher fees to new investors attracted by prior high performance, and to attract and retain capital. Managers, likewise, have an incentive to overstate asset values to increase management fees and an incentive to understate returns when an investor withdraws capital to increase the capital the fund retains. In addition, managers have an incentive to understate the volatility a fund's returns to increase its risk-adjusted performance. Empirical studies indicate that some managers may act on these incentives to the detriment of investors.

In a study comparing hedge funds' stock holding valuations reported to the SEC with the stocks' closing prices as reported in the widely used Center for Research in Security Prices, 25% of hedge fund managers were found to have reported economically significant valuation discrepancies (2.5% on average).[108] The valuation discrepancies were likely not random, as they were found to be more likely where managers self-report to commercial performance databases, are domiciled in offshore jurisdictions, and performed poorly in the prior year.[109] Other studies have also found that hedge funds report higher returns in December by underreporting returns earlier in the year,[110] increase the value of their stock holdings through end-of-month market purchases,[111] and revise or delay poor past performance.[112]

Studies also suggest that some hedge funds may deliberately understate the volatility of their returns. The funds most likely to do so are those holding illiquid as-

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106 INV. CO. INST., SEC VALUATION AND LIQUIDITY GUIDANCE FOR REGISTERED INVESTMENT COMPANIES 87-102 (2011), http://www.ici.org/pdf/pub_11_valuation_volume1.pdf.

107 LACK, *supra* note 25, at 129.

108 Gjergji Cici et al., *The Valuation of Hedge Funds' Equity Positions* 2 (AFA 2012 Chicago Meetings Paper, Working Paper No. 10-15, 2013), *available at* http://ssrn.com/abstract=1664461.

109 *Id.* at 4-5.

110 Vikas Agarwal et al., *Do Hedge Funds Manage Their Reported Returns?*, 24 REV. FIN. STUD. 3281, 3283 (2011).

111 Itzhak Ben-David et al., *Do Hedge Funds Manipulate Stock Prices?*, 68 J. FIN. 2383, 2432 (2013) (finding "data to test the conjecture that hedge funds manipulate stock prices at the the end of the month by buying some of their stock holdings before market close").

112 Andrew J. Patton et al., *Change You Can Believe In? Hedge Fund Data Revisions*, J. FIN. (forthcoming 2014), *available at* http://ssrn.com/abstract=1934543; George O. Aragon & Vikram Nanda, Strategic Delays and Clustering in Hedge Fund Reported Returns 3 (Sept. 3, 2013) (unpublished manuscript), *available at* http://www.public.asu.edu/~goaragon/Papers/HFDelay.pdf.

sets or assets that otherwise give managers discretion in valuation,[113] funds advised by managers with greater performance incentives,[114] and funds with investors that are more likely to withdraw in response to return volatility.[115] Other hedge funds with a greater tendency to misreport include those where managers have more to gain from misreporting, such as funds that have a stronger relationship between reported returns and capital inflows[116] and funds that recently reported poor returns.[117] A relatively common type of misreporting by managers is reporting small positive returns, as opposed to small losses, when the discretion inherent in valuing illiquid assets permits them to do so.[118]

Important questions include the economic significance and the effects of fraud or misreporting.[119] Empirical studies suggest they may be significant when they occur but that they are not pervasive in the industry. A study by Castle Hall, a hedge fund due diligence firm, estimated that through June 30, 2009, only about 3% of hedge management companies committed fraud and that the losses from hedge fund

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[113] Gavin Cassar & Joseph Gerakos, *Hedge Funds: Pricing Controls and the Smoothing of Self-reported Returns*, 24 REV. FIN. STUD. 1698, 1698 (2011) ("We find that funds using less verifiable pricing sources and funds that provide managers with greater discretion in pricing investment positions are more likely to have returns consistent with intentional smoothing."); Mila Getmansky et al., *An Econometric Model of Serial Correlation and Illiquidity in Hedge Fund Returns*, 74 J. FIN. ECON. 529, 546, 589 (2004). *See also* Jennifer Banzaca, *Key Considerations for Hedge Fund Managers in Organizing and Operating Valuation Committees*, 5 HEDGE FUND L. REP., no. 32, Aug. 2012, ("As a general rule, greater difficulty in valuing portfolio assets leads to a more acute valuation conflict . . . . For assets of uncertain value, a manager can strike its mark within a range of plausible values."), available at http://www.hflawreport.com/articles/by/topic/85.

[114] Shuang Feng & Mila Getmansky, Return Smoothing, Managerial Incentives, and Hedge Fund Failures 19 (Sept. 19, 2011) (unpublished manuscript), *available at* http://www.fma.org/Denver/Papers/smoothing.pdf.

[115] *See generally* Nicolas P. B. Bollen & Veronika K. Pool, *Conditional Return Smoothing in the Hedge Fund Industry*, 43 J. FIN. & QUANTITATIVE ANALYSIS 267 (2009).

[116] Ben-David et al., *supra* note 111; Petri Jylha, Hedge Fund Return Misreporting: Incentives and Effects 2 (Nov. 10, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1661075.

[117] Adam L. Aiken, Hedge Funds, Return Smoothing, and the Pricing of Illiquid Assets: Evidence from Debt Holdings 31 (Aug. 2009) (unpublished manuscript), *available at* http://www.researchgate.net/publication/228547284_Hedge_funds_return_smoothing_and_the_pricing_of_illiquid_assets_Evidence_from_debt_holdings.

[118] *See generally* Nicolas P. B. Bollen & Veronika K. Pool, *Do Hedge Fund Managers Misreport Returns? Evidence from the Pooled Distribution*. 64 J. FIN. 2257 (2009).

[119] In general, fraud or misreporting reduces the wealth of existing investors by causing transfers of wealth and economic losses. The welfare effects among groups of investors may be ambiguous under certain circumstances, however. Existing investors may benefit from overstatements of performance because new investors will be overcharged for their shares when they buy into the fund. And if investors are withdrawing capital from a fund, understating returns benefits the investors that remain because too little will be paid out to departing investors. Jylha, *supra* note 116.

fraud totaled $15 billion,[120] which was less than 1% of the total assets hedge funds managed at the time (approximately $1.4 trillion).[121] In their study of potential artificial smoothing of hedge fund returns, Bollen and Pool estimated that, at most, only of a subgroup of hedge funds had returns that could indicate fraud.[122]

However, other studies suggest that subtle manipulation of performance returns may impose significant costs on at least some investors. A study by Bollen and Pool of mangers that avoided reporting small negative returns found approximately 10% of relevant returns to be misreported, such that new investors overpaid by approximately $1 to $2 billion to the benefit of existing investors.[123] Patton et al. found that over 15% of the over 18,000 hedge funds in their sample revised a previous monthly return by at least 1%.[124] Cici et al. found that 25% of hedge fund managers make small, yet economically significant, misstatements about the value of their stock holdings.[125] Feng and Getmansky's study of hedge fund return smoothing found evidence implying that, on average, hedge funds report only 84.9 percent of their monthly returns, with the 15.1% distributed over the next two months.[126] Agarawal et al. found small, but economically significant, reported performance spikes in December,[127] and Ben-David et al. found that hedge fund manipulation causes end-of-month stock prices to be inflated by an average of 0.3% for stocks in the top quartile of hedge fund ownership.[128]

B. Fee-Based Incentive Misalignments

Agency costs also arise from the structure of hedge fund managers' annual compensation. A basic agency cost arises from managers earning fees on an annual basis for investment positions or strategies that are longer-term in nature. In such a case, a manager may be able to earn performance fees in the early years of a strategy and then pass losses along to investors when the investment ultimately suffers loss-

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[120] CASTLE HALL ALTS., FROM MANHATTAN TO MADOFF: THE CAUSES AND LESSONS OF HEDGE FUND OPERATIONAL FAILURE 6 (2009), http://www.castlehallalternatives.com/upload/publications/2507_ManhattantoMadoffPaper.pdf.

[121] PRICEWATERHOUSECOOPERS, A GLOBAL APPROACH TO REGULATING HEDGE FUNDS? 8 (2009), http://www.pwc.com/gx/en/asset-management/assets/pdf/AMN0609_04.pdf.

[122] Bollen & Pool, *supra* note 115.

[123] Bollen & Pool, *supra* note 118.

[124] Patton et al., *supra* note 112, at 2.

[125] Gjergji Cici et al, *supra* note 108.

[126] Feng & Getmansky, *supra* note 114.

[127] Vikas Agarwal et al., *supra* note 110, at 3297, 3299.

[128] Itzhak Ben-David et al., *supra* note 111, at 2383.

es.[129] Paying managers on an annual basis may, therefore, give them an incentive to pursue strategies that have relatively short-term gains and are likely to have long-term losses, strategies often described as selling disaster insurance (or deep out-of-the-money put options).

A second hedge fund compensation-based agency cost is similar to a general agency problem in the corporate context, which stems from business managers increasing their risk taking after obtaining capital from investors. In particular, a firm's equityholders have an incentive to increase risk at the expense of a firm's creditors because equityholders have limited liability, while nonetheless benefitting from potentially unlimited upside. Creditors, on the other hand, generally do not stand to benefit from a firm increasing its risk after a credit extension. The agency cost from this divergence of interests is known as "asset substitution" and is extensively studied in corporate finance literature.[130]

In the hedge fund context, a fund's equity investors — as opposed to its debt holders — may likewise be subject to an asset substitution problem in the sense that managers change their risk-taking behavior after equity investors have contributed their capital. Hedge fund managers may have incentives to take on greater risk after obtaining investor capital because of the asymmetric payoff structure resulting from their performance-based compensation arrangement: the manager shares in the profits of a fund with investors but not in fund losses. In addition, potential for agency costs may be especially high because hedge fund managers potentially have far more to gain from performance-based compensation than from the part of their compensation that is based upon assets under management (i.e., management fees).

However, management fees may also impose agency costs on investors. At least in the short term, a fixed management fee is not dependent on performance. This may result in managers earning compensation even if investors have suffered net losses. This is especially true in "zombie funds," which are funds that continue to

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[129] ALT. INV. MGMT. ASS'N, *supra* note 4, at 20. This incentive problem is a general one that exists throughout the corporate context. As noted by Lucian Bebchuk and Jesse Fried:

> Consider an executive who expects to be rewarded at the end of a given year based on performance measures tied to the stock price at the end of that year. This compensation structure may lead to two types of undesirable behavior. First, managers may take actions that boost the stock price in the short run, even if such actions would destroy value in the long run. For example, executives may enter into transactions that improve the current bottom line but create large latent risks that could cripple the firm in the future.

Bebchuk & Fried, *supra* note 27, at 1922.

[130] *See generally* Nengjiu Ju & Hui Ou-Yang, Asset Substitution and Underinvestment: A Dynamic View (April 2, 2006) (unpublished manuscript), *available at* http://ssrn.com/abstract=686407.

operate and collect management fees even though their losses have been so large that they are unlikely to ever be profitable for investors. For very large hedge funds, compensation earned pursuant to management fees far exceeds that necessary to pay for operating overhead and, thereby, reduces the incentives for managers to earn profits for investors. As one observer states:

> For the 200-plus funds with $1 billion or more in assets, management fees alone can keep the lights on — and then some. One hedge fund honcho whose multibillion-dollar fund shut down in 2008 says that he got the biggest payday of his career that year, thanks to the management fees collected before the fund's demise.[131]

Incentive misalignments from management fees may be exacerbated by the fact that, on average, management fees account for a greater share of industry-wide manager compensation than performance fees.[132]

C. Restrictions on Investor Redemptions

Redemption restrictions give hedge fund investments the quality of asset-specificity. According to transaction cost economics, asset-specificity gives rise to potential agency costs because investment-specific assets leave an investor vulnerable to unexpected changes in asset prices or opportunistic conduct by managers.[133] In the hedge fund context, the use of lockups, notice periods, or gates temporarily reduce the ability of investors to withdraw their capital and may permit the manager to opportunistically use investor funds for its own benefit, thereby imposing an agency cost on investors. Moral hazard is also created in such a situation because when redemptions are restricted, the investor has little, if any, ability to discipline the manager. For example, in the 2011 case of *Paige Capital Management v. Lerner Master Fund*, a hedge fund manager acting pursuant to a contractual gate prevented an investor from withdrawing its capital. The court found that the gate was enacted solely to

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[131] Michelle Celarier, *Survival of the Fattest*, INSTITUTIONAL INVESTOR (Mar. 28, 2012), http://www.institutionalinvestor.com/Article/3001820/Survival-of-the-Fattest-Magazine-Version.html?ArticleId=3001820.

[132] Shuang Feng et al., Flows: The 'Invisible Hands' on Hedge Fund Management 14 (Sept. 16, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1929205.

[133] Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.L. & ECON. 233, 255 (1979).

enable the fund to opportunistically collect management fees, while doing little to attract new investors or pursue the fund's investment strategy.[134]

Redemption restrictions also impose agency costs to the extent that the inability to withdraw capital imposes a foregone (opportunity) cost from not being able to use the capital elsewhere. This may especially be the case when redemption restrictions coincide with the fund experiencing losses, thereby increasing the risk of outright loss as well. Andrew Ang and Nicolas Bollen model the cost of hedge fund redemption restrictions by measuring how much a restriction reduces the value of an investor's right to redeem at any time (a "liquidity option").[135] They conclude that, for an investor with typical risk aversion preferences, the combination of standard lockup, notice, and gating provisions can impose an annual cost equivalent to over 5% of the fund's net asset value.[136] In addition, a study of hedge funds from 2006 to 2011 found that funds that restricted redemptions through gates and side pockets underperformed comparable funds not enacting such restrictions.[137] However, because the study did not compare funds with different levels of redemption restrictions, it fails to show that funds with more restrictions are generally worse for investors.[138]

D. Overcompensation of Managers

Another potential hedge fund agency cost is investors may pay more in fees than is necessary to produce a given level of returns, thereby allowing fund managers to capture a portion of the fund's profits at the investors' expense. One way for managers to appropriate fund profits is to increase fees *after* good performance. Although most hedge funds do not change their fees with respect to any particular investor, a study of 3,814 funds from April 2008 until June 2011 found that 7.8% of funds increased or decreased some aspect of their fees over a three-year period.[139] The authors found that performance fee increases typically followed superior performance

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[134] Paige Capital Mgmt., LLC v. Lerner Master Fund, LLC, No. 5502-CS, 2011 WL 3505355, at *1 (Del. Ch. Aug. 8, 2011).

