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Improving Hedge Fund Governance

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Improving Hedge Fund Governance

This article provides a comprehensive analysis of the internal governance of hedge funds. The primary components of hedge fund governance are investors with a high propensity to exercise their short-term redemption rights; managers with high pay-performance sensitivity, because they are being compensated with an annual performance-based fee plus earnings from their own investment in the funds they manage; sophisticated investors who demand quality governance; and short-term creditors and derivatives counterparties who provide close monitoring. Hedge fund governance needs the most improvement in the areas of performance reporting (valuation) and the timing of performance-fee calculations. Further, counterintuitively, in some circumstances investors may benefit from less disclosure, higher fees, and less access to their capital.

HOUMAN B. SHADAB

The hedge fund industry is currently at a crossroads where several fundamental trends meet. Capital is flowing into the industry from institutional investors like never before. In the first half of 2014, \$56.9 billion was allocated to hedge funds globally, causing the industry to near \$3 trillion in assets for the first time.¹ At the same time, hedge fund performance in absolute terms has trailed the stock market for five consecutive years, causing investors to raise concerns about fees and other aspects of their investments. In addition, there are now a number of alternatives to hedge funds that are cheaper and have more investor-friendly characteristics, and that are competing for institutional investors. These alternatives include regulated mutual funds that employ hedge fund-like investment strategies.²

¹ "Hedge Fund Capital Surges to New Milestone on Strong 2Q Inflows" (Press Release, Hedge Fund Research, July 18, 2014), available at https://www.hedgefundresearch.com/pdf/pr_20140718.pdf.

² "Deutsche Bank Study Shows Investor Demand Fuelling Dramatic Growth of Hedge Fund Liquid Alternatives" (MarketWatch, Sept. 8, 2014), available at http://www.marketwatch.com/story/deutsche-bank-study-shows-investor-demand-fuelling-dramatic-growth-of-hedge-fund-liquid-alternatives-2014-09-08?reflink=MW_news_stmp.

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Underlying these trends is the growing importance to investors of the internal governance of hedge funds. Since the financial crisis of 2008, concerns about hedge fund governance have centered on transparency, operational practices, and the growing view that fund directors do not effectively monitor fund managers. The June 2012 enforcement action by the United States Securities and Exchange Commission (SEC) against the prominent hedge fund manager Phillip Falcone exemplifies these governance concerns. 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.

There is reason to focus on these governance issues. Hedge fund governance matters to investors because better governance can lead to higher returns. Governance matters to managers because better governance can help managers raise and retain capital. The growing focus on governance, combined with the increasing number of hedge funds competing for capital, has resulted in greater bargaining power for investors concerning fees and other governance devices.

This article provides a comprehensive analysis of the internal governance of hedge funds. Hedge fund governance is a form of managerialism because the

³ SEC, "Philip A. Falcone and Harbinger Charged With Securities Fraud" (Press Release, June 27, 2012), available at <http://www.sec.gov/news/press/2012/2012-122.htm>.

funds' underlying legal regime gives managers near complete authority over the structure and operations of the funds they manage. At the same time, 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. Although hedge fund investors usually face short-term redemption restrictions, they typically can disrupt the operations of a fund, or even

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.

cause it to wind down in a few months to a year, by withdrawing their capital.

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, because they are compensated with an annual performance-based fee plus gains on their own investment in the funds they manage;
- Sophisticated investors who demand quality governance; and
- Short-term creditors and derivatives counterparties who provide 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 not subject to stringent board oversight, removal by investors, or any market for corporate control. Unlike private equity and venture capital funds, hedge funds are not organized as “closed-end” funds for a finite (e.g., 10-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.

This is not to say that hedge fund managers are systematically ripping off investors. Empirical stud-

ies do not find pervasive or significant fraud or other types of agency costs. 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. For example, a study of hedge fund performance from January 1994 to September 2008 found that most hedge fund investment strategies returned alpha and that alpha did not decrease on an industry-wide level over that time.⁴ 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 percent annually (using the study's most conservative estimate).⁵ In addition to outperforming the stock market 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.⁶

Nonetheless, there is still plenty of room for improvement in hedge fund governance. The areas needing the most improvement are (1) performance reporting (valuation) and (2) the timing of performance-fee calculations. Investors should be careful of what they wish for, however, 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. Counterintuitively, investors may benefit from less disclosure, higher fees, and less access to their capital.

BASIC LEGAL FRAMEWORK

A “hedge fund” consists of three basic entities:

1. The fund itself;
2. The fund's management company; and
3. The fund's equity investors.

⁴ Manuel Ammann, Otto R. Huber & Markus M. Schmid, “Has Hedge Fund Alpha Disappeared?” (Unpublished manuscript, Sept. 24, 2009), available at <http://ssrn.com/abstract=1532742>.

⁵ Juha Joenväärä, Robert Kosowski & Pekka Tolonen, “New ‘Stylized Facts’ About Hedge Funds and Database Selection Bias” 3 (Unpublished manuscript, Oct. 25, 2013), available at <http://ssrn.com/abstract=1989410>.

⁶ See, e.g., Wolfgang Bessler, Julian Holler & Philipp Kurmann, “Hedge Funds and Optimal Asset Allocation: Bayesian Expectations and Spanning Tests,” 26 *Fin. Mkts. Portfolio Mgmt.* 109, 136-138 (2012).

Organizing the fund as either a U.S. limited partnership or an 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.

Hedge Fund Limited Partnerships. A hedge fund limited partnership's general partner serves as the fund's portfolio manager and investment adviser. Because the general partner bears unlimited liability for any debts the partnership itself cannot satisfy,⁷ it is organized as a limited liability entity to prevent the manager from being subject to personal liability. The fund's general partner (management company) is governed by its operating agreement which determines issues such as how the manager's profits and losses are allocated and the terms of withdrawal.

