MOODY'S
INVESTORS SERVICE

SPECIAL COMMENT

Hedge Fund Governance and Oversight[1]

Table of Contents:

SUMMARY 1
BACKGROUND 1
POTENTIAL IMPACT OF WEAK GOVERNANCE 2
USE OF COMMITTEES FOR OVERSIGHT IN HEDGE FUNDS 2
KEY GOVERNANCE FACTORS 3
CHALLENGES FACED BY SMALL FIRMS 4
THE CORPORATE GOVERNANCE PARADOX OF "OFFSHORE" VS. "ONSHORE" HEDGE FUNDS 5
LOOKING AHEAD 6
MOODY'S RELATED RESEARCH 7

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Summary

Corporate governance of hedge fund firms has come under greater scrutiny with the shift in the hedge fund paradigm from predominantly high net worth individuals and families to an institutional investor base, increased regulatory oversight in both the US and Europe, well-publicized insider trading cases, and the recent financial crisis. This increased scrutiny has created the need for hedge fund firms in many cases to improve and upgrade their corporate governance regimes, which play a key role in protecting a firm and its investors from various operational risks and the potential liabilities associated with them.

There are, however, challenges associated with implementing strong corporate governance practices, particularly for smaller resource-constrained firms which could experience difficulties separating the investment function from other supporting infrastructure functions. In spite of this, Moody's believes that with careful thought and consideration to structural and functional operational dependencies, strong corporate governance in hedge funds of all sizes is possible. The purpose of the following discussion is to provide additional guidance on the key considerations and aspects that Moody's takes into account when evaluating the corporate governance of hedge fund firms.

Background

Corporate governance can be described as the set of procedures, policies and management control mechanisms that provide the framework within which company objectives are set, documented and monitored. It facilitates expedient remediation when problems occur, and ensures that management and board decision-making is aligned with the interests of varied stakeholders and investors.

[1] Moody's Operational Quality (OQ) Special Comments are publications highlighting best practices of hedge fund managers in accordance with the Moody's Operational Quality Rating Methodology for Hedge Funds.

Corporate governance practices for hedge fund firms are more closely examined today than at any other time in the history of the industry. There are two main reasons for this trend. Firstly, hedge funds firms have experienced a shift in their investor composition from high net worth individual investors to institutional investors. This is significant as historically high net worth investors often did not perform rigorous due diligence on hedge fund managers, whereas institutional investors typically spend significant time and resources on their due diligence efforts. Institutional investors have shown that they view the evaluation of governance and oversight as it relates to risk management, valuations, operational controls, transparency and the investment process as important as analyzing a hedge fund manager's investment performance.

Secondly, the ratification of the Dodd-Frank Act in the U.S. and AIFMD[2] in Europe promises to introduce more demands on hedge fund managers from both a compliance and risk management perspective. Although it is too soon to gauge the full impact of the new regulatory regime, the ultimate rules and regulations that are implemented will challenge the governance frameworks of hedge fund managers with respect to their depth of reporting and standards of accountability.

Potential Impact of Weak Governance

Governance weaknesses are significant because they are likely to amplify various operational risks, and could result in inefficiencies and potential conflicts of interest in the day-to-day management of the hedge fund. In some cases, it could expose the firm to potential liabilities vis-à-vis investors, law authorities and other third parties. Moreover, with the increased sophistication and diligence of the hedge fund investor base, hedge fund managers with weak governance frameworks, will likely experience a decrease in investor confidence over time as doubts are raised with regards to the manager's ability to execute