[135] *See generally* Andrew Ang & Nicolas P. B. Bollen, When Hedge Funds Block the Exits (Jan. 14, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1916286.

[136] *Id.* at 2.

[137] Aiken et al., *supra* note 2, at 3-4.

[138] Indeed, funds that place more restrictions on investor redemptions may perform better. *See infra* Part III.E.

[139] Vikas Agarwal & Sugata Ray, Determinants and Implications of Fee Changes in the Hedge Fund Industry 4-5 (Mar. 15, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2024362.

and that funds with increasing capital flows increased management fees.[140] Because performance typically decreased after fees were increased, the fee increases may indicate that managers were opportunistically taking advantage of high demand for their funds.[141] Likewise, other studies provide evidence suggesting that managers with abnormally high performance increase their performance fee rate (when starting new funds) to capture a larger portion of their above-average profits, which ultimately reduces investors' returns to the average.[142]

Even for managers that do not increase their fees for existing or new investors, the typical hedge fund fee structure may overcompensate hedge fund managers in the sense that investors could have obtained the same or greater returns by investing in vehicles with lower fees. In a 2011 study of the returns of nearly 11,000 hedge funds, Ilia Dichev and Gwen Yu used a "dollar-weighted" measure of performance to estimate the actual returns investors' obtained.[143] They found that returns to hedge funds investors from 1990 to 2008 were typically lower than the stock market and only slightly higher than the risk-free rate earned by investing in government bonds.[144] An implication of their study is that any fees or other additional costs associated with hedge fund investing are agency costs that can be eliminated or substantially reduced by directly investing in the markets or in low-cost passive investment vehicles (e.g., index funds that track the performance of markets). The time-weighted measure of hedge fund performance, however, indicates that hedge funds provide value to investors even after fees are paid to managers.[145] In addition, a recent study found that nearly three-quarters of fund profits go to investors, not managers, which indicates that performance fees are not generally too high or structured to allow managers to be paid before losses are passed along to investors.[146]

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140 *Id.* at 5-7.

141 *Id.* at 7.

142 Ivan Guidotti & Istvan G. Nagy, Rational Behavior of Hedge Fund Managers and Investors 4 (December 10, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1972148. *See also* William Fung et al., *Hedge Funds: Performance, Risk, and Capital Formation*, 63 J. FIN. 1777, 1780 (2008) ("Our evidence also suggests that capital inflows adversely impact alpha at the aggregate level."); Tarun Ramadorai & Michael Streatfield, Money for Nothing? Understanding Variation in Reported Hedge Fund Fees 3 (Mar. 28, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1798628.

143 *See generally* Ilia D. Dichev & Gwen Yu, *Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn*, 100 J. FIN. ECON. 248 (2011).

144 *Id.*

145 *See infra* Part III.D.

146 *See* CTR. FOR HEDGE FUND RESEARCH, *supra* note 26.

E. Favoritism of Certain Investors or Service Providers

Hedge fund investors may suffer from agency costs due to managers giving favorable treatment to some investors over others or to service providers at the expense of investors generally. Favoritism may exacerbate any preexisting incentive or tendency to commit fraud or misreport returns because favoritism may require the manager to misreport returns or some other aspect of the fund's operations.

Through separate agreements known as "side letters," certain hedge fund investors may obtain favorable terms for themselves that are not offered to all investors in the fund's general offering documents.[147] Managers may grant favorable terms to curry favor with certain investors because the size, timing, or nature of their investments make their capital particularly important to the manager. Side letters may give investors favorable treatment regarding fees, disclosure, liquidity, and other terms.[148] Favorable liquidity or disclosure terms may allow some investors to exit the fund ahead of other investors and, thereby, create a conflict of interest between the manager and the investors without the favorable terms. As a matter of law, side letters are permitted so long as giving favorable treatment to some investors does not violate the contractual rights of other investors or the manager's fiduciary duty to generally avoid giving preferential treatment to some investors to the detriment of others.[149] Compliance with these legal obligations can be accomplished by disclosing the nature of the fund's side letters or by establishing separate classes of investors with differential investment terms.[150] Side letters likely do not impose significant, if any, costs on hedge fund investors when they are disclosed and their terms are followed. However, undisclosed side letters granting preferential withdrawal rights may impose significant costs on some investors, when they allow favored investors to exit a poorly performing fund.[151]

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[147] Mark Perlow, *Managing Hedge Fund Conflicts of Interest*, 40 REV. SEC. & COMMODITIES REG., no. 7, Apr. 2007, at 75.

[148] *Id.* A "most favored nation" side letter clause promises that an investor will be offered any superior terms offered to other investors. *Id.*

[149] *Testimony Concerning Hedge Funds Before the Subcomm. on Sec. & Inv. of the S. Comm. on Banking, Hous., and Urban Affairs* (2006) (statement of Susan Ferris Wyderko, Director, Office of Investor Education & Assistance); HAMMER ET AL., *supra* note 28, at 90.

[150] Perlow, *supra* note 147, at 77-78; SEC, *supra* note 96 ("As a fiduciary, you . . . must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your *clients* that could affect the advisory relationship.") (emphasis in original).

[151] *See* Press Release, SEC, SEC Charges Connecticut-Based Hedge Fund Managers with Fraud (Feb. 26, 2013), http://www.sec.gov/news/press/2013/2013-28.htm (alleging that hedge fund secretly

Investors may also suffer from agency costs due to managers giving favorable treatment to service providers at their expense. For example, prime brokers provide a wide array of services to hedge funds including trade execution, securities lending, investment research, and investor referrals, which help establish new funds. Hedge funds may pay for such services with "soft dollar" payments — by directing trades to their prime broker or affiliated third parties, or paying above-market rates for brokerage commissions.[152] Soft dollar payments may impose an agency cost on investors if the services purchased by inflated commissions or trades directed to suboptimal brokers benefit the manager more than investors, who ultimately subsidize the soft dollar payments.[153] Undisclosed soft dollar payments to prime brokers may constitute a conflict of interest subject to an enforcement action by the SEC or other regulatory authorities.[154] Favoring certain service providers may also take the form of appointing service provider representatives to the fund's board of directors. In such a case, the director may impose agency costs by providing relatively less independent oversight on managers.[155] However, despite the potential for agency costs

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granted favorable liquidity terms to largest investor prior to the fund's collapse).

[152] GREGORY CURTIS, GREYCOURT & CO, INC., WHITE PAPER NO. 4 – SOFT DOLLARS: GREYCOURT'S POSITION 1 (2001), *available at* http://www.greycourt.com/wp-content/uploads/file/White_Paper004-Soft_dollars-GDC.pdf ("The phrase 'soft dollars' refers to several related activities, all involving the practice of paying for services other than securities trades with commission dollars" owed to the broker.); SEC, INSPECTION REPORT ON THE SOFT DOLLAR PRACTICES OF BROKER-DEALERS, INVESTMENT ADVISERS AND MUTUAL FUNDS (1998), *available at* http://www.sec.gov/news/studies/softdolr.htm (defining soft dollar payments as "arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer").

[153] *See* Stephen M. Horan & D. Bruce Johnsen, *Does Soft Dollar Brokerage Benefit Investors: Agency Problem or Solution?* 6 (George Mason School of Law, Law & Econ. Working Series, Paper No. 04-50, 2004), *available at* http://ssrn.com/abstract=615281. In the words of former SEC Chairman Christopher Cox, soft dollar payments may result in managers using "their clients' commissions [or fees] to buy research that the managers would otherwise have to pay for out of their own pockets or produce themselves." Letter from Christopher Cox, Chairman, SEC, to The Honorable Christopher Dodd, Chairman, Comm. on Banking, Hous., & Urban Affairs (May 17, 2007) (on file with author).

[154] *See* Mass. Fin. Servs. Co., Investment Company Act Release No. 26,409, Advisors Act Release No. 2224, 82 SEC Docket 2036 (Mar. 31, 2004); Commission Guidance Regarding Client Commission Practices Under Section 28(a) of the Securities and Exchange Act of 1934, Exchange Act Release No. 54,165, 71 Fed. Reg. 41,978 (July 24, 2006); PROSKAUER, CLIENT COMMISSION (SOFT DOLLAR) ARRANGEMENTS: THE SECTION 28(E) SAFE HARBOR 1 (2011), *available at* http://www.proskauer.com/files/uploads/broker-dealer/Client-Commission-Soft-Dollar-Arrangements.pdf; Press Release, Fin. Indus. Regulatory Auth., SMH Capital Fined $450,000 for Procedural Failures Regarding Soft Dollar Payments, Distributing Improper Hedge Fund Sales Materials (Jan. 9, 2008), *available at* http://www.finra.org/Newsroom/NewsReleases/2008/P037758.

[155] *See* ALT. INV. MGMT. ASS'N, AIMA'S OFFSHORE ALTERNATIVE FUND DIRECTORS' GUIDE 6, (2d ed. 2008) ("Best practice for any Fund would be to . . . avoid appointing Directors who represent the advisers or service providers to the Fund because of the potential for conflicts of interest.").

from service provider favoritism, they may not be substantial in practice. Soft dollar payments may reduce agency costs stemming from underinvestment in research.[156] In addition, the benefit of bringing service providers' expertise to the board may mitigate any problems associated with appointing them as directors.

III. Hedge Fund Governance Devices

Despite the managerialist foundations of hedge fund governance, managers adopt investor-friendly governance devices that reduce agency costs in response to investor demand and competition. In addition to the funds' underlying legal regime and the contractual device of placing short-term redemption restrictions on investor redemptions,[157] hedge fund governance devices fall into three categories: those that are driven directly by equity investors, those that arise from managers' performance-based compensation, and those that are required by the funds' short-term creditors. This Part reviews each of these types of governance mechanisms and concludes by assessing whether the investor-responsive aspects of hedge fund governance are sufficient to overcome the agency costs allowed for by managerialism.

A. Investor Driven Governance

1. Capital Inflows and Outflows

Despite being subject to short-term restrictions on their withdrawal rights, a primary governance mechanism over hedge fund managers is the high propensity of investors to withdraw or not commit their funds in response to poor performance or governance. Unsurprisingly, hedge fund investors decide to invest largely based on the fund's past performance.[158] Hedge fund investors are also quick to withdraw their

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[156] *See* Horan & Johnsen, *supra* note 153, at 20-21.

[157] *See supra* notes 54-64 and accompanying text.

[158] Vikas Agarwal et al., *Flows, Performance, and Managerial Incentives in Hedge Funds* 30 (EFA 2003 Annual Conference, Paper No. 501, 2004), *available at* http://ssrn.com/abstract=424369 (finding that "money-flows chase recent good performance"); Andrea Beltratti & Claudio Morana, *Aggregate Hedge Funds' Flows and Returns*, 18 APP. FIN. ECON. 1755, 1755-57 (2008); Guido Bolliger et al., *Hedge Fund Investing in the Aftermath of the Crisis: Where Did the Money Go?*, 14 J. ALT. INVESTMENTS 8, 8-9 (2011); Bill Ding et al., Market Volatility, Investor Flows, and the Structure of Hedge Fund Markets 3 (Nov. 6, 2006) (unpublished manuscript) (on file with author) (finding evidence that hedge fund investors are "smart" such that they have skill in allocating capital to funds that perform above-average); Ivan Guidotti & Istvan G. Nagy, Rational Behavior of Hedge Fund Managers and Investors (Dec. 10, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1972148

capital from poorly performing funds.[159] Hedge fund investors seem particularly sensitive to performance and are more likely than mutual fund investors to withdraw their capital in sufficiently large amounts to jeopardize the fund's survival.[160]

In addition to performance, hedge fund investors care about governance. Institutional hedge fund investors typically demand some threshold level of quality with respect to governance and will withdraw their funds, or refuse to invest in the first place, if the fund lacks the desired quality.[161] For example, in 2009 CalPERS stated that it would no longer invest in hedge funds in which manager compensation was perceived as misaligning incentive.[162] Accordingly, maintaining a baseline level of governance is necessary for funds to attract and retain investor capital. Indeed, satisfying investors' performance and governance preferences is so important that hedge funds employ full-time professionals tasked with raising capital from investors and addressing their concerns so long as they are invested.[163]

General financial industry trends are likely putting additional pressure on managers to provide more investor-friendly governance terms. This is because, as the hedge fund industry has grown, the ability to outperform other hedge funds has likely become more difficult. Not only does more funds pursuing the same investment strategy generally reduce potential gains from the strategy,[164] but it also increases the

("Flows rationally respond to expected abnormal returns."); Jenke ter Horst & Galla Salganik, Style Chasing by Hedge Fund Investors (Jan. 25, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1362576. Investors' allocations to high performing funds may, however, be undermined by their lack of ability to detect true outperformance. Guillermo Baquero, On Hedge Fund Performance, Capital Flows and Investor Psychology 162 (Dec. 7, 2006) (unpublished Ph. D. Thesis, Erasmus University Rotterdam), *available at* http://repub.eur.nl/res/pub/8192/EPS2006094F&A905892131XBaquero.pdf.

[159] Guillermo Baquero & Marno Verbeek, A Portrait of Hedge Fund Investors: Flows, Performance and Smart Money 6-7 (Oct. 22, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=773384 (finding that hedge fund investors rapidly withdraw capital from underperforming funds). *See also* Horst & Salganik, *supra* note 158, at 1 (finding that hedge fund investors "subsequently reallocate funds *from* less successful to more successful styles") (emphasis added).