Fiduciary Duties. Fiduciary duties imposed on the management company stem from two sources. First, as investment advisers, federal law imposes fiduciary duties on hedge fund management companies of loyalty and care to the funds they advise.⁸ 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. Second, state-level limited partnership law typically imposes default fiduciary duties upon managers.⁹ Although fiduciary duties are generally viewed as contractual in nature and may be eliminated entirely in the fund's operating agreement, in practice, hedge funds typically do not entirely eliminate the fiduciary duties the management company (general partner) owes to the limited partners.

⁷ See Del. Code Ann. tit. 6, § 17-403 (West 2012).

⁸ SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963); SEC, *Study on Investment Advisers and Broker-Dealers* (Jan. 2011), available at <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>; see especially discussion at p. 22. 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).

⁹ 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.").

Management Compensation. 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 percent of the fund's net asset value and is calculated monthly or quarterly. The manager is also compensated with a performance fee averaging approximately 18 percent of the annual profits of the fund.¹⁰

A defining feature of hedge funds is that their management companies are also compensated based upon the performance of the funds they advise. Fund performance typically is calculated on an annual basis. Hedge fund performance-based fee rates average 18 percent of profits in excess of prior losses and net of management fees.¹¹

Contractual provisions requiring the fund to exceed a threshold level of returns *before* any compensation

A defining feature of hedge funds is that their management companies are also compensated based upon the performance of the funds they advise.

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. 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. High-water marks are utilized by most hedge funds. When hedge funds use high-water marks, they typically charge investors a performance fee five times higher than those funds that do not (i.e., 15.3 percent versus about 3 percent), likely in exchange for investors not having to pay a performance fee until the fund produces a profit for them.¹² Because investors may invest at different times, a process known as share equalization must be undertaken to ensure that performance fees

¹⁰ See Glocap Search, Inc. & Hedge Fund Research, Inc., 2011 Glocap Hedge Fund Compensation Report.

¹¹ Gregory Zuckerman, Juliet Chung & Michael Corkery, "Hedge Funds Cut Back on Fees" (Wall St. J., Sept. 9, 2013), available at <http://online.wsj.com/news/articles/SB10001424127887323893004579054952807556352>.

¹² Gokce Soydemir, Jan Smolarski & Sangheon Shin, "Hedge Funds, Fund Attributes and Risk Adjusted Returns 7" (Unpublished manuscript, Sept. 15, 2010), available at <http://ssrn.com/abstract=1896524>.

subject to high-water marks are properly calculated with respect to each investor.

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. 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. High-water marks are more common than hurdle rates. Approximately 19 percent of hedge funds use hurdle rates,¹³ and, when a hurdle is used, it is typically in conjunction with a high-water mark.¹⁴

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. It is estimated that between 59 percent and

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.

32 percent of managers have personal wealth in their funds.¹⁵ 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.

Limited Investor Rights. Under limited partnership law, the hedge fund manager (general partner) has the exclusive right to manage the company,¹⁶ except with respect to a few extraordinary issues.¹⁷ 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

¹³ Sangheon Shin, Jan Smolarski & Gokce Soydemir, "For Whom Hurdle Rate and High-Watermark Exist?" 30-31 (Unpublished manuscript, Sept. 30, 2012), available at <http://ssrn.com/abstract=2154639>.

¹⁴ Id.

¹⁵ 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 percent had personal wealth invested); Haitao Li, Xiaoyan Zhang & Rui Zhao, "Investing in Talents: Manager Characteristics and Hedge Fund Performances," 46 J. Fin. & Quantitative Analysis 59, 65 (Feb. 2011).

¹⁶ Unif. Ltd. P'ship Act § 406(a) (2001).

¹⁷ The 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. Unif. Ltd. P'ship Act § 406(b).

wide-ranging authority to manage all aspects of the hedge fund's business, including its investment portfolio.

The limited partners provide capital as the fund's equity investors. Although limited partnership statutes permit a partnership agreement to grant voting rights to limited partners,¹⁸ hedge fund limited partnerships do not typically grant limited partners any voting rights or the ability to nominate directors.¹⁹ The hedge fund management company directly or indirectly owns all of the fund's voting shares in a separate class with no economic rights.²⁰ Accordingly, the limited partners of a hedge fund are passive investors whose decision-making is limited to deciding when and how much capital to contribute or redeem.

Hedge funds also place significant short-term restrictions on investors' ability to redeem their capital and to resell or otherwise transfer their shares. A fund operating agreement typically restricts investors' ability to withdraw capital to a periodic basis, such as monthly, quarterly, or semi-annually, and may permit the manager to completely bar withdrawals at its discretion. In addition, investors must typically give 30 to 90 days' notice before withdrawing capital. 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. Lockup periods generally range from less than one quarter to one full year.²¹ A 2012 industry study found the average hedge fund redemption period to be 35 days and the average lockup period to be 5.85 months.²² Hedge funds may

¹⁸ See, e.g., Unif. Ltd. P'ship Act § 17-302(b) ("[T]he partnership agreement may grant to all or certain identified limited partners or 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.").

¹⁹ 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.").

²⁰ See Alexander Ineichen, *AIMA's Roadmap to Hedge Funds*, 8 (12th ed., Alt. Inv. Mgmt. Ass'n, 2012), available at <http://www.aima.org/download.cfm/docid/E9031A27-E978-4009-85EA1A8D325DAF7D>; James D. Spellman, *Hedge Funds: How They Serve Investors in U.S. and Global Markets* 10 (Coal. of Private Inv. Cos., 2009), available at http://www.hedgefundfacts.org/hedge/wp-content/uploads/2009/09/Hedge_Funds.pdf.

²¹ James R. Barth, Tong Li, Triphon Phumiwasana & Glenn Yago, *Hedge Funds: Risks and Returns in Global Capital Markets* 38-41 (Milken Inst., 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 lock-up period by paying the fund a penalty fee for doing so.

²² Ross Ford, Joe Childs & Graeme Terry, "Liquidity: Overview of Hedge Fund Liquidity Structures" (Hedge Fund Spotlight, Dec. 2012, at 2, available at https://www.prequin.com/docs/newsletters/hf/Prequin_HFSL_Dec_2012_Liquidity_Structures.pdf).

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 percent to 25 percent 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. 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.

Hedge Fund Corporations. 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. 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., pension funds 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.

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. 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 the jurisdiction to have boards.²³ Offshore hedge funds also sometimes list their shares on stock exchanges that mandate independent directors as part of their listing requirements.

The duties of hedge fund directors are similar to those of public company directors. 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

²³ See, e.g., *BVI, Cayman and Jersey Hedge Funds 20* (Walkers Global, 2012), available at <http://hb.betterregulation.com/external/Global%20Hedge%20Funds%20%28Client%20Guide%29.pdf> (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), available at <http://www.mondaq.com/x/131154/Banking/So+You+Want+To+Start+A+Hedge+Fund>.

investors and overseeing third-party administrators responsible for preparing financial statements and determining the fund’s net asset value.²⁴

In practice, the oversight role hedge fund directors play does not seem to be rigorous—probably because directors are appointed by managers (as opposed to investors), often sit on the boards of numerous funds, and/or lack the requisite financial expertise or independence from fund managers to provide independent and disinterested oversight. Hedge fund directors are also not subject to any form of market for corporate control. Hedge fund investors usually do not have voting shares and hence lack the ability to replace directors.

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

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are the Investment Advisers Act of 1940 (Advisers Act),²⁵ the Securities Act of 1933 (Securities Act),²⁶ and the Securities and Exchange Act of 1934 (Exchange Act).²⁷ Although hedge funds’ investing and trading activities are subject to the Investment Company Act of 1940,²⁸ hedge funds limit their investor base by number and wealth-qualifications so as to be exempt from its regulation.²⁹ The Investment Company Act

²⁴ Judgment of Aug. 26, 2011, *Weaving Macro Fixed Income Fund Ltd. (In Liquidation) v. Peterson*, Grand Court, Cayman Islands (Cause No. FSD 113 of 2010).

²⁵ 15 U.S.C. §§ 80b-1-80b-21 (2012).

²⁶ 15 U.S.C. §§ 77a-77b (2012).

²⁷ 15 U.S.C. §§ 78a-78pp (2012).

²⁸ 15 U.S.C. §§ 80a-1-80a-64 (2012).

²⁹ Hedge funds operate so as to qualify for at least one of two exclusions from the definition of an investment company. Under 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. 15 U.S.C. § 80a-3(c)(1). Further, hedge funds are excluded from the definition of investment company so long as they only sell securities to “qualified purchasers” through a private sale. 15 U.S.C. § 80a-3(c)(7). Qualified purchasers include both natural persons owning at least \$5 million in investments and certain companies with at least \$100 million in securities investments. 15 U.S.C. § 80a-2(a)(51)(A)(i); 17 C.F.R. § 270.2a51-1(g)(2) (2005).

subjects regulated funds to wide-ranging and detailed regulation,³⁰ including substantial limitations on a fund's use of leverage and ability to engage in short sales and derivatives transactions.

All U.S.-based hedge fund managers must register under the Advisers Act, unless they fall within an exemption, such as advising funds with less than \$150 million in assets under management or qualifying as a foreign private adviser.³¹ Hedge funds also

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. In addition, in raising capital from limited partner investors, hedge funds are subject to the antifraud provisions of the Securities Act and the Exchange Act.

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.³²

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from limited partner investors, hedge funds are subject to the antifraud provisions of the Securities Act and the Exchange Act.³⁴ Under Securities Act Section 17(a), it is unlawful for any issuer to make an untrue statement of material fact or to omit any fact so that a statement that was made is misleading.³⁵ Under Exchange Act Section 10(b) and Rule 10b-5, material omissions in connection with the sale of any security are likewise prohibited.³⁶ Rule 10b-5-1 prohibits hedge fund managers from using material nonpublic information to purchase or sell securities (insider trading).³⁷ 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.³⁸

The Advisers Act requires registered hedge fund managers to electronically file and keep current Form ADV with the SEC.³⁹ 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.⁴⁰ The brochure must be written in "plain English" and be provided to prospective clients and annually to existing clients. 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.⁴¹ For the purposes of assisting regulatory authorities in preserving financial stability, registered hedge fund advisers with 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, which makes the form available to the Financial Stability Oversight Council.⁴² Hedge funds must also

³⁰ 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 disclose portfolio holdings quarterly 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 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).

³¹ 15 U.S.C. §§ 80b-3(b), 80b-3(l), 80b-3(m).

³² 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 million in assets and natural persons whose net worth (or whose joint net worth with a spouse) exceeds \$1 million or who 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).

³³ 17 C.F.R. § 275.206(4)-(8). Prohibition of Fraud by Advisers to Certain Pooled Investment Vehicles, 72 Fed. Reg. 44756, 44759 (Aug. 9, 2007).

³⁴ 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.

³⁵ 15 U.S.C. § 77q(a).

³⁶ Exchange Act § 10(b), 15 U.S.C. § 78j; Rule 10b-5, 17 C.F.R. § 240.10b-5 (2007).

³⁷ 65 Fed. Reg. 51716, 51737 (2000).

³⁸ Larry D. Soderquist, *Understanding the Securities Laws* § 14:5 (4th ed. 2004).

³⁹ 17 C.F.R. §§ 275.203.1, 275.204-1.

⁴⁰ The Investment Adviser Public Disclosure website is located at <http://www.adviserinfo.sec.gov>.

⁴¹ See SEC, Form ADV pt. 2.