[160] *See* Ben-David et al., *supra* note 10; Burton G. Malkiel & Atanu Saha, *Hedge Funds: Risk and Return*, 61 FIN. ANALYSTS J. 80, 85 (2005) ("Most hedge fund attrition rates are three or four times greater than the mutual fund rates.").

[161] ALT. INV. MGMT. ASS'N, *supra* note 4 ("Governance has become a 'make or break' area in the investment decision-making process."); CARNE GLOBAL FIN. SERVS., CORPORATE GOVERNANCE IN HEDGE FUNDS: INVESTOR SURVEY 2011 9-11 (2011); *see also* ALT. INV. MGMT. ASS'N, *supra* note 4, at 9 ("Most sophisticated investors will scrutinise the entire legal structure prior to investment . . . .").

[162] Letter from Kurt Silberstein, Senior Portfolio Manager, Global Equity, & Craig Dandurand, Portfolio Manager, Global Equity, to CalPERS Hedge Fund Partners (Mar. 11, 2009) (on file with author).

[163] *See generally* LAURIE A. THOMPSON, HEIDRICK & STRUGGLES, ALTERNATIVE INVESTMENTS SALES & MARKETING A VIEW OF COMPENSATION & RECRUITING TRENDS (2009), *available at* http://www.heidrick.com/PublicationsReports/PublicationsReports/HS_AlternativeInvestments.pdf.

[164] William Fung et al., *supra* note 142, at 1797.

likelihood that any superior returns obtained by a particular strategy will be short-lived, as rival managers and other traders discover and imitate each other's trading strategies.[165] Hedge fund managers as a whole may also be facing increasing pressure due to growing competition from other potential investment opportunities. This competition includes the growing market for cheaper and more liquid hedge funds alternatives, such as mutual funds using hedge fund-like strategies, exchange-traded funds, and synthetic hedge fund "clones," potentially able to replicate the returns of hedge funds.[166]

2. Investor Demand for Quality Governance

Given that investors base their investment decisions in part upon the hedge funds' perceived governance quality, it is important to note the specific governance (and operational) characteristics that investors consider to be high quality. Investor surveys indicate a substantial degree of uniformity and sophistication regarding the types of governance and operational characteristics they demand. Hedge fund investors' demand for higher quality governance has increased in the past decade due to increasing institutionalization and sophistication, negative experiences during the financial crisis of 2008, and the reaction to the Bernard Madoff fraud.[167]

Unsurprisingly, hedge fund investors have strong preferences when it comes to risk. Investors demand that portfolio-level risks be subject to pre-defined limits,

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[165] RICHARD BOOKSTABER, A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION 195 (2008).

[166] Vikas Agarwal et al., *Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds*, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming), *available at* http://ssrn.com/abstract=891621; William Fung & David A. Hsieh, *Hedge Fund Replication Strategies: Implications for Investors and Regulators*, 10 BANQUE DE FR. FIN. STABILITY REV., no. 10, Apr. 2007, at 55; Marc Hogan, *Hedge Funds: Attack of the Clones*, BLOOMBERG (Dec. 4, 2006), http://www.bloomberg.com/news/2013-06-03/attack-of-the-hedge-fund-clones.html.

[167] CARNE GLOBAL FIN. SERVS., *supra* note 161, at 12; QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 11–12 (indicating trend toward greater transparency); Lori Barton, *Opening the Door on Hedge Fund Infrastructure*, RISK UNIVERSE, Mar. 2012, at 20, *available at* http://beaumontadvisors.com/news-events/beaumont-advisors-authors-article-opening-the-door-on-hedge-fund-infrastructure-in-risk-universe-magazine/; Christine Williamson, *Demand by Clients Gives Firms Offering Details on Portfolios a Competitive Edge*, PENSIONS & INVESTMENTS (Nov. 6, 2007), http://www.pionline.com/article/20071015/PRINT/710120043/institutional-interest-lights-transparency-fire. Nonetheless, as of the end of 2011, a substantial portion of hedge fund investors view hedge fund governance as deficient. CARNE GLOBAL FIN. SERVS., *supra* note 161, at 13-14; Jonathan Stapleton, *USS: Hedge Fund Governance Needs 'Significant' Improvement*, GLOBAL PENSIONS (May 31, 2011), http://www.professionalpensions.com/professional-pensions/news/2074857/uss-hedge-fund-governance-significant-improvement.

that new positions be simulated before adoption, and that operational, counterparty, and liquidity risks be measured, identified, limited, and tested.[168] Although investors may demand lockups and other short-term redemption restrictions to preserve fund stability,[169] they nonetheless prefer to be able to redeem most, if not all, of their capital within one year.[170]

Investors also have strong preferences regarding transparency. Investors seek comprehensive, intelligible disclosures about risk, occurring anywhere from monthly to in real-time.[171] Investors desire detailed and frequent performance reporting, to have the fund precisely identify its investment strategy, and to monitor the manager's investments, preventing a deviation from the stated strategy (style drift).[172] In practice, an estimated 89% of hedge funds make at least monthly disclosures to investors.[173] In addition to performance, these disclosures typically describe what returns were attributable to a given strategy and various measures of risk-adjusted performance.[174] Since the financial crisis of 2008, hedge fund investors have been receiving greater disclosures and more transparency from hedge funds.[175]

Investors also seek an alignment between performance fee payment period and investment horizon.[176] Accordingly, investors express a desire for performance fees to be calculated on a multi-year basis to align incentives for long-term investments and prevent managers from being paid for investments that later result in losses.[177] However, although there does seem to be a trend towards calculating perfor-

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168 CARNE GLOBAL FIN. SERVS., *supra* note 161, at 14-17.

169 Laurence Fletcher, *Hedge Investors Ask For Lock-ups to Avoid Closures*, REUTERS (Oct. 8, 2008), http://uk.reuters.com/article/2008/10/08/hedge-redemptions-idUKLNE49704I20081008.

170 ALT. INV. MGMT. ASS'N, *supra* note 4, at 21-22.

171 *Id.* at 12-13; QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 13.

172 ALT. INV. MGMT. ASS'N, *supra* note 4, at 8.

173 PRICEWATERHOUSECOOPERS, TRANSPARENCY VERSUS RETURNS: THE INSTITUTIONAL INVESTOR VIEW OF ALTERNATIVE ASSETS 50 (2008), *available at* http://www.qrmo.com/pdf/PwC_alternatives_briefing.pdf.

174 *See* Email from Bruce Gibney & Alda Leu, Clarium Capital Management LLC, to Nancy M. Morris, Secretary, SEC, at 5 (Mar. 9, 2007), *available at* http://www.sec.gov/comments/s7-25-06/s72506-566.pdf.

175 STATE STREET, HEDGE FUNDS: REBUILDING ON A NEW FOUNDATION 4-5 (2011); Diane Harrison, *A Battle Cry for Hedge Funds: Separate But Not Equal*, FINALTERNATIVES (Apr. 3, 2012), http://www.finalternatives.com/node/20097.

176 ALT. INV. MGMT. ASS'N, *supra* note 4, at 18-26; Letter From Kurt Silberstein & Craig Dandurand, *supra* note 162.

177 *See* K&L GATES & OPTCAPITAL, FUND APPRECIATION RIGHTS: WHAT THEY ARE AND HOW THEY CAN WORK FOR INSTITUTIONAL INVESTORS AND HEDGE FUND MANAGERS 4-5 (2009); UTAH RET. SYS., SUMMARY OF PREFERRED HEDGE FUND TERMS 2 (2009), *available at* http://online.wsj.com/public/resources/documents/ursnote03102009.pdf.

mance fees on a multi-year basis,[178] only a small portion of hedge funds actually do so.[179] This discrepancy likely reflects the strong bargaining power that managers have over investors on this issue and presents a potential significant area for improvement in governance.

Investors expect that trade processing be automated as much as possible, that internal controls relating to trading be automated and documented, and that fund service providers be fully vetted and frequently interact with management.[180] When it comes to valuation, investors expect that managers have external oversight and well-documented practices and controls, especially with respect to illiquid assets, to guard against fraud and performance smoothing.[181] Overall, there has been a trend for funds to move away from using in-house capabilities or prime brokers towards using third-party administrators and other less conflicted service providers for valuation, asset custody, and other operational functions.[182]

Investor surveys also indicate that, with respect to hedge fund board oversight and powers, investors prefer that boards have the power to replace managers, that service providers report directly to boards, and that boards (instead of managers) be ultimately responsible for valuation and decisions regarding suspending fund redemptions.[183] Investors also prefer that hedge fund directors sit on no more than thirty boards, that hedge funds boards have no less than three directors (at least two of whom are independent), that the manager is represented on the board, and that directors be full-time, professional directors.[184] Investors in funds that do not have boards indicate that having a board would be a welcomed development.[185] Investors may also seek an option to purchase shares with voting rights over important events, includ-

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[178] *See* Emma Cusworth, *Hedge Fund Fees Under the Microscope by Investors as Performance Slides*, HEDGE FUNDS REV. (Jan. 5, 2012), http://www.risk.net/hedge-funds-review/feature/2245575/hedge-fund-fees-microscope-investors-performance-slides.

[179] *See* SEWARD & KISSEL LLP, MEMORANDUM TO OUR INVESTMENT MANAGEMENT CLIENTS AND FRIENDS: 2011 NEW HEDGE FUND STUDY 2 (2011), *available at* http://fundtaxservices.com/PDFs/2011NewHedgeFundStudy.pdf (finding that relative to standard performance compensation measured annually "[l]ess than 10% of funds, in the aggregate, had modified high-water mark provisions, hurdle rates or incentive allocation/fees measured over multi-year periods").

[180] ALT. INV. MGMT. ASS'N, *supra* note 4, at 34-37.

[181] *Id.* at 37-40.

[182] DELOITTE, HEDGE FUND ADMINISTRATORS: HOW TO CAPITALISE ON THE GROWING DEMANDS OF A SHIFTING INVESTOR BASE 1 (2011); QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 13-16.

[183] ALT. INV. MGMT. ASS'N, *supra* note 4, at 9.

[184] *Id.* at 10-11; CARNE GLOBAL FIN. SERVS., *supra* note 161, at 19, 23-24, 27.

[185] CARNE GLOBAL FIN. SERVS., *supra* note 161, at 33.

ing fund dissolution or certain changes in the investment manager and directors.[186] However, hedge fund investors do not typically demand the ability to remove managers.[187]

Hedge fund investors also have preferences regarding a wide range of other specific governance issues. To align incentives, investors prefer that hedge fund managers co-invest in the funds they manage and have the same liquidity rights as other investors.[188] Investors desire clear communications regarding fund organizational structure and related entities, clear segregation between front and back office personnel, and documentation regarding internal controls and conflicts.[189] Investors also expect disclosure of any legal issues, an independent and well-documented compliance function, and that any preferential treatment given to some investors be disclosed and receive board approval.[190] Investors may also want assurances that the fund has a diversified and sophisticated client base[191] and carries insurance to protect against legal claims.[192]

High quality operational practices are a substitute governance mechanism for other mechanisms, such as strict regulatory enforcement and reputation. Accordingly, hedge fund investors demand higher quality operational practices when a fund is organized in a jurisdiction where enforcement is considered lax or if the fund is less established.[193] Investors also price in the risk of fraud and other operational problems by paying lower fees to funds with weaker operational practices.[194]

Investor demand for quality operational practices can also be assisted by the fact that investors may detect fraud and other operational risks ex ante. There is an entire advisory industry dedicated to providing hedge fund due diligence services, which include making books and other materials available to prospective and current investors to assist them in assessing the operational quality of hedge funds.[195] A

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[186] ALT. INV. MGMT. ASS'N, *supra* note 4, at 8.
[187] Sklar, *supra* note 52, at 7.
[188] ALT. INV. MGMT. ASS'N, *supra* note 4, at 20.
[189] *Id.* at 30.
[190] *Id.* at 31-33.
[191] *Id.* at 25.
[192] Ricardo Kaulessar, *Hedge Funds Face Higher Insurance Rates in 2012*, EVESTMENT (Mar. 15, 2012) (quoting an insurance advisory firm executive as stating that "[w]hat's driven the need to carry the [hedge fund] insurance is investor demand").
[193] Gavin Cassar & Joseph Gerakos, *Determinants of Hedge Funds Internal Controls and Fees*, 85 ACCT. REV. 1887, 1888 (2010).
[194] *Id.*
[195] *See, e.g.*, MATTHEW RIDLEY, HOW TO INVEST IN HEDGE FUNDS: AN INVESTMENT PROFESSIONAL'S GUIDE (2004).

growing body of academic studies may also be able to help investors detect which hedge funds are more likely to commit fraud or suffer from other operational deficiencies.[196] For example, one study found that returns are more likely to be misreported as marginally positive (rather than zero or marginally negative) when funds can be sold via distribution channels with relatively less third party scrutiny and in funds without lockups preventing investors from withdrawing capital.[197] Another study found that regulatory investigations for fraud or misstatements are far more likely when the manager — as opposed to an independent third party — is involved in setting and reporting a fund's net asset value.[198] Stephen Brown and various co-authors have also developed various measures to assist investors in predicting fraud and operational risk.[199] Investor demands for quality operational practices, and their ability to predict them, are important because losses are as likely to arise from operational risks as they are from financial ones.[200]

3. Secondary Markets for Hedge Fund Shares

Hedge fund managers may also face market discipline due to the increasingly stable and liquid secondary market for hedge fund shares. Prior to the financial crisis of 2008, the secondary market was small, illiquid, and run by investment banks and one specialized intermediary between hedge fund buyers and sellers, Hedgebay.[201] During the financial crisis, hedge fund managers enacted gates to reduce the impact of investor redemptions in a market where hedge fund asset values were plummeting and capital was often locked up in illiquid investments. As a result, hedge fund investors increasingly sold their fund shares to raise cash and typically did so at a deep discount to the fund's net asset value.[202] By 2011, the secondary hedge fund market

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[196] *See, e.g.*, Stephen J. Brown et al., *Trust and Delegation*, 103 J. FIN. ECON. 221 (2012); Stephen J. Brown et al., *Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration*, 63 J. FIN. 2785 (2008); Cassar & Gerakos, *supra* note 193.

[197] Douglas Cummings, *Hedge Fund Regulation and Misreported Returns*, 16 EUR. J. FIN. MGMT. 829, 831 (2010).

[198] Casar & Gerakos, *supra* note 193.

[199] *See generally* Stephen J. Brown et al., *Estimating Operational Risk for Hedge Funds: The É-Score* (N.Y. Univ., Working Paper No. FIN-08-001, 2008), http://ssrn.com/abstract=1354491.

[200] *See* STUART PFEFFER & CHRISTOPHER KUNDRO, CAPITAL MKTS. CO., UNDERSTANDING AND MITIGATING OPERATIONAL RISK IN HEDGE FUND INVESTMENTS 5 (2003).

[201] *See, e.g.*, FRANK K. REILLY & KEITH C. BROWN, INVESTMENT ANALYSIS AND PORTFOLIO MANAGEMENT 101 (2011).

[202] LUIS M. VICEIRA ET AL., SHELLEY CAPITAL AND THE HEDGE FUND SECONDARY MARKET 2-3 (2011).

had matured to include broader market participation, several new trading intermediaries in the form of online brokers and interdealer brokers, and highly sought after shares trading near or above their net asset values.[203]

A secondary market allows buyers and sellers to engage in price discovery by attempting to determine the true value of what is being traded.[204] Given that hedge fund investors value quality governance, it follows that the secondary market price for a hedge fund share will reflect the quality of the fund's governance.[205] Accordingly, the rise of hedge fund share trading creates an incentive for managers to improve, maintain, and demonstrate quality governance to prevent their shares from being sold at a discount and to attract investors in the first place.[206]

B. Performance-Based Governance

A defining feature of hedge funds is that their management companies are also compensated based upon the performance of the funds they advise.[207] Fund performance is typically calculated on an annual basis.[208] Hedge fund performance-based fee rates average 18% of profits in excess of prior losses and net of management fees.[209] A fund manager's compensation attributable to the performance fee is effectively the same as a payout from a call option with a "strike price" set at the value of the fund when each investor joins.[210]

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203 *Id.* at 4-5; *Hedge Fund Secondary Market Sees First Trade Above NAV In Almost Two Years*, FINALTERNATIVES (Mar. 25, 2010), http://www.finalternatives.com/node/11901.

204 *See, e.g.*, REILLY & BROWN, *supra* note 201.

205 *See* Viceira et al., *supra* note 202, at 5 (noting that the secondary market price for hedge fund shares depends in part upon the transparency of the fund's assets).

206 *See* Tullett Prebon, *Secondary Hedge Fund Market Average Discount to NAV Grew in July*, MONEYSCIENCE (Aug. 8, 2011, 9:09 AM), http://www.moneyscience.com/pg/newsfeeds/moneyscience/item/58625/secondary-hedge-fund-market-average-discount-to-nav-grew-in-july-discount-to-net-asset-value-continued-to-incre-httpbitlynjgpot ("As the secondary market has continued to mature with a growing number and range of buyers, general partners have allowed greater transparency to underlying assets remaining in illiquid hedge fund classes. This has generally helped to improve levels as buyers gain more pricing comfort and face wider competition for transactions.").

207 *See* LHABITANT, *supra* note 56, at 30.

208 HAMMER ET AL., *supra* note 28, at 94-95.

209 Gregory Zuckerman et al., *Hedge Funds Cut Back on Fees*, WALL ST. J. (Sept. 9, 2013), http://online.wsj.com/news/articles/SB10001424127887323893004579054952807556352.

210 Mark J.P. Anson, *Hedge Fund Incentives Fees and the "Free Option,"* 4 J. ALT. INVESTMENTS 43, 43-44 (2001); William N. Goetzmann et al., *High-Water Marks and Hedge Fund Management Contracts*, 4 J. FIN. 1685, 1714-16 (2003).

Contractual provisions requiring the fund to exceed a threshold level of returns *before* any compensation is allocated to the manager typically limit managers' performance-based compensation. One such provision is a high-water mark, which limits the performance allocation to positive gains above the amount of the investor's capital contribution.[211] A high-water mark requires any losses from previous years to be recouped first, meaning that an investor must actually receive a net positive return on its investment before a manager is paid a performance fee.[212] High-water marks are utilized by most hedge funds.[213] When hedge funds use high-water marks, they typically charge investors a performance fee five times higher than those funds that do not (15.3%), likely in exchange for investors not having to pay a performance fee until the fund produces a profit for them.[214]

A second limit on managerial performance-based competition is a hurdle rate, which prevents the manager from being paid unless a minimum rate of return is achieved.[215] Hurdle rates may be calculated annually or on a cumulative basis and may be fixed at an absolute rate or depend on some other rate or performance benchmark.[216] High-water marks are more common than hurdle rates. Approximately 19% of hedge funds use hurdle rates,[217] and, when a hurdle is used, it is typically in conjunction with a high-water mark.[218]

In addition to performance fees, a manager's own investment in the fund may be a source of compensation. Managers often co-invest a significant portion of their own capital directly in the underlying funds they manage.[219] It is estimated that be-

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211 HAMMER ET AL., *supra* note 28, at 329-330.

212 *Id.* at 329; *See also* Goetzmann et al., *supra* note 210, at 1686 ("High-water mark contracts have the appealing feature of paying the manager a bonus only when the investors make a profit, and in addition, requiring that the manager make up any earlier losses before becoming eligible for the bonus payment."). To prevent individual managers from leaving the employment of a fund well below its high-water mark, some hedge fund operating agreements allow for a reduced performance fee allocation, even if the high-water mark is not achieved, and other funds will reset the high-water mark at a level below that required for an investor to recoup losses.

213 Feng et al., *supra* note 132, at 9.

214 Gokce Soydemir et al., Hedge Funds, Fund Attributes and Risk Adjusted Returns 7 (Sept. 15, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1896524. Because investors may invest at different times, a process known as share equalization must be undertaken to ensure that performance fees subject to high-water marks are properly calculated with respect to each investor. HAMMER ET AL., *supra* note 28, at 335.

215 *Id.* at 330-31.

216 *Id.*

217 Gokce Soydemir et al., For Whom Hurdle Rate and High-Watermark Exist? 30-31 (Sept. 30, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2154639.

218 *Id.* at 30.

219 HAMMER ET AL., *supra* note 28, at 92.

tween 59% and 32% of managers have personal wealth in their funds.[220] Managers with higher co-investment may be less likely to use a high-water mark, since co-investment can be a substitute incentive alignment device.[221]

Importantly, hedge fund manager compensation seems far more performance-sensitive than that of corporate managers.[222] Empirical researchers use delta to measure the relationship between management pay and firm performance. Specifically, delta measures how much managers' wealth increases if the value of their company increases by 1%.[223] A higher delta indicates a higher sensitivity of pay to firm performance. For hedge fund managers, their performance incentives are based primarily upon their annual performance-based fees and how much they have invested in the fund.[224] Based on a sample of nearly 5,000 hedge funds from January 1994 to April 2010, Feng et al. estimated the median hedge manager delta to be $1.98 million.[225] By contrast, based on a sample of public corporations from 1992 to 2006, Liu and Mauer estimated the median delta for chief executive officers to be only $205,000.[226] Hedge fund managers thus seem to have much stronger incentives to perform well than do corporate managers, indicating that their unique form of compensation serves as an important governance device.[227]

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[220] George O. Aragon & Vikram Nanda, *On Tournament Behavior in Hedge Funds: High Water Marks, Fund Liquidation, and the Backfilling Bias* 25 REV. FIN. STUD. 937, 946 (2012) (finding that, among the hedge fund managers investigated, 32% had personal wealth invested); Haitao Li et al., *Investing in Talents: Manager Characteristics and Hedge Fund Performances*, 46 J. FIN. & QUANTITATIVE ANALYSIS 59, 65 (2011); Horst & Salganik, *supra* note 158.

[221] Martin Ruckes & Margarita Sevostiyanova, Time to Wind Down: Closing Decisions and High Water Marks in Hedge Fund Management Contracts 15 (Mar. 31, 2011) (unpublished manuscript), *available at* http://gsf.aalto.fi/seminar_papers/HighWaterMarksHelsinki.pdf.

[222] Feng et al., *supra* note 132, at 2 ("With such a high rate of incentive fees, the pay-performance sensitivity of the hedge fund manager *is higher than that of any other industry.*") (emphasis added).

[223] H. KENT BAKER & GERALD S. MARTIN, CAPITAL STRUCTURE AND CORPORATE FINANCING DECISIONS: THEORY, EVIDENCE, AND PRACTICE 99 (2011).

[224] *See* Vikas Agarwal et al., *Role of Managerial Incentives and Discretion in Hedge Fund Performance*, 64 J. FIN. 2221, 2223-24 (2009).

[225] Feng et al., *supra* note 132, at 18.

[226] Yixin Liu & David C. Mauer, *Corporate Cash Holdings and CEO Compensation Incentives*, 102 J. FIN. ECON. 183, 188 (2011). *See also* David Larker & Brian Tayan, *Seven Myths of Corporate Governance* 2 (Rock Ctr. for Corp. Governance at Stanford Univ. Closer Look Series, Paper No. CGRP-16, 2011), *available at* http://ssrn.com/abstract=1856869 (finding that on average a 1% change in firm value leads to a $54,000 increase in the equity-based compensation of public company CEO). Notably, Feng et al. estimates a much lower *mean* delta for hedge fund managers than public company CEOs than do Liu and Mauer. *Cf.* Feng et al., *supra* note 132, at 18. This most likely reflects the fact that the population of hedge fund managers includes a significant portion of managers operating below their high-water mark, such that an increase in firm value does not trigger performance-based compensation.

[227] Pay-performance sensitivity is similarly high for private equity firms but lower for venture capital funds. *See* Ji-Woong Chung et al., *Pay for Performance from Future Fund Flows: The Case of Pri-*

C. Short-Term Creditors and Counterparties

Hedge funds often obtain some form of short-term credit financing, or leverage, as part of their investment strategies.[228] Hedge funds obtain leverage through several types of transactions, including collateralized (margin) borrowing secured by their investment positions,[229] cash raised through short-term sales and repurchases (repos) of financial instruments,[230] and options, swaps, or other derivatives transactions.[231]

From a governance perspective, the most important aspect of hedge fund leverage is that it results in the funds being continuously and closely monitored by creditors and derivatives counterparties.[232] Indeed, a 2008 Government Accountability Office investigation of the oversight activities of prime brokers and other hedge fund

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vate Equity (Charles A. Dice Ctr., Working Paper No. 2010-003, 2001), *available at* http://ssrn.com/abstract=1554626; *see also* Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161, 163 (2009) ("[A] 1 percent increase in the net present value (NPV) of a [venture capital] fund's returns translated into a 0.47 percent increase in VC compensation.").

[228] For an overview of the sources of hedge fund financing, see generally BARCLAYS CAPITAL SOLUTIONS GRP., EVOLUTION OF THE HEDGE FUND FINANCING MODEL (2012), http://www.thehedgefundjournal.com/sites/default/files/evolution_of_financing_model.pdf.

[229] Margin financing means to borrow against a particular investment position or an entire portfolio. FRANK BARBARINO, NEPC, LEVERAGE, HEDGE FUNDS, AND RISK 6 (2009), http://www.nepc.com/writable/research_articles/file/09_07_nepc_leverage_hf_and_risk.pdf.

[230] LHABITANT, *supra* note 56, at 15-16. In a repo, the amount of short-term cash a hedge fund is able to raise depends upon the haircut being applied to the asset used as collateral. A hedge fund will not be able to raise as much short-term cash through repos when the perception of risk increases because it causes the haircut to the repo's collateral to increase and the repo lenders' willingness to fund the trade to decrease. *See* Gary Gorton & Andrew Metrick, *Haircuts*, FED. RES. BANK ST. LOUIS REV., Nov.-Dec. 2010, at 507, 512-516.

[231] Hedge funds may also obtain leverage by borrowing securities (to short sell) or through synthetic leverage structures. *See* JPMORGAN ALT. ASSET MGMT, *supra* note 10, at 1, 8-11.

[232] *See generally* PRESIDENT'S WORKING GRP. ON FIN. MKTS., HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT 7-10 (1999) (noting that hedge fund counterparties manage their exposures to hedge funds through safeguards including due diligence, disclosure, collateral practices, credit limits, and monitoring). The amount of credit extended in margin financing is typically less than the market value of the collateral. For example, to invest in a position worth $10 million, a hedge fund may only be required to post $6 million in cash, with the rest financed through a margin loan. The percentage of the position that the lender requires the hedge fund to post is known as the initial margin (or haircut) and increases with the perceived risk of the investment position or in the general economy. The initial margin may increase over the life of a particular margin-financed transaction and is also greater for borrowers considered to be more risky. BANK FOR INT'L SETTLEMENTS, THE ROLE OF MARGIN REQUIREMENTS AND HAIRCUTS IN PROCYCLICALITY 2 (2010); DAVID P. BELMONT, MANAGING HEDGE FUND RISK AND FINANCING: ADAPTING TO A NEW ERA 124-25 (2011). In addition, additional "variation margin" is typically required to be posted as the market value of the financed investment decreases (this is known as a margin call). LHABITANT, *supra* note 56, at 124-25. Hedge fund prime brokers provide margin financing.

creditors and counterparties took note of their stringent practices.[233] When hedge funds take excessive risks, it is often their creditors (not their equity investors) that force them to close and liquidate their assets.[234]

In margin financing, hedge fund investment positions are evaluated and marked-to-market on a daily basis by prime brokers; a fund must add additional margin to the extent that the investments' market value falls below a minimum threshold level (maintenance margin).[235] Prime brokers have full transparency over the investment positions of hedge funds using their services[236] and are quick to terminate their relationships with funds failing to comply with their risk management protocols.[237] Prime brokers' relationships with hedge funds are also monitored by their own banking or securities regulators.[238]

Hedge fund repo counterparties are also generally prudent about their short-term exposures to the funds and consider hedge funds among the riskiest type of counterparties, such that the funds receive a larger haircut than other counterparties.[239] Hedge fund derivatives counterparties typically require the funds' trades to be supported by substantial amounts of collateral.[240] Hedge fund derivatives transactions require the fund to post margin (collateral) at the inception of the trade and to add additional collateral if the market value of the trade decreases. The special discipline imposed on hedge funds likely stems, in part, from the funds not being viewed as "too big to fail" and, hence, as not being eligible for government aid if they pose systemic risks to their creditors or counterparties.