⁴² 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).

comply with other disclosure requirements under the Exchange Act arising out of any large equity investments in public companies.⁴³

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. Rule 206(4)-7 under the Advisers Act requires fund managers to establish a compliance program that includes written policies and procedures and a designated chief compliance officer.⁴⁴ These requirements have spurred a renewed focus on compliance and best practices by market participants.

HEDGE FUND GOVERNANCE DEVICES

In response to market pressures, managers adopt investor-friendly governance devices that reduce agency costs and provide additional assurance over and above applicable federal and state law. 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.

Investor-Driven Governance. 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

⁴³ First, hedge funds must disclose large shareholdings of public companies. To regulate the market for control of public companies, Exchange Act Sections 13(d) and 13(g) require that hedge funds or their advisers disclose beneficial ownership of greater than 5 percent 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 percent 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).

⁴⁴ 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 fund's past performance.⁴⁵ Investors are also quick to withdraw their capital from poorly performing funds.⁴⁶ 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.⁴⁷ For example, in 2009 CalPERS stated that it would no longer invest in hedge funds in which manager compensation was perceived as misaligning incentive.⁴⁸

Investor Demand for Quality Governance. Given that investors base their investment decisions in part upon the hedge funds' perceived governance quality,

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.

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.⁴⁹

Unsurprisingly, hedge fund investors have strong preferences when it comes to risk. Investors demand

⁴⁵ See, e.g., Vikas Agarwal, Naveen D. Daniel & Narayan Y. Naik, "Flows, Performance, and Managerial Incentives in Hedge Funds" 30 (EFA 2003 Annual Conference, Paper No. 501, July 22, 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).

⁴⁶ Guillermo Baquero & Marno Verbeek, "A Portrait of Hedge Fund Investors: Flows, Performance and Smart Money," 6-7 (Unpublished manuscript, Oct. 22, 2009), available at <http://ssrn.com/abstract=773384> (finding that hedge fund investors rapidly withdraw capital from underperforming funds).

⁴⁷ Ineichen, supra note 20 ("Governance has become a 'make or break' area in the investment decision-making process.").

⁴⁸ 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).

⁴⁹ See, e.g., *Corporate Governance in Hedge Funds: Investor Survey 2011* (Carne Global Fin. Servs., 2011), available at <http://www.carnegroup.com/wp-content/uploads/2012/06/Carne-Hedge-Fund-Governance-Survey.pdf>; PriceWaterhouseCoopers, *Transparency Versus Returns: The Institutional Investor View of Alternative Assets* 50 (2008), available at www.qrmo.com/pdf/PwC_alternatives_briefing.pdf.

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

Investors also have strong preferences regarding transparency, seeking comprehensive, intelligible disclosures about risk, occurring anywhere from monthly to in real-time. In practice, an estimated 89 percent of hedge funds make at least monthly disclosures to investors.⁵⁰

Investors also seek an alignment between performance fee payment period and investment horizon

Although investors may demand lockups and other short-term redemption restrictions to preserve fund stability, they nonetheless prefer to be able to redeem most, if not all, of their capital within one year.

and, accordingly, 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.

Investors further expect that trade processing will be automated as much as possible, that internal controls relating to trading will be automated and documented, and that fund service providers will be fully vetted and will interact frequently with management. When it comes to valuation, investors expect managers to have external oversight and well-documented practices and controls, especially with respect to illiquid assets, in order to guard against fraud and performance smoothing.

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 (rather than managers) ultimately be responsible for valuation and decisions regarding suspending fund redemptions. Investors also prefer that hedge fund directors sit on no more than 30 boards, that hedge fund boards have no fewer than three directors (at least two of whom are independent), that the manager is represented on the board, and that directors are full-time, professional directors.

⁵⁰ PriceWaterhouseCoopers, *supra* note 49, at 50.

Investor demand for quality operational practices can also be bolstered by the fact that investors may be able to 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 the funds.⁵¹ In addition, a growing body of academic studies is available, which may also be able to help investors detect which hedge funds are more likely to commit fraud or suffer from other operational deficiencies.⁵²

Short-Term Creditors and Counterparties. Hedge funds often obtain some form of short-term credit financing, or leverage, as part of their investment strategies.⁵³ Leverage may come from margin collateral;⁵⁴ cash raised through short-term sales and repurchases (repos) of financial instruments;⁵⁵ and options, swaps, or other derivatives transactions.⁵⁶ Leverage is relevant to governance because it results in the funds being continuously and closely monitored by creditors and derivatives counterparties. Indeed, a 2008 Government Accountability Office investigation of the oversight activities of prime brokers and other hedge fund creditors and counterparties took note of their stringent practices.⁵⁷ When hedge funds take

⁵¹ See, e.g., Matthew Ridley, *How to Invest in Hedge Funds: An Investment Professional's Guide* (2004).

⁵² See, e.g., Stephen J. Brown, William Goetzmann, Bing Liang & Christopher Schwarz, "Trust and Delegation," 103(2) *J. Fin. Econ.* 221 (2012); Stephen J. Brown, William Goetzmann, Bing Liang & Christopher Schwarz, "Mandatory Disclosure and Operational Risk: Evidence from Hedge Fund Registration," 63(6) *J. Fin.* 2785 (2008).

⁵³ For an overview of the sources of hedge fund financing, see generally *Evolution of the Hedge Fund Financing Model* (Barclays Capital Solutions Grp., Sept. 2012), available at http://www.thehedgefundjournal.com/sites/default/files/evolution_of_financing_model.pdf.

⁵⁴ Margin financing means to borrow against a particular investment position or an entire portfolio. Frank Barbarino, "Leverage, Hedge Funds, and Risk," 6 (NEPC, 2009), available at http://www.nepc.com/writable/research_articles/file/09_07_nepc_leverage_hf_and_risk.pdf.

⁵⁵ In a repo transaction, 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.

⁵⁶ Hedge funds may also obtain leverage by borrowing securities (to short sell) or through synthetic leverage structures.

⁵⁷ Orice M. Williams, Director Financial Markets and Community Investment, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, House of Representatives, *Hedge Funds: Overview of Regulatory Oversight, Counterparty Risks, and Investment Challenges 30-32* (GAO-09-667T, 2009), available at <http://www.gao.gov/new.items/d09677t.pdf>.

excessive risks, it is often their creditors (not their equity investors) that force them to close and liquidate their assets.

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). Prime brokers have full transparency over the investment positions of hedge funds using their services and are quick to terminate their relationships with funds failing to comply with their risk management protocols. Prime brokers' relationships with hedge funds are also monitored by their own banking or securities regulators.

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. Hedge fund derivatives counterparties typically require the funds' trades to be supported by substantial amounts of collateral.

Discipline by creditors and counterparties may be inadequate to protect hedge fund investors, however. 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. In addition, competition for hedge fund clients may lead prime brokers to ease credit terms or fund oversight.

HEDGE FUND AGENCY COSTS

Hedge fund managers are the agents of their investors. Despite the investor-friendly governance devices that hedge funds adopt, the wide-ranging powers that the hedge fund legal regime bestows upon hedge fund managers potentially allows them to impose significant agency costs on investors in the form of losses and inefficiencies. Hedge fund agency costs arise from five primary sources:

1. Fraud or misreporting with respect to a fund's performance and other characteristics;
2. Incentive misalignments due to how hedge fund managers are compensated;
3. Overly long redemption restrictions;
4. Managers appropriating fund profits; and
5. Managers favoring certain investors or service providers.

Empirical studies (cited in the following paragraphs) suggest that the most significant source of agency costs is the subtle manipulation of performance returns (valuation) by managers when it suits their interests.

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. Hedge fund investors may potentially be subject to higher agency costs from misreporting than are investors in regulated investment funds because hedge funds are not required to value their assets according to SEC guidelines.⁵⁸ Studies have found data consistent with a wide variety hedge fund misreporting, including reporting higher returns in December by underreporting returns earlier in the year,⁵⁹ increasing the value of their stock holdings through end-of-month market purchases,⁶⁰ and revising or delaying poor past performance.⁶¹ Studies also suggest that some hedge funds may deliberately understate the volatility of their returns. A relatively common type of misreporting by managers

When hedge funds take excessive risks, it is often their creditors (not their equity investors) that force them to close and liquidate their assets.

is reporting small positive returns, as opposed to small losses.⁶² The hedge funds most likely to misreport returns are those holding illiquid assets or assets that otherwise give managers discretion in valuation. Nonetheless, while misreporting may be significant when it takes place, it is not widespread.⁶³

⁵⁸ *SEC Valuation and Liquidity Guidance for Registered Investment Companies*, 87-102 (Inv. Co. Inst., 2011), available at http://www.ici.org/pdf/pub_11_valuation_volume1.pdf.

⁵⁹ Vikas Agarwal, Naveen D. Daniel & Narayan Y. Naik, "Do Hedge Funds Manage Their Reported Returns?," 24(10) *Rev. Fin. Stud.* 3281, 3283 (2011).

⁶⁰ Itzhak Ben-David, Francesco Franzoni, Augustin Landier & Rabih Moussawi, "Do Hedge Funds Manipulate Stock Prices?," 68(6) *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").

⁶¹ Andrew J. Patton, Tarun Ramadorai & Michael Streatfield, "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 (Unpublished manuscript, Sept. 3, 2013), available at <http://www.public.asu.edu/~goaragon/Papers/HFDelay.pdf>.

⁶² 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).

⁶³ *From Manhattan to Madoff: The Causes and Lessons of Hedge Fund Operational Failure 6* (Castle Hall Alts., 2009), available at http://www.cfainstitute.org/learning/products/publications/contributed/Pages/from_manhattan_to_madoff_the_causes_and_lessons_of_hedge_fund_operational_failure.aspx.

Fee-Based Incentive Misalignments. Agency costs also arise from the structure of hedge fund managers' annual compensation. Because managers earn performance fees on an annual basis for investment positions or strategies that may be longer-term in nature, 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 losses. Hedge fund managers may also have incentives to take on greater risk after obtaining investor capital because of the asymmetric payoff structure of their performance-based compensation arrangement: the manager shares in the profits of a fund with investors but not in fund losses.

In addition, management fees may impose agency costs on investors because, at least in the short term, a fixed management fee is not dependent on performance. For very large hedge funds, management fee compensation earned pursuant to management fees far exceeds the amount necessary to pay for operating overhead and, thereby, reduces the incentives for managers to earn profits for investors.

Hedge fund managers may also have incentives to take on greater risk after obtaining investor capital because of the asymmetric payoff structure of their performance-based compensation arrangement: the manager shares in the profits of a fund with investors but not in fund losses.

Restrictions on Investor Redemptions. The use of lockups, notice periods, or gates temporarily reduces investors' ability to withdraw their capital and may permit the manager to use investor funds opportunistically for its own benefit, thereby imposing an agency cost on investors. 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.

Overcompensation of Managers. Another potential hedge fund agency cost is that 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 percent of

funds increased or decreased some aspect of their fees over a three-year period.⁶⁴

Favoritism Toward Certain Investors or Service Providers. Hedge fund investors may suffer from agency costs because managers give favorable treatment to some investors over others or to service providers at the expense of investors generally. 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.⁶⁵ Side letters may give selected investors favorable treatment regarding fees, disclosure, liquidity, and other terms.⁶⁶ 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 that do not have the favorable terms.