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233 U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-09-667T, HEDGE FUNDS: OVERVIEW OF REGULATORY OVERSIGHT, COUNTERPARTY RISKS, AND INVESTMENT CHALLENGES 30-32 (2008).

234 *See* JPMORGAN ALT. ASSET MGMT, *supra* note 10, at 15-16.

235 BELMONT, *supra* note 232.

236 LARS JAEGER, THE NEW GENERATION OF RISK MANAGEMENT FOR HEDGE FUNDS AND PRIVATE EQUITY INVESTMENTS 10 (2004).

237 U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 30-31.

238 *Id.* at 23 ("Bank regulators (the Federal Reserve, OCC, and FDIC) monitor the risk management practices of their regulated institutions' interactions with hedge funds as creditors and counterparties."); *Id.* at 18 ("SEC also conducts oversight over hedge fund activities through the supervision of the regulated securities firms that transact business with hedge funds as brokers, creditors, and counterparties."). *See also* COMPTROLLER OF CURRENCY, OCC'S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES FOURTH QUARTER 2008 5 (2008) (For U.S. commercial banks, "large credit exposures from derivatives, whether from other dealers, large non-dealer banks or hedge funds, are collateralized on a daily basis.").

239 BANK FOR INT'L SETTLEMENTS, *supra* note 232.

240 INT'L SWAPS & DERVIATIVES ASS'N, COUNTERPARTY CREDIT EXPOSURE AMONG MAJOR DERIVATIVES DEALERS 8 (2007), *available at* http://www.isda.org/statistics/pdf/ISDA-Concentration-Survey2007.pdf ("[V]irtually all hedge fund exposures are more than fully collateralized with independent amounts posted up-front and variation margin posted subsequently as exposures change.").

However, discipline by creditors and counterparties may be inadequate to protect hedge fund investors. For example, hedge funds often use multiple prime brokers to finance their positions, which prevents any single broker from knowing a fund's total leverage.[241] In addition, competition for hedge fund clients may lead prime brokers to ease credit terms or fund oversight.[242] Given prime borkers' experience during the financial crisis of 2008, these actual or potential inadequacies do not seem substantial. Over a year before the financial crisis, and in response to Bear Stearns' collapse in March of 2008, prime brokers began to demand tighter credit terms of hedge funds financing mortgage-related securities.[243] Overall, hedge fund leverage from prime brokers and other sources began to significantly decrease in mid-2007,[244] likely due in part to the funds' own prudent risk management and the discipline provided by hedge fund prime brokers, repo creditors, and derivatives counterparties. As prime brokers' oversight of hedge funds has become more robust since the collapse of hedge fund Long-Term Capital Management in 1999, hedge fund leverage has also decreased.[245]

The close monitoring of hedge funds by their short-term creditors and counterparties is another distinguishing aspect of hedge fund governance. Private equity funds, venture capital firms, and mutual funds typically use little to no short-term leverage or derivatives. In addition, while corporations are certainly subject to discipline by their creditors and counterparties, it likely is not as intense as it is with hedge funds. Although corporations take on as much debt as hedge funds in total,[246] it is

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[241] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 32.

[242] FITCH RATINGS, HEDGE FUNDS: THE CREDIT MARKET'S NEW PARADIGM 4-5 (2007), *available at* http://mountainmentorsassociates.com/files/Hedge_Funds_The_Credit_Market_s_New_Paradigm_Fitch_5_June07.txt.pdf ("Most prime brokers agreed that there was continued pressure to provide more relaxed credit terms to funds — through higher leverage or other lending terms — due to growing competition to attract hedge fund clients."); U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 233, at 33.

[243] Gwen Robinson, *Hedge Funds Face Subprime 'Haircut,'* FTALPHAVILLE (July 6, 2007, 8:55 AM), http://ftalphaville.ft.com/2007/07/06/5715/hedge-funds-face-subprime-haircut/. *See also* Alistair Barr, *Hedge Funds Leaving Bear May Be Cutting Leverage*, MARKETWATCH (Mar. 20, 2008), http://www.marketwatch.com/story/hedge-funds-leaving-bear-may-be-facing-tougher-leverage-limits; Deborah Brewster, *US Banks Refuse to Accept Subprime Collateral*, Fin. Times (Aug. 14, 2007), http://www.ft.com/intl/cms/s/0/21097556-4ac8-11dc-95b5-0000779fd2ac.html#axzz2rpKJGfMS.

[244] Andrew Ang et al., *Hedge Fund Leverage*, 102 J. FIN. ECON. 102, 119 (2011).

[245] Michael R. King & Philipp Maier, *Hedge Funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks*, 5 J. FIN. STABILITY 283, 295 fig. 1 (2009).

[246] *See* Ang et al., *supra* note 244, at 108 (estimating the mean gross leverage of hedge funds to be 2.13); Sebnem Kalemli-Ozcan et al., *Leverage Across Firms, Banks, and Countries* 14 (Nat'l Bureau ofEcon. Research, Working Paper No. 17354, 2012), *available at* http://www.uh.edu/~bsorense/leverage_feb28d_12.pdf ("Mean firm leverage for listed U.S. firms is . . . around 2.3-2.4 while the leverage ratio is slightly larger for non-listed firms.").

from a mix of short-term and long-term sources, which does not provide the same type of targeted monitoring of corporate assets and activities as does short-term-only hedge fund debt. In addition, corporations that use short-term borrowing typically do so on an unsecured basis, are financially stable, and use the short-term borrowings to fund relatively safe working capital needs, such as making payroll and purchasing inventory.[247] Finally, corporations have access to permanent capital and, relative to hedge funds, a wide variety of financing sources, which alleviates the need for intense monitoring by any particular group of creditors.

D. Hedge Funds Produce Alpha

One way to assess whether hedge fund governance mechanisms are effective in reducing managerial agency costs is to determine to what extent hedge funds produce superior returns, or alpha, relative to the stock market or other active investment vehicles. This is because the production of alpha indicates that the creation of superior returns, in comparison to those of alternatives, more than compensates for any costs imposed upon hedge fund investors.

The best method for measuring hedge fund performance from an agency cost perspective is to examine fund performance after fees are paid to managers,[248] as opposed to measuring the actual returns earned by investors after adjusting for how they invest in hedge funds.[249] Most empirical studies of hedge fund returns, which are

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[247] *See also* Mark Jewell, *Commercial Paper, What It Is and Why It Matters*, SYRACUSE.COM (Oct. 7, 2008, 7:36 PM), http://blog.syracuse.com/indepth/2008/10/commercial_paper_what_it_is_an.html. *See generally* Matthias Kahl et al., Why Do Firms Use Commercial Paper? (Dec. 15, 2010) (unpublished manuscript), *available at* http://ihome.cuhk.edu.hk/~b121318/kahl_shivdasani_wang.pdf.

[248] This approach is the known as the time-weighted (or geometric) rate of return. *See* HERBERT B. MAYO, INVESTMENTS: AN INTRODUCTION 359 (2010); *see also Performance Calculations*, ALBRIDGE, http://resourcecenter.albridge.com/rc%20documents/Data%20Sheets/AWR/performancecalculations.pdf (last visited Jan. 15, 2014).

[249] This approach goes by various names such as the dollar- or money-weighted rate of return. *See* MAYO, *supra* note 248, at 358-59; *see also Performance Calculations*, *supra* note 248. One study applying the dollar-weighted approach to hedge fund returns found that investors in hedge funds were worse off than investing in the S&P 500 and only slightly better off than investing in the risk-free bond market. *See* Dichev & Yu, *supra* note 143, at 261. The dollar-weighted measure of returns is not a good measure for estimating agency costs because it incorporates how well hedge fund investors time their investments into funds — something the manager has no fundamental control over. For a criticism of the dollar-weighted approach, see generally Simon Hayley, Measuring Investors' Historical Returns: Hindsight Bias in Dollar-Weighted Returns (March 12, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1698088. Another approach to measuring the returns actually earned by hedge fund investors is that of financial economists Fung and Hsieh, who examine the returns to funds that invest in hedge funds because such funds "are actual pools of hedge funds, and, as such, they directly reflect actual investment experience in hedge funds." William K.H. Fung & David A. Hsieh, *Hedge*

based on the former approach, find that at least a significant portion of hedge funds produce alpha. Numerous studies that analyzed hedge fund performance prior to the financial crisis of 2008 find that hedge funds produce superior risk-adjusted returns relative to traditional long-only investments.[250] Studies covering hedge fund performance throughout and after the financial crisis also find that hedge funds produce alpha.[251] For example, a study of hedge fund performance from January 1994 to Sep-

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Funds: An Industry in Its Adolescence, 91 ECON. REV. 1, 15 (2006). Studies of funds investing in hedge funds are mixed but generally find that the funds produce alpha. *See* Yigit Atilgan, *Reward-to-Risk Ratios of Fund of Hedge Funds*, *in* RECONSIDERING FUNDS OF HEDGE FUNDS: THE FINANCIAL CRISIS AND BEST PRACTICES IN UCITS, TAIL RISK, PERFORMANCE, AND DUE DILIGENCE 275 (Greg N. Gregoriou ed., 2012) ("find[ing] that the fund of funds index has higher reward-to-risk ratios compared to several stock and bond market indices"); Raphaële Chappe et al., *"Seeking Alpha": The Performance of Funds of Hedge Funds*, *in* RECONSIDERING FUNDS OF HEDGE FUNDS: THE FINANCIAL CRISIS AND BEST PRACTICES IN UCITS, TAIL RISK, PERFORMANCE, AND DUE DILIGENCE 303 (Greg N. Gregoriou ed., 2012) (finding that less than 10% of funds of hedge funds deliver alpha); Daniel Edelman et al., *Funds of Hedge Funds: Performance, Risk and Capital Formation 2005 to 2010*, 26 FIN. MKTS. PORTFOLIO MGMT. 87, 87 (2012) (finding "a dramatic decline in the population of alpha producing funds of hedge funds post 2008 compared to the FHNR findings"); Fung et. al, *supra* note 142, at 1779 (finding that hedge fund-of-funds delivered alpha only in the period between October 1998 and March 2000); Thomas Heidorn et al., *The Risk of Funds of Hedge Funds: An Empirical Analysis of the Maximum Drawdown*, 12 J. WEALTH MGMT. 89, 89 (2009) ("the advantages of FHFs are more likely to be in their low long-term correlations with traditional asset classes, as well as in their low volatility"); Serge Darolles & Mathieu Vaissié, Do Funds of Hedge Funds Really Add Value? A 'Post' Crisis Analysis 2 (Sept. 20, 2010) (unpublished manuscript), *available at*, http://ssrn.com/abstract=1670571 ("[F]unds of hedge funds appear to succeed in overcoming their double fee structure, and add value across market regimes, although to varying degrees and in different forms."); Benoit Dewaele et al., Assessing the Performance of Funds of Hedge Funds 1 (Oct. 9, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1929097 ("[W]e find that, after fees, the majority of FoHFs do not channel alpha from single manager hedge funds.").

[250] *See* Vigdis Boasson & Emil Boasson, *Risk and Returns of Hedge Funds Investment Strategies*, 8 INV. MGMT. FIN. INNOVATIONS 110, 110 (2011); Daniel Capocci & Georges Hubner, *Analysis of Hedge Fund Performance*, 11 J. EMPIRICAL FIN. 55, 77 (2004) (finding that hedge funds as a whole "[d]eliver significant excess returns"); Bill Ding & Hany A. Shawky, *The Performance of Hedge Fund Strategies and the Asymmetry of Return Distributions*, 13 EUR. FIN. MGMT. 309, 329 (2007) (finding that, from 1990 to 2003, all hedge fund categories achieved above average performance when measured against an aggregate equity market index); Robert Kosowski et al., *Do Hedge Funds Deliver Alpha? A Bayesian and Bootstrap Analysis*, 84 J. FIN. ECON. 229, 262-63 (2007). *See generally* Harry M. Kat & Joelle Miffre, *The Impact of Non-Normality Risks and Tactical Trading on Hedge Fund Alphas*, 10 J. ALT. INVESTMENTS 8 (2008) (finding that representative hedge fund managers have superior trading skills but noting that previous studies and their own may overstate alpha).

[251] *See, e.g.*, Shuang Feng, A Comparison of Hedge Fund Gross and Net Performance 10-12 (Sept. 16, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1929213 (finding hedge fund performance from January 1994 to April 2010 produced alpha and no evidence that alpha had been decreasing); *see also* Roger G. Ibbotson et al., *The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs*, 67 FIN. ANALYSIS J. 15, 23 (2011) (finding that hedge funds returns from January 1995 through December 2009 have an annual net-of-fees alpha averaging 3%). *See generally* Andrea J. Heuson & Mark Hutchinson, Which Hedge Fund Managers Deliver Alpha? (March 15, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1786547 (finding positive alpha using a novel performance meas-

tember 2008 found that most hedge fund investment strategies returned alpha and that alpha did not decrease on an industry-wide level over that time.[252] Another study of hedge fund returns, which included data regarding over 20,000 funds from January 1994 to December 2010, found significant hedge fund alpha of 5.2% per year (using the study's most conservative estimate).[253] Two additional studies of hedge fund returns, each using a dataset from January 1994 to December 2011, found that hedge funds outperformed stock and bond markets.[254] Most studies that do not find hedge fund alpha are limited to small and unrepresentative fund pools.[255]

In addition to outperforming on a stand-alone basis, numerous studies find that hedge funds can help to diversify, and hence improve the performance of, a traditional investment portfolio of stocks and bonds.[256] For example, a study of successful university endowments attributed their superior investment returns in part to their hedge fund investments.[257] These findings are the most important for hedge fund investors, since most investors include hedge funds as a part of broader investment portfolio. These studies strongly indicate that the typical hedge fund, or at least a significant portion of the funds, provide unique value to investors by helping them to improve their returns.

IV. Improving Hedge Fund Governance

A. Governance and Firm Characteristics

As investors seek to improve hedge fund governance, they should attempt to strike the right balance between governance devices that empower managerialism

ure for hedge funds from 1994 to October or September 2009).

252 Manuel Ammann et al., Has Hedge Fund Alpha Disappeared? 3-4 (Sept. 24, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1532742.

253 Juha Joenväärä et al., New 'Stylized Facts' About Hedge Funds and Database Selection Bias 3 Oct. 25, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1989410.

254 CTR. FOR HEDGE FUND RESEARCH, *supra* note 26, at 4-10; Turan G. Bali et al., Do Hedge Funds Outperform Stocks and Bonds? 2 (Sept. 20, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2055507 (finding several hedge fund strategies outperformed the stock market and that almost all types of hedge funds outperformed the bond market on a long-term basis). *See also* Schneeweis & Kazemi, *supra* note 26, at 8 (finding that fund performance "results [from 1998 to 2010] show the benefit of hedge funds to the average investor").

255 Dichev & Yu, *supra* note 143, at 250.

256 *See, e.g.*, Wolfgang Bessler et al., *Hedge Funds and Optimal Asset Allocation: Bayesian Expectations and Spanning Tests*, 26 FIN. MKTS. PORTFOLIO MGMT. 109, 136-138 (2012).

257 *See generally* Josh Lerner et al., *Secrets of the Academy: The Drivers of University Endowment Success* (Harvard Bus. Sch. Fin., Working Paper No. 07-066, 2007), *available at* http://ssrn.com/abstract=1027450.

and those that provide investor protection. There are likely several baseline corporate governance devices that, if adopted, would help strike the right balance and lead to better returns for all hedge fund investors. Such governance devices include a substantial level of transparency, some type of performance-based compensation, and effective operational controls.

However, beyond a baseline set of general governance devices, there is likely no universal set of specific governance mechanisms (e.g., fee rates, redemption terms) that will optimize investor returns for investors in all hedge funds. This is because, as empirical corporate governance research indicates, whether a particular governance mechanism is associated with better performance depends on the specific economic characteristics of the firm.[258] Hedge funds pursue an extremely wide variety of investment strategies and hence have a wide range of economic characteristics.

Accordingly, the adoption of any governance mechanisms often involves tradeoffs related to the firm's characteristics. In the hedge fund context, these governance-relevant characteristics include the horizon of the fund's investment strategy, the strategy's risk and return properties (including its correlation with broader markets), and the redemption terms provided to investors. Improving the governance of a hedge fund, therefore, requires considering any inherent tradeoffs involved in choosing a particular governance device and the fund's governance-relevant characteristics. For example, reducing the redemption restrictions of a fund with a relatively long-term investment horizon may, at some point, interfere with the ability of the manager to carry out the fund's strategy.

B. Fees

1. Performance-Based Compensation and Rate

There is a general tradeoff in paying managers performance-based fees. Performance fees may benefit investors to the extent that they incentivize managers to improve their performance and attract higher talented managers to the industry. However, performance fees are also a cost to investors, in that they are deducted

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[258] *See* Philip Brown et al., *Corporate Governance, Accounting and Finance: A Review*, 51 ACCT. FIN. 96, 118 (2011) ("The consensus view in the literature is that the relationship between firm performance and [corporate governance] is endogenous and may depend on other (unobserved) firm characteristics as well . . . . Overall, research that takes the endogenous relationship into account finds at best only weak support for the proposition that better [corporate governance] practices create value.").

from increases in the value of their assets.[259] Empirical evidence supports the theory that performance-based compensation improves investors' net-of-fee returns. Studies find that hedge fund performance fees, in part, account for their outperformance of mutual funds (which by law cannot charge asymmetric performance fees)[260] and that private investment funds that do not charge performance fees underperform those that do.[261] In addition, most studies examining the issue find that hedge funds that charge higher performance fees have better returns.[262] Charging higher performance fees (and lower management fees) may also serve as a signal to investors of superior managerial ability.[263]

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[259] Goetzmann et al., *supra* note 210, at 1704-05 (discussing formal conditions under which performance fees are justified).

[260] *See generally* Carl Ackermann et al., *The Performance of Hedge Funds: Risk, Return, and Incentives*, 54 J. FIN. 833 (1999) (finding that in a sample of funds from 1988–1995, hedge funds consistently outperformed mutual funds in part because of incentive fees); Bing Liang, *On the Performance of Hedge Funds*, 55 FIN. ANALYSTS J. 72 (1999) (finding that hedge funds exhibit superior risk-adjusted returns as compared to mutual funds).

[261] Cecile Le Moigne & Patrick Savaria, *Relative Importance of Hedge Fund Characteristics*, 20 FIN. MKTS. PORTFOLIO MGMT. 419, 424 (2006). *But see* Roy Kouwenberg & William T. Ziemba, *Incentives and Risk-Taking in Hedge Funds*, 31 J. BANKING FIN. 3291, 3308 (2007) (finding that "hedge funds with incentive fees have significantly lower mean returns (net of fees) and worse risk-adjusted performance").

[262] *See generally* Ackermann et al., *supra* note 260 (finding average hedge fund returns positively related to performance fees); Hung-Gay Fung et al., *Global Hedge Funds: Risk, Return, and Market Timing*, 58 FIN. ANALYSTS J. 19 (2002) (finding average hedge fund returns positively related to performance fees for a sample of 115 equity funds from 1994 to 2000); William Fung & David A. Hsieh, *Hedge-Fund Benchmarks: Information Content and Biases*, 58 FIN. ANALYSTS J. 22 (2002); Liang, *supra* note 260 (finding average hedge fund returns positively related to performance fees); Gokce Soydemir et al., *supra* note 214 ("Funds that charge a high performance fee appear to outperform those that charge a relatively low fee."); Press Release, Preqin, Hedge Funds With Highest Performance Fees Deliver Best Net Returns (Aug. 29, 2013), *available at* https://www.preqin.com/docs/press/Hedge_Fund_Fees_Aug13.pdf. Some studies find no relationship between incentive fee rate and performance. *See generally* Stephen J. Brown et al., *Offshore Hedge Funds: Survival and Performance 1989-1995*, 72 J. BUS. 91 (1999) (finding no relationship between incentive fee rates and performance); Thomas Schneeweis et al., *Understanding Hedge Fund. Performance: Research Issues Revisited: Part I*, 5 J. ALTERNATIVE INvestment 6 (2002) (finding little relationship between performance fees and returns in a group of long/short equity funds). The evidence is also mixed regarding the impact of performance fees on hedge fund survival, although no study finds that funds with higher incentive fees and high-water marks have an increased probability of failure. BARTH ET AL., *supra* note 59, at 63-64 (finding that funds with higher management and performance fees are less likely to fail); Guillermo Baquero et al., *Survival, Look-Ahead Bias and the Performance of Hedge Funds*, 40 J. FIN. & QUANTITATIVE ANALYSIS 493, 504 (2005) ("[T]he higher the incentive fee, ceteris paribus, the more likely it is that the fund will liquidate in the next quarter."); Naohiko Baba & Hiromichi Goko, *Survival Analysis of Hedge Funds* 27 (Bank of Japan Working Paper Series, Paper No. 06-E-05, 2006) (finding funds with higher performance fees are less likely to be operational).

[263] *See generally* Prachi Deuskar et al., *The Dynamics of Hedge Fund Fees* (March 15, 2013) (unpublished manuscript), *available at* http://ssrn.com/abstract=1659275; Ramadorai & Streatfield, *supra*

Accordingly, investors' desires for lower fees should be tempered by the potential for higher fees to induce greater (and more skilled) managerial effort. Although lower fees may increase the portion of returns allocated investors, they may also decrease the incentives for managers to expend the kind of effort required to produce better returns. Higher fees may also allow a hedge fund to attract and retain higher skilled managers. Thus, a combination of high performance fees and low management fees may be optimal for investors.

Investors should also focus on having performance-fee compensation match the time horizon of the manager's investment strategy. Doing so would prevent managers from getting paid in the short run while investors suffer losses in the long run. It would also allow investors to make more informed decisions regarding which managers are able to consistently perform well over time, compared to those that are lucky in the short run.[264] Moving towards a multi-year compensation structure for managers may be a significant area for improvement. Currently, less than an estimated 10% of hedge funds measure manager performance over multi-year periods.[265] However, nearly a quarter of hedge funds pursue investment strategies that likely extend past an annual period and, hence, should most likely adopt a multi-year performance fee measure.[266]

One way of accomplishing a better intertemporal alignment may be to implement a rolling and deferred performance fee arrangement that calculates performance fees over a multi-year period to match the actual realized gains from an investment strategy.[267] Another method would be to place a portion of the annual performance fees in an escrow account allowing investors to clawback and retrieve the fees if there is underperformance in subsequent years.[268]

2. High-Water Marks and Hurdle Rates

With respect to high-water marks, empirical studies have found that funds with high-water marks perform better than those without, which suggests that man-

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note 142 (finding that hedge funds that recently outperformed their peers start new funds with higher management and performance fees).

[264] *See* Cusworth, *supra* note 178 ("Calculating performance fees over longer periods would make the market more efficient at pricing hedge fund talent.").

[265] *See* SEWARD & KISSEL LLP, *supra* note 179, at 2.

[266] *See* INEICHEN, *supra* note 1, at 19 (noting that 24.6% of hedge funds pursue "event driven" strategies including investing around mergers and acquisitions and in illiquid distressed debt instruments).

[267] QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 32-33; UTAH RET. SYS., *supra* note 177, at 2.

[268] *See* DONDE, *supra* note 4, at 33-35.

agers respond positively to the incentive. Using a sample of 8,752 hedge funds from January 1990 to December 2005, Chakraborty and Ray found that high-water marks seemed to induce managers at or just below the mark to expend more effort.[269] High-water marks have generally been found to reduce the incentive of managers to increase risk after performing poorly, due to their aversion to falling even further below the mark.[270] High-water marks also create incentives for managers to close or continue to operate poorly performing funds based on what is in the investors' best interest.[271] Excessive risk-taking has been found in empirical and theoretical studies to be constrained by a desire to prevent the fund from collapsing, the loss of co-invested funds, or a fall far below the high-water mark in the first place.[272] Using a sample of 4,990 hedge funds from January 1994 through December 2007, Andrew Clare and Nick Motson found that hedge fund managers well below their high-water mark do not "put it all on black" and increase their risk-taking activities, even though they may jeopardize earning performance fees.[273]

However, there is evidence that compensating a manager with an annual performance fee subject to a high-water mark may also cause an incentive misalignment between investors and managers when a fund's performance drops significantly below its high-water mark. In these situations, earning a performance fee requires a substantial gain by the end of the year, thereby giving the manager an incentive to substantially increase risk because coming in at, just below, or far below the high-

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[269] Indraneel Chakraborty & Sugata Ray, Effort, Risk and Walkaway Under High Water Mark Style Contracts 2, 20 (Mar. 14, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1083089. *See also* Agarwal et al., *supra* note 224, at 2225 (finding that "funds with high-water mark provisions produce higher returns").

[270] Aragon & Nanda, *supra* note 220.

[271] Ruckes & Sevostiyanova, *supra* note 221, at 2-3, 15.

[272] *See* Stavros Panageas & Mark M. Westerfield, *High-Water Marks: High Risk Appetites? Convex Compensation, Long Horizons, and Portfolio Choice*, J. FIN. 4, 14-15 (2009) (arguing that a desire to avoid falling below the high-water mark restrains hedge fund manager risk-taking); *see generally* James E. Hodder & Jens C. Jackwerth, *Incentive Contracts and Hedge Fund Management*, 42 J. FIN. & QUANTITATIVE ANALYSIS 811 (2007) (arguing that managerial co-investment induces managers to reduce risk as fund value fall below the high-water mark); Serge Amvella, Managerial Incentives and the Risk-Taking Behavior of Hedge Fund Managers (July 20, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=1652306 (developing a model which indicates that hedge fund managers will not take excessive risk given the path-dependent nature of the payoffs); Neng Wang et al., The Economics of Hedge Funds (Sept. 6, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2024669 (developing a model which indicates that "managerial concern for fund survival induces the manager to choose prudent leverage").

[273] *See generally* Andrew Clare & Nick Motson, *Locking in the Profits or Putting it All on Black? An Investigation into the Risk-Taking Behaviour of Hedge Fund Managers* 12 J. ALT. INVESTMENTS 7 (2009).

water mark will all result in the manager not being paid a performance fee.[274] There is evidence of this "swing for the fences" effect: one study found that returns for funds 10% below their high-water mark were more volatile than those at the mark, and funds further from the high-water mark took more and relatively poorer risks.[275] Yet another found evidence that, as hedge funds fall below their high-water mark, they increase risk, have lower expected risk-adjusted returns, and are more likely to close due to inability to ever recover losses to get "above water" (and hence allow managers to be paid performance fees).[276] For this reason, industry commentators have called for abolishing high-water marks altogether.[277]

High-water marks may also reduce returns in another way. Hedge fund managers have an incentive to reduce their risk-taking after surpassing a high-water mark to lock-in profits. By doing so, managers may deprive investors of the forgone gains from the manager pursuing the same strategy that allowed them to surpass the high-water mark in the first place.[278]

Hedge fund investors should accordingly consider investing in funds that have attractive characteristics but do not use high-water marks or in funds that remove or reset their high-water marks if the fund drops substantially below the mark. The latter will remove the incentive for managers taking on undue risks to reach the high-water mark and prevent employees from leaving a fund that is substantially under water.