Investors may also suffer from agency costs due to managers giving favorable treatment to service providers at their expense or appointing service provider representatives to the fund's board of directors. For example, hedge funds may pay for prime broker services with "soft dollar" payments—by directing trades to their prime broker or affiliated third parties, or paying above-market rates for brokerage commissions.⁶⁷ 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.⁶⁸

IMPROVING HEDGE FUND GOVERNANCE

From the level and structure of fees to the amount and timing of disclosures, hedge fund governance can

⁶⁴ Vikas Agarwal & Sugata Ray, "Determinants and Implications of Fee Changes in the Hedge Fund Industry," 4-5 (Unpublished manuscript, Mar. 15, 2012), available at <http://ssrn.com/abstract=2024362>.

⁶⁵ Mark Perlow, "Managing Hedge Fund Conflicts of Interest," 40(7) Rev. Sec. & Commodities Reg. 75 (Apr. 2007), available at http://www.klgates.com/files/tempFiles/a3ff2ce8-8ff0-4971-a8e9-34a575d155ce/Perlow_Review_of_Securities_Commodities_Regulation.pdf.

⁶⁶ Id. A "most favored nation" side letter clause promises that an investor will be offered any superior terms offered to other investors.

⁶⁷ Gregory Curtis, *White Paper No. 4—Soft Dollars: Greycourt's Position*, 1 (Sept. 2001), available at http://www.greycourt.com/wp-content/uploads/file/White_Paper004-Soft_dollars-GDC.pdf.

⁶⁸ See Mass. Fin. Servs. Co., Investment Company Act Release No. 26,409, Advisors Act Release No. 2224, 82 SEC Docket 2036 (Mar. 31, 2004); Fin. Indus. Regulatory Auth., "SMH Capital Fined \$450,000 for Procedural Failures Regarding Soft Dollar Payments, Distributing Improper Hedge Fund Sales Materials" (Press Release, Jan. 9, 2008), available at <http://www.finra.org/Newsroom/NewsReleases/2008/P037758>.

be improved. This section offers suggestions for such improvement, based on academic and industry studies of how different governance structures impact the performance of hedge funds. Beyond a baseline set of general governance devices, there is likely no group of specific governance mechanisms that will optimize investor returns for investors in all hedge funds. This is because whether a particular governance mechanism will cause better performance depends on the characteristics of the firm. Hedge funds pursue a wide variety of investment strategies and hence have a wide range of characteristics.

Fees. Performance fees may benefit investors to the extent that they incentivize managers to improve their performance and attract more talented managers to the industry. However, performance fees are also a cost to investors, in that they are deducted from increases in the value of their assets. Empirical evidence supports the theory that performance-based compensation improves investors' net-of-fee returns. Hedge fund performance fees, in part, account for the funds' outperformance of mutual funds (which by law cannot charge asymmetric performance fees)⁶⁹—and private investment funds that do not charge performance fees underperform those that do.⁷⁰ In addition, most studies examining the issue find that hedge funds that charge higher performance fees have better returns.⁷¹ Higher fees may induce managers to take undertake greater (and more skilled) effort and will make a fund more attractive to higher-skilled managers. Thus, a combination of high performance fees and low management fees may be optimal for investors.

⁶⁹ See generally Carl Ackermann, Richard McEnally & David Ravenscraft, "The Performance of Hedge Funds: Risk, Return, and Incentives," 54(3) *J. Fin.* 833 (June 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(4) *Fin. Analysts J.* 72 (July-Aug. 1999) (finding that hedge funds exhibit superior risk-adjusted returns as compared to mutual funds).

⁷⁰ 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").

⁷¹ See, e.g., Hung-Gay Fung, Xiaoqing Eleanor Xu & Jot Yau, "Global Hedge Funds: Risk, Return, and Market Timing," 58(6) *Fin. Analysts J.* 19 (Nov.-Dec. 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 (Jan.-Feb. 2002).

Another fee-related issue is the timing of performance-based compensation. In particular, moving toward a multi-year compensation structure for managers may be a significant area for improvement. Currently, fewer than an estimated 10 percent of hedge funds measure manager performance over multi-year periods.⁷² However, nearly a quarter of hedge funds pursue investment strategies that likely extend past an annual period⁷³ and, hence, should most likely adopt a multi-year performance fee measure. There are two

A combination of high performance fees and low management fees may be optimal for investors.

basic ways to compensate managers on a basis longer than a year:

1. 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; or
2. Place a portion of the annual performance fees in an escrow account allowing investors to retrieve the fees if the fund experiences losses in subsequent years.

High-Water Marks. Empirical studies generally find that funds with high-water marks perform better than those without.⁷⁴ High-water marks (1) have generally been found to reduce managers' incentive to increase risk after performing poorly, due to their aversion to falling even further below the mark,⁷⁵ and also (2) create incentives for managers to close or continue to operate poorly performing funds based on what is in the investors' best interest.

However, there is also evidence of that problems can be caused by high-water marks. Compensating a

⁷² See *2011 New Hedge Fund Study* (Seward & Kissel LLP Memorandum, Feb. 21, 2012), available at <http://fundtaxservices.com/PDFs/2011NewHedgeFundStudy.pdf>.

⁷³ See Ineichen, *supra* note 20, at 19 (noting that 24.6 percent of hedge funds pursue "event driven" strategies including investing around mergers and acquisitions and in illiquid distressed debt instruments).

⁷⁴ See, e.g., Indraneel Chakraborty & Sugata Ray, "Effort, Risk and Walkaway Under High Water Mark Style Contracts," 2, 20 (Unpublished manuscript, Mar. 14, 2010), available at <http://ssrn.com/abstract=1083089>.