Although hurdle rates are relatively uncommon, the higher the performance fee, the lower the management fee, or the lower the leverage, the more likely the fund will use them.[279] Soydemir, Smolarskiand, and Shin argue that hurdle rates are offered in an attempt to compensate investors for investing in certain funds they find relatively risky or otherwise unattractive from a risk-return standpoint.[280] The authors view hurdle rates primarily as marketing tools, however, because they find no correlation between fund performance and offering a hurdle.[281]

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[274] *New Research Illustrates Wide-ranging Implications of the Ubiquitous "High Water Mark,"* ALLABOUTALPHA.COM (Jan. 21. 2008), http://allaboutalpha.com/blog/2008/01/21/new-research-illustrates-wide-ranging-implications-of-the-ubiquitous-high-water-mark/.

[275] *See* Chakraborty & Ray, *supra* note 269.

[276] *See generally* Sugata Ray, The Downside of High Water Marks: An Empirical Study (Mar. 22, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1476372.

[277] QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 29, 33-34.

[278] Clare & Motson, *supra* note 273.

[279] Gokce Soydemir et al., *supra* note 214, at 18.

[280] *Id.* at 12-13.

[281] *Id.* at 15-17.

Hurdle rates are most likely to benefit investors in hedge funds whose returns are highly correlated to stock, bond, or other broad markets.[282] Accordingly, investors should probably only demand hurdle rates in funds that run the risk of providing the same risk-adjusted returns as a cheaper, passive investment vehicle (such as a stock index). Investors should also consider having the hurdle rate be based upon a specified level of correlation, instead of an absolute level of return.[283] That way, investors will not have to pay fees for returns that they sought to avoid by investing in hedge funds in the first place (i.e., returns correlated with broader markets).

3. Managerial Co-Investment

Managerial co-investment unsurprisingly seems to align incentives and increase performance. A study by Agarwal et al. of a representative sample of 7,535 hedge funds from 1995 to 2004 found a positive and statistically significant relationship between co-investment and performance.[284] Other researchers have also found that managerial co-investment overcomes incentive misalignments that may arise when managers are paid only based on a performance-based fee constrained by a high-water mark or hurdle rate.[285] Co-investment may also increase the incentives for managers to close poorly performing funds when doing so is best for investors.[286] After taking into account the incentives facing hedge fund managers from a wide variety of factors, Agarwal et al. found that hedge funds perform better when overall incentives are higher — in the presence of higher performance fees, more managerial co-investment into the fund, and higher high-water marks.[287]

Nonetheless, there is likely a governance tradeoff with co-investment. Co-investment beyond a certain level may decrease performance to the extent that high

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282 QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 33; Beer, *supra* note 26.

283 Houman B. Shadab, *Correlation: The New Hedge Fund Hurdle*, LAWBITRAGE (Nov. 23, 2011, 6:02 PM), http://lawbitrage.typepad.com/blog/2011/11/correlation-the-new-hedge-fund-hurdle.html.

284 Agarwal et al., *supra* note 269 at 2224-25; *see also* Le Moigne & Savaria, *supra* note 261, at 424 (finding, in a sample of 3,775 funds from 1989 to 2005, that funds with the personal capital of managers invested had higher returns).

285 Gong Zhan, *Manager Fee Contracts and Managerial Incentives*, 14 REV. DERIVATIVES RES. 205, 226 (2011).

286 Ruckes & Sevostiyanova, *supra* note 221.

287 Agarwal et al., *supra* note 269, at 2224-25; *see also* Liang, *supra* note 262, at 74 (finding that funds with high-water marks outperformed funds without them). In a separate study, Agarwal et al. found that hedge fund managers with higher incentives and opportunities to artificially manage their earnings may be doing so to improve performance results. Vikas Agarwal et al., *Why is Santa So Kind to Hedge Funds? The December Return Puzzle!* 1-3 (Ctr. for Fin. Research, Working Paper No. 07-09, 2007), *available at* http://www.econbiz.de/archiv/k/uk/ifinanzmarkt/why_is_santa.pdf.

co-investment could result in the fund manager becoming too cautious.[288] Although the optimal range of co-investment is an issue yet to be analyzed in-depth, investors should require managers to make at least some significant amount of co-investment, including requiring managers to reinvest profits into the fund to help assure long-term incentive alignment.

C. Transparency

Transparency in the hedge fund context refers to the extent and frequency of disclosures about a fund's or manager's performance, operations, and structure. Even prior to the Dodd-Frank Act of 2010, which effectively mandated that all hedge fund managers publicly disclose information on Form ADV, the typical established fund disclosed a significant amount of information about its investments, performance, and other characteristics.[289] However, the level of transparency differed significantly among hedge funds and ranged from funds providing only summary statistics of returns to full, position-level transparency.[290] Since the 2008 financial crisis, investors have demanded more transparency and hedge funds have responded by increasing their disclosures and reporting. Nonetheless, investor surveys indicate that transparency remains a top concern.[291]

Investors can generally make more informed investment decisions with more frequent and expansive hedge fund disclosures. Greater disclosures will also likely lower a hedge fund's cost of capital and increase the liquidity of its shares in secondary markets, by giving investors more information about the fund and the manager's activities.[292] However, there are some nuances that qualify the "more-transparency-is-better" principle. The first is that investors may suffer from information overload and be unable to process the vast amount of information effectively.[293] For example,

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[288] Kouwenberg & Ziemba, *supra* note 261, at 3307 (concluding that "if the manager's own stake in the fund is substantial (e.g. > 30%), risk taking will be reduced considerably"). *See also* LHABITANT, *supra* note 56, at 33 (noting that "a successful fund manager at the end of his [or her] career will have so large a commitment in the fund that he [or she] will refrain from taking risks, even though these are well remunerated").

[289] Email from Gibney & Leu, *supra* note 174.

[290] FRANK J. TRAVERS, INVESTMENT MANAGER ANALYSIS: A COMPREHENSIVE GUIDE TO PORTFOLIO SELECTION, MONITORING AND OPTIMIZATION 371 (2011)

[291] KPMG, TRANSFORMATION: THE FUTURE OF ALTERNATIVE INVESTMENTS 5 (2010).

[292] *See* Christian Luez & Peter D. Wysocki, Economic Consequences of Financial Reporting and Disclosure Regulation: A Review and Suggestions for Future Research 8-10, 27-31 (Mar. 2008) (unpublished manuscript), *available at* http://ssrn.com/abstract=1105398.

[293] *See* FRANÇOIS-SERGE LHABITANT, HEDGE FUNDS: QUANTITATIVE INSIGHTS 18 (2004). *See gener-*

complete transparency into a fund's specific investment positions may be overwhelming and may not provide a basis for investors to make a meaningful comparison between managers.[294] Even sophisticated investors may have difficulty distinguishing between the unique aspects of different hedge fund disclosures.[295] For hedge funds that hold illiquid securities or complex instruments, transparency into the fund's investment positions is unlikely to give investors significant insight into the fund's investment strategy due to the numerous potential ways the manager may be seeking to profit from the relationship between the positions.[296] Periodic short-term disclosures (e.g., weekly) about the investment positions in long-term strategies are also unlikely to offer investors much value. The fact that investors typically do not seek full position-level disclosures from managers or require managers to report performance in a way that mitigates performance-smoothing suggests that, beyond a certain point, additional transparency is not necessarily beneficial.[297]

In addition, at some point, greater disclosures may erode a manager's competitive advantage and, hence, decrease returns.[298] If another investor or trader obtains knowledge about a hedge fund's investment positions, the competitor may be able to enter into offsetting trades that reduce the value of the fund's investments.[299]

A related issue is *what* information about the fund is most important to investors when making investment decisions. Sophisticated hedge fund investors already have well-defined preferences regarding what information and level of transparency they seek.[300] In addition, a large practitioner literature exists on hedge fund disclosures and typically differentiates between what information investors should look for

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ally Troy A. Parades, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417 (2003).

[294] *See* SCOTT SOMERVILLE & TYLER KIM, MAPLES FUND SERVICES, TRANSCENDING TRANSPARENCY 4-5 (2012).

[295] *See* Pat Hayes, *Defining Hedge Fund Transparency—The Challenge of Balancing Risk Management and Alpha Generation*, ST. STREET (Sept. 21, 2011).

[296] *See* Richard Bookstaber, *Hedge Fund Existential*, 59 FIN. ANALYSTS J. 19, 19-23 (2003); *see generally* Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, SEATTLE U. L. REV. (forthcoming 2013) (arguing that even sophisticated investors may fail to properly examine disclosures regarding complex investments), *available at* http://ssrn.com/abstract=2168427.

[297] *See* Felix Golitz & David Schroder, *Hedge Fund Transparency: Where Do We Stand?*, 12 J. ALT. INVESTMENTS 20, 20-35 (2010).

[298] *See generally* George O. Aragon et al., *Why Do Hedge Funds Avoid Disclosure? Evidence From Confidential 13F Filings*, J. FIN. & QUANTITATIVE ANALYSIS (forthcoming 2014); Sitikantha Parida & Terence Teo, The Impact of More Frequent Portfolio Disclosure on Mutual Fund Performance (June 22, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=2097883.

[299] *See* Markus K. Brunnermeier & Lasse H. Pedersen, *Predatory Trading*, 60 J. FIN. 1825, 1825-26 (2005).

[300] *See supra* notes 173-175 and accompanying text.

prior to making an investment (due diligence) and what should be the subject of their ongoing monitoring, once they have invested with a fund.[301] Studies by financial economists also suggest that investors should focus on a particular fund's risk, including operational risk.[302] In particular, investors should focus on disclosures about the uniqueness of the fund's investment strategy and its lack of correlation with broad market risk factors.[303]

The foregoing analysis of transparency suggests that hedge fund investors should not seek real-time, position-level disclosure across the board or for every type of fund. Rather, investors should focus on disclosures that provide the right level and frequency of meaningful information about the manager's strategy, investment risks, and operational controls.

D. Hedge Fund Boards of Directors

Investors should be skeptical of the value of boards in hedge funds. In the corporate context, boards provide value due to shareholder capital lock-in. Because equity investors in corporations make a permanent contribution of capital to the firm, a board is needed to oversee management to ensure that the capital is used productively.[304] In the hedge fund context, by contrast, investor capital is not locked-in and can be redeemed at any time, subject to relatively short-term and limited redemption restrictions. As a result, hedge fund investors may not need an intermediary board to protect their interests, since they can protect themselves by simply cashing out of the fund.[305] This likely explains why 85% of the hedge funds based in North America do not have boards and why there is no evidence that funds with boards perform better than those without them.

Likewise, investors in hedge funds with boards should hesitate before pressuring managers to adopt governance characteristics that appear to serve their inter-

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[301] *See, e.g.*, TRAVERS, *supra* note 290; *see also* LHABITANT, *supra* note 56, at 569-78.

[302] *See generally* Keith H. Black, *Preventing and Detecting Hedge Fund Failure Risk Through Partial Transparency*, 12 DERIVATIVES USE, TRADING & REG. 330 (2007); Stephen J. Brown, *Quantitative Measures of Operational Risk: An Application to Funds Management*, 52 ACCT. & FIN. 1001 (2012).

[303] *See generally* Sheridan Titman & Cristian Tiu, *Do the Best Hedge Funds Hedge?*, 24 REV. FIN. STUD. 123 (2010); Zheng Sun et al., *The Road Less Traveled: Strategy Distinctiveness and Hedge Fund Performance*, 25 REV. FIN. STUD. 96 (2012).

[304] *See* Lynn A. Stout, *On the Nature of Corporations*, 2005 U. ILL. L. REV. 253, 261 (2005).

[305] *See also* Jerry W. Markham, *Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments*, 3 HASTINGS BUS. L.J. 67, 154 (2006) ("[H]edge funds have conflicts of interest but have dealt with them adequately without a mandated number of outside directors.").

ests. Empirical studies of corporate governance do not find that "good governance," including director independence, increases performance.[306] Hedge funds may be particularly ill-served by independent directors because the funds' investment strategy and risks are relatively difficult for outsiders, such as independent directors, to understand.[307] Nonetheless, one study of hedge fund boards found that, for funds that do have boards, (risk adjusted) performance is better where boards are independent and directors have with risk management experience.[308] Investors should, accordingly, approach the reform of any particular hedge fund board on a case-by-case basis.[309] Compensating hedge fund directors with equity interests in the fund as a way to align incentives should be considered, due to its association with better performance in public companies.[310] Alternatively, compensating directors with structured notes tied to the performance of the director's fund may be another way to align the director's incentives.[311]

Investors should be mindful that their efforts to reform hedge fund boards might also be problematic given that governing financial institutions seems particularly problematic. Due to the inherent complexity of the financial world, reliance on boards to monitor managers in banks has proven to be an ineffective model of governance.[312] Heavily regulated mutual fund boards also seem generally ineffective in furthering investors' interests and introduce their own layer of agency costs into governance.[313] A hedge fund board may do little more than create a false sense of security among investors and may impose significant costs.[314]

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[306] *See* Paul Rose, *The Corporate Governance Industry*, 32 J. CORP. L. 887, 910-11 (2007).

[307] *See* Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, *When Are Outside Directors Effective?*, 96 J. FIN. ECON. 195, 195 (2010) ("[W]hen the cost of information [about a firm] is high, performance worsens when outsiders are added to the board.").

[308] *See generally* Peter G. Szilagyi & Chong Wei Wong, *The Board of Directors in Hedge Fund Governance*, (Dec. 17, 2012) (unpublished manuscript), *available at* http://www.aeaweb.org/aea/2013conference/program/retrieve.php?pdfid=412.

[309] *See generally* CASTLE HALL ALTS. & SELECT FUND SERVS., REDEFINING CORPORATE GOVERNANCE: TOWARDS A NEW FRAMEWORK FOR HEDGE FUND DIRECTORS (2012).

[310] *See* Sanjai Bhagat et al., *The Effect of Corporate Governance on Performance*, *in* CORPORATE GOVERNANCE: A SYNTHESIS OF THEORY, RESEARCH, AND PRACTICE 97, 118-19 (H. Kent Baker & Ronald Anderson eds., 2010).

[311] For an overview of structured hedge fund products *see generally* PIRMIN STUTZER, STRUCTURED HEDGE FUND PRODUCTS (2006), *available at* http://db.riskwaters.com/global/events/FLAGSHIPS/sppb2006/presentations/masterclass_pirmin_stutzer.pdf.

[312] *See* Hussein Tarraf, Literature Review on Corporate Governance and the Recent Financial Crisis 14-16 (Dec. 27, 2010) (unpublished manuscript), *available at* http://ssrn.com/abstract=1731044.

[313] *See* John Morley & Quinn Curtis, *Taking Exit Rights Seriously: Why Governance and Fee Litigation Don't Work in Mutual Funds*, 120 YALE L.J. 84, 123-26, 136 (2010); *see also* Anita Krug, *In-*

However, none of the foregoing suggests that hedge fund investors should be the primary or direct monitors of hedge fund managers. Instead of relying on a board, investors should require funds to establish committees relevant to their areas of concern and rely on independent third-party service providers for monitoring. This is because internal committees can discipline a fund to commit to pre-established policies and procedures and are more focused on specific issues, as opposed to a wide variety of governance tasks. In addition, third-party service providers have their own reputational incentives to provide a check on managers and are likely to be in a better position to effectively do so.[315] For example, when it comes to the important issue of valuing fund assets, a valuation committee can establish applicable valuation policies and procedures and address conflicts of interests in doing so.[316] In addition, third-party administrators should be hired to conduct their own valuation of fund assets, to the extent possible. So long as practices ensure that administrators are independent from managers, administrators can provide investors with valuations that are free from conflicts of interests, a signal that managers are committed to accurate reporting, and a valuable "second opinion" when reliance on the manager to value illiquid assets is necessary.[317] Relying on service providers has become more commercially

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vestment Company as Instrument: The Limitations of the Corporate Governance Regulatory Paradigm, 86 S. CAL. L. REV. 263, 278-89 (2013) (arguing that mutual fund managers have incentives to keep information from directors and that directors are insufficiently independent); Markham, *supra* note 305, at 153 (concluding that the "the use of outside directors to guard against conflicts of interest on the part of investment advisers to mutual funds has proven to be ineffective"). *See generally* Alan R. Palmiter, *Mutual Fund Boards: A Failed Experiment in Regulatory Outsourcing*, 1 BROOK. J. CORP. FIN. & COM. L. 161 (2006) (arguing that mutual fund boards are overly reliant on management and not subject to proper oversight).

[314] Deborah Prutzman, *A Hedge Fund Board is Not a Magic Bullet*, INSTITUTIONAL INVESTOR'S ALPHA (Dec. 18, 2012), http://www.institutionalinvestorsalpha.com/Article/3133058/Blogs/A-Hedge-Fund-Board-Is-Not-a-Magic-Bullet.html. *See also* James Tinworth, *Hedge fund Governance Part Two: The Future of the Fund Board* (Nov. 28, 2011), http://www.lexology.com/library/detail.aspx?g=dcaae9fe-c2e4-4d76-9355-1f9e4e906c02 ("[E]ven if the necessary improvements are made, investors need to appreciate the legal, fiscal and practical limitations on a fund's board.").

[315] *See* QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 16.

[316] *See* ASSET MANAGERS' COMM. TO PRESIDENT'S WORKING GRP. ON FIN. MKTS., *supra* note 33, at 14-21.

[317] *See generally* NAVIGANT CAPITAL ADVISORS, THE GROWING MANDATE FOR INDEPENDENCE IN ILLIQUID ALTERNATIVE INVESTMENT VALUATION (2012), *available at* http://www.navigant.com/~/media/WWW/Site/Insights/Corporate%20Finance/Growing_Mandate_for_Independence%20FINAL.ashx; *see also* HOULIHAN LOKEY, INDEPENDENT THIRD-PARTY VALUATION INSIGHTS, *available at* http://www.hl.com/email/pdf/ValuationBestPractices_International.pdf; Banzaca, *supra* note 113; Margie Lindsay, *Independence at Centre of Valuation*, RISK.NET (Apr. 10, 2010), http://www.risk.net/hedge-funds-review/feature/2248780/independence-centre-valuation.

feasible due to innovations that have reduced their cost and increased their ability to integrate into a fund's operations.[318]

E. Redemption Restrictions

Although redemption restrictions may impose agency costs on investors to the extent they do not help a fund's performance,[319] they may also allow investors to access funds with higher returns. In general, relatively long-term, illiquid investment strategies are a source of higher returns because such strategies are offered at a discount to compensate investors for giving up the ability to quickly exit the investment.[320] Long-term investment strategies may also allow investors to access unique sources of value not present in more widely available, short-term investment strategies. As a result, investors in hedge funds with illiquid strategies are compensated for illiquidity risk with higher returns.[321] Illiquid hedge fund investment strategies may be undermined with frequent investor redemptions, however, because illiquid investments require more time to realize gains than do liquid investments. Indeed, empirical studies confirm that investors generally benefit when hedge funds use redemption restrictions that allow managers to realize gains from illiquid investments.[322] Lockups may also have the benefit of preventing a fund from collapsing due to temporary poor returns, as they give managers enough time to recover losses.[323]

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318 *See* PALADYNE, OUTSOURCING TRENDS IN THE HEDGE FUND INDUSTRY 9-10, *available at* http://www.paladyne.com/wp-content/white-papers/Outsourcing-Trends-in-the-Hedge-Fund-Industry.pdf.

319 *See supra* Part II.D.

320 This discount is reflected in the well-documented "illiquidity premium" in financial markets. Amir E. Khandani & Andrew W. Lo, Illiquidity Premia in Asset Returns: An Empirical Analysis of Hedge Funds, Mutual Funds, and U.S. Equity Portfolios 3-6 (June 25, 2009) (unpublished manuscript), *available at* http://ssnr.com/absract=14254954.

321 *See generally* Agarwal et al., *supra* note 224, at 2234-35; *see also* Ronnie Sadka, Hedge-Fund Performance and Liquidity Risk (Apr. 27, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1917118; Nic Schaub & Markus Schmid, Hedge Fund Liquidity and Performance: Evidence from the Financial Crisis (Sept. 21, 2012) (unpublished manuscript), *available at* http://ssrn.com/abstract=2150182.

322 George A. Aragon, *Share Restrictions and Asset Pricing: Evidence from the Hedge Fund Industry*, 8 J. FIN. ECON. 33, 34 (2007). *See also generally* Phelim Boyle et al., Hedge Fund Redemption Restrictions, Financial Crisis, and Fund Performance (Dec. 2010) (unpublished manuscript), *available at* http://efmaefm.org/0EFMSYMPOSIUM/Toronto-2011/papers/Paper_Nov08_2010_withtables.pdf; Schaub & Schmid, *supra* note 321.

323 *See generally* Guillaume Simon, Does Lockup Increase Hedge Funds Lifetimes? 2 (June 3, 2011) (unpublished manuscript), *available at* http://gsimon.edu.free.fr/cariboost_files/Does_20Lockup_20Influence_20HF_20Lifetimes.pdf.

Accordingly, investors should be willing to accept redemption restrictions, when doing so is consistent with the goals of a long-term investment strategy.[324] Investors should not to place too high a value on liquidity given that the premium investors receive for accepting restrictions on withdrawals is likely one of the main reasons why hedge funds outperform other investments.[325] In addition, the development of increasingly liquid secondary markets for hedge fund shares should decrease the importance of short-term liquidity because a secondary market provides investors with an additional means of exit.

F. Managed Accounts

One hedge fund structure that may reflect an optimal governance arrangement for some investors is a managed account. A managed account is a structure in which an investor retains full ownership of its funds and hires the fund manager to invest the funds as a third party.[326] In a managed account, it is the responsibility of the investor to hire independent third-party service providers and undertake the account's operations (such as risk management and reporting).[327] Managed accounts have become increasingly popular with investors since the financial crisis of 2008.[328]

The benefits of managed accounts relative to traditional hedge fund structures are that managed accounts give investors greater transparency (providing as much as real-time, position-level transparency), at least some degree of direct control over how the assets are managed, a high degree of liquidity, and greater control over how fees and taxes are allocated.[329] Managed accounts, however, have several disad-

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[324] *See* QUIRK & BANK OF N.Y. MELLON, *supra* note 2, at 30-31.

[325] *See generally* Rajna Gibson & Songtao Wong, *Hedge Fund Alphas: Do They Reflect Managerial Skills or Mere Compensation for Liquidity Risk Bearing?* (Swiss Fin. Inst., Research Paper No. 08-37, 2010), *available at* http://ssrn.com/abstract=1304541.

[326] MOODY'S INVESTOR SERV., HEDGE FUNDS: INVESTING THROUGH MANAGED ACCOUNTS 2 (2010), *available at* http://www.opalesque.com/files/MoodysHedgeFundsMACs-May2010.pdf.

[327] PETER DOM & JASPER HAAK, AF ADVISORS, MANAGED ACCOUNTS: THE ANSWER TO THE TREND OF INSTITUTIONALIZATION IN HEDGE FUND INVESTING? 22 (2012).

[328] TOWERS WATSON, HEDGE FUND INVESTING: OPPORTUNITIES AND CHALLENGES 6 (2012), *available at* http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2012/04/Hedge-Fund-investing-opportunities-and-challenges.

[329] Victor L. Zimmerman et al., *An Investment Decision for the New Economic Reality: Hedge Funds or Discretionary Managed Accounts?*, ALT. INTELLIGENCE QUOTIENT, Mar. 2009, at 25, 27. *See also* ADVENT SOFTWARE & MAPLES FUND SERVS., ALTERNATIVE MANAGED ACCOUNTS: OPPORTUNITIES IN FUND ADMINISTRATION 4 (2010), *available at* http://www.maplesfundservices.com/sites/default/files/Managed%20Accounts%20White%20Paper%20 10.5.pdf; TOWERS WATSON, *supra* note 328, at 7-8; *Focus on Managed Accounts*, HFMWEEK, Sept. 27–Oct. 3, 2012, at 30.

vantages. One disadvantage is higher administrative costs, which necessarily arise from establishing and operating numerous distinct accounts.[330] Managed accounts also limit access to certain investment strategies, such as those that invest in hard-to-value illiquid assets making it difficult to allocate the positions across different accounts.[331] Managed accounts may also suffer from an agency cost in the form of adverse selection. Because managed accounts are a structure with governance devices very much in the investor's favor, the most sought-after or skilled managers are generally not willing to accede to their terms.[332] Accordingly, investors may fail to differentiate the quality of managed account providers. Investors in managed accounts also have a higher monitoring burden to ensure that the manager does not stray from its strategy, does not favor the funds it manages over its managed accounts, and adequately shadows any underlying fund it is meant to track.[333] Finally, managed accounts also lack co-investment by managers,[334] which is an important governance device and underlies managers' high pay-performance sensitivity.

The disadvantages of managed accounts reflect the inherent limitations investors face when they attempt to obtain investor-friendly governance. Indeed, the limitations on managed accounts are precisely the reason why hedge fund investors may be better off with less disclosures, higher fees, and less access to their capital. Agreeing to those terms has its own set of disadvantages, but it has the benefit of allowing investors to access a wider variety of hedge fund strategies and, more likely, higher skilled managers.

Conclusion

Hedge fund governance consists of the funds' underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs. The analysis in this Article suggests that hedge fund governance devices are generally successful in disciplining and incentivizing managers to generate valuable risk-adjusted returns for investors. Nonetheless, investors should seek to improve hedge fund governance by striking the right balance between governance devices that empower managers and those that provide investor protection. Although lower fees, greater liquidity, and more disclosures may generally improve governance and re-

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[330] TOWERS WATSON, *supra* note 328, at 8-9.
[331] *Id.* at 8.
[332] *Id.*
[333] MOODY'S INVESTOR SERV., *supra* note 326, at 6.
[334] TOWERS WATSON, *supra* note 328, at 8.

turns, investors should take a measured approach in negotiating for such outcomes. Indeed, investors may benefit from less disclosure, higher fees, and less access to their capital.

With respect to fees, investors should seek relatively low management fees in particularly large funds to prevent paying substantial non-performance-based fees to managers that go above their operating costs. Lower performance fees, on the other hand, may reduce the incentives of managers to perform well and reduce the ability of a fund to attract skilled managers. Greater use of performance fees calculated over a multi-year period is likely an area where governance can be substantially improved.

Investors also should not always attempt to negotiate greater redemption rights. Instead, investors should focus on performance fees and liquidity terms matching the time horizon of the manager's investment strategy, so managers are paid when actual investment gains are realized and investors do not withdraw their capital until the strategy has been implemented. Redemption rights will also matter less as secondary markets for hedge fund shares develop. Investors should also question the use of high-water marks and hurdle rates in certain contexts and attempt to have a manager invest a substantial portion of its own wealth, and a portion of fund profits, in the funds they manage.

In terms of transparency, real-time, position-level transparency may do little to produce more valuable information for investors. Such a high level of transparency may, however, unduly burden managers and reduce their competitive advantage. More important than real-time, position-level transparency is transparency about the strength of a hedge fund's operational controls and the correlation of the fund's returns with stock and credit markets. Investors should also not pressure hedge funds to adopt boards or increase their reliance on, or expectations of, existing fund directors. Hedge fund investors should instead pressure managers to establish proper internal committees and rely more on administrators and other third-party service providers to serve as an independent check, especially in the area of performance reporting and valuation. To the extent boards are relied on, equity-based compensation for directors may make them more effective.

In providing the first scholarly analysis of the internal governance of hedge funds, this Article establishes a framework for future research. It identifies the primary types of hedge fund agency costs and governance devices and the various choices that managers and investors face in attempting strike the right balance between managerialism and investor-responsiveness.