⁷⁵ 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 (2012).

manager with an annual performance fee subject to a high-water mark might cause an incentive misalignment between investors and managers when a fund's performance drops significantly below the mark. In these situations, earning a performance fee requires a substantial gain by year end, thereby giving the manager an incentive to substantially increase risk. The reason for this is that coming in at, just below, or far below the high-water mark will all result in the manager not being paid any performance fee.⁷⁶ There is evidence of this "swing for the fences" effect.⁷⁷ One study found that as hedge funds fall below their high-water mark

High-water marks may also reduce returns by giving managers an incentive to lock-in profits by reducing their risk-taking after surpassing a 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).⁷⁸ For this reason, industry commentators have called for abolishing high-water marks altogether. High-water marks may also reduce returns by giving managers an incentive to lock-in profits by reducing their risk-taking after surpassing a high-water mark.

Hedge fund investors should accordingly consider investing in funds that (1) have attractive characteristics but do not use high-water marks or (2) remove or reset their high-water marks if the fund drops substantially below the mark. The latter will remove the incentive for managers to take on undue risks in an attempt to reach the high-water mark, and will make it less likely that employees will leave a fund that is substantially under water.

Hurdle Rates. Hurdle rates are most likely to benefit investors in hedge funds whose returns are highly correlated to stock, bond, or other broad markets. Accordingly, investors should probably demand hurdle rates only 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.⁷⁹ That way, they 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).

Managerial Co-Investment. Managerial co-investment unsurprisingly seems to align incentives and increase performance. One study 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.⁸⁰ Co-investment may also increase the incentives for managers to close poorly performing funds when doing so is best for investors. However, there may be a governance trade-off with co-investment. Co-investment beyond a certain level may decrease performance to the extent that high co-investment could result in the fund manager becoming too conservative. 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 the reinvestment of profits into the fund to help assure long-term incentive alignment.

Transparency. Investors are best off when they receive all of the information they need on a timely basis to make informed investment decisions—but nothing more. 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. Prior to the Dodd-Frank Act of 2010, which effectively mandated that all hedge fund managers publicly disclose information on Form ADV, a typical established fund disclosed a significant amount of information about its investments, performance, and other characteristics. However, the level of transparency differed significantly among hedge funds, ranging from funds that provided only summary statistics of returns to those providing full, position-level transparency.⁸¹ Since the 2008 financial crisis,

⁷⁶ *New Research Illustrates Wide-ranging Implications of the Ubiquitous "High Water Mark"* (AllAboutAlpha.com, Jan. 21, 2008), available at <http://allaboutalpha.com/blog/2008/01/21/new-research-illustrates-wide-ranging-implications-of-the-ubiquitous-high-water-mark/>.

⁷⁷ See Chakraborty & Ray, *supra* note 74; Sugata Ray, "The Downside of High Water Marks: An Empirical Study" (Unpublished manuscript Mar. 22, 2011), available at <http://ssrn.com/abstract=1476372>.

⁷⁸ See generally Ray, *supra* note 77.

⁷⁹ Housman B. Shadab, "Correlation: The New Hedge Fund Hurdle" (Lawbitrage, Nov. 23, 2011, 6:02 PM), available at <http://lawbitrage.typepad.com/blog/2011/11/correlation-the-new-hedge-fund-hurdle.html>.

⁸⁰ Vikas Agarwal, Naveen D. Daniel & Naraya Naik, "Role of Managerial Incentives and Discretion in Hedge Fund Performance," 64 *J. Fin.* 2221 (2009).

⁸¹ Frank J. Travers, *Investment Manager Analysis: A Comprehensive Guide to Portfolio Selection, Monitoring and Optimization* 371 (Kindle ed., 2011).

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.⁸²

Investors can generally make more informed investment decisions when they get more frequent and expansive hedge fund disclosures. More disclosure 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.

However, greater transparency does not always make investors better off. Investors may suffer from information overload and be unable to process vast amounts of information effectively. Even sophisticated investors may have difficulty distinguishing between the unique aspects of different hedge fund disclosures.⁸³ 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 given the numerous potential ways the manager may be seeking to profit from the relationship between the positions.⁸⁴ 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.⁸⁵

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. In addition, there is a great deal of practitioner literature on hedge fund disclosures, which typically differentiates between what information investors should look for prior to making an investment (due diligence) versus what should be the subject of their ongoing monitoring after they have invested with a fund. Studies by financial economists also suggest that investors should focus on a particular fund's risk, including operational risk.⁸⁶ 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.⁸⁷

The foregoing analysis of transparency suggests that hedge fund investors should not seek real-time, position-level disclosure across the board or for every

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 given the numerous potential ways the manager may be seeking to profit from the relationship between the positions.

type of fund. Rather, they should focus on disclosures that provide the right level and frequency of meaningful information about the manager's strategy, investment risks, and operational controls.

Hedge Fund Directors. In the corporate context, strong boards are essential 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. 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; they can protect themselves by simply cashing out of the fund. This likely explains why 85 percent of the hedge funds based in North

⁸² See, e.g., *Corporate Governance in Hedge Funds: Investor Survey 2011*, supra note 49; *A Guide to Institutional Investors' Views and Preferences Regarding Hedge Fund Operational Infrastructures* (Alternative Investment Mgt. Ass'n, 2011), available at <http://www.aima.org/en/document-summary/index.cfm/docid/CF822EF3-CB7A-4B13-81A7949E4C97C0AA>.

⁸³ See Patrick Hayes, "Defining Hedge Fund Transparency—The Challenge of Balancing Risk Management and Alpha Generation" (State Street, Sept. 21, 2011), available at http://www.statestreet.com/wps/portal/internet/corporate/home/aboutstatestreet/newsmedia/newsarticles/newsarticledetail!/ut/p/c4/fY5Na8JAFEV_zayymJcPk2l3KWiptW0VQbMZxmZeksFkIppm2n_fSF2UUspd3AsHLocXflzFs6nRm95iy_e8SOVytwHxFOYg1s8AL68CZpP3WQxvIT_wlvvBVysx8mi6Dee7CCDlc17UbV-Otw-d-aLw_PTJgsCDUNLgIXRwDXtxa5oM3qiUn1-gbvmdwUV1rStkdvTTW02DJS9WPY3oGqu-63jKg641gG9jxI3DIwLn6eyRa0yQESET6UGU6EokGUIGmIsGsqsL_jKZXUh_enEnewV9WrsGB9G-noB-0sTh8BncQOOOJQWn6esBTY-iuJ1SsYgFJhqUWJSBUMYoKVEKh0lnEt8bz03HTnhdV_gUvZzxe/.

⁸⁴ See Richard Bookstaber, "Hedge Fund Existential," 59(5) *Fin. Analysts J.* 19, 19-23 (Sept.-Oct. 2003).

⁸⁵ See Felix Golitz & David Schroder, "Hedge Fund Transparency: Where Do We Stand?," 12(4) *J. Alt. Investments* 20, 20-35 (Spring 2010).

⁸⁶ 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(4) *Acct. & Fin.* 1001 (Dec. 2012).

⁸⁷ See generally Sheridan Titman & Cristian Tiu, "Do the Best Hedge Funds Hedge?," 24 *Rev. Fin. Stud.* 123 (2010); Zheng Sun, Ashley Wang & Lu Zheng, "The Road Less Traveled: Strategy Distinctiveness and Hedge Fund Performance," 25(1) *Rev. Fin. Stud.* 96 (Jan. 2012).

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 interests. Empirical studies of corporate governance do not find that “good governance,” including director independence, increases performance.⁸⁸ 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. Compensating hedge fund directors with equity interests in the fund as a way to align incentives should be considered; such compensation is associated with better performance in public companies.⁸⁹ Compensating directors with structured notes tied to the performance of the director’s fund may be another way to align the director’s incentives.⁹⁰

Investors should be mindful that their efforts to reform hedge fund boards might also be problematic given that governing financial institutions

policies and procedures and are more focused on specific issues, as opposed to a wide variety of governance tasks. 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.

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. Then, third-party administrators should be hired to conduct their own independent 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. Relying on service providers has become more commercially feasible due to innovations that have reduced their cost and increased their ability to integrate into a fund’s operations.

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seems particularly problematic. Given the inherent complexity of the financial world, reliance on boards to monitor managers in banks has proven to be an ineffective model of governance. A hedge fund board may do little more than create a false sense of security among investors, while imposing significant costs.

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. Internal committees can discipline a fund to commit to pre-established

Redemption Restrictions. Although redemption restrictions may impose agency costs on investors to the extent they do not help a fund’s performance, 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.⁹¹ 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. Illiquid hedge fund investment strategies may be undermined by 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.⁹² Lockups

⁸⁸ See Paul Rose, “The Corporate Governance Industry,” 32 J. Corp. L. 887, 910-11 (2007).

⁸⁹ See Sanjai Bhagat, Brian Bolton & Roberta Romano, “The Effect of Corporate Governance on Performance,” in H. Kent Baker & Ronald Anderson, eds., *Corporate Governance: A Synthesis of Theory, Research, and Practice* 97, 118-19 (2010).

⁹⁰ 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.

⁹¹ 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 (Unpublished manuscript, June 25, 2009, available at <http://ssrn.com/abstract=14254954>).

⁹² George A. Aragon, “Share Restrictions and Asset Pricing: Evidence From the Hedge Fund Industry,” 83(1) J. Fin. Econ. 33, 34 (Jan. 2007).

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.

Accordingly, managers should adopt redemption restrictions when doing so is consistent with the goals of a long-term investment strategy. Liquidity may not be as valuable as the premium investors receive for accepting restrictions on withdrawals. 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.

Managed Accounts. A hedge fund structure that may reflect an optimal governance arrangement for some investors is a managed account. With a managed account, an investor retains full ownership of its funds and hires the fund manager to invest the funds as a third party.⁹³ 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).⁹⁴ Managed accounts have become increasingly popular with investors since the 2008 financial crisis.⁹⁵

Benefits. 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.⁹⁶

Disadvantages. Managed accounts do have several disadvantages. One disadvantage is higher administrative costs, which necessarily arise from establishing and operating numerous distinct accounts. These accounts

⁹³ *Hedge Funds: Investing Through Managed Accounts*, 2 (Moody's Investor Serv., May 2010), available at <http://www.opalesque.com/files/MoodysHedgeFundsMACs-May2010.pdf>.

⁹⁴ Peter Dom & Jasper Haak, *Managed Accounts: The Answer to the Trend of Institutionalization in Hedge Fund Investing?* 22 (AF Advisors, Nov. 2012).

⁹⁵ *Hedge Fund Investing: Opportunities and Challenges*, 6 (Towers Watson, 2012), available at <http://www.towerswatson.com/en-US/Insights/IC-Types/Survey-Research-Results/2012/04/Hedge-Fund-investing-opportunities-and-challenges>.

⁹⁶ Victor L. Zimmerman Jr., Bradley H. Doline & Joshua S. Geller, "An Investment Decision for the New Economic Reality: Hedge Funds or Discretionary Managed Accounts?," *Alt. Intelligence Quotient*, Mar. 2009, at 25, 27.

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. 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.⁹⁷ Accordingly, investors may fail to assess 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. Finally, managed accounts also lack co-investment by managers, which

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is an important governance device and underlies hedge fund 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 fewer 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

Although lower fees, greater liquidity, and more disclosures may generally improve governance and returns, 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.

⁹⁷ *Id.*

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, they should focus on ensuring that performance fees and liquidity terms match 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 it manages.

In terms of transparency, real-time, position-level transparency may do little to produce more valuable information for investors. In fact, such a high level of transparency may 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 also should not pressure hedge funds to adopt boards or increase their reliance on, or expectations of, existing fund directors. They 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. ■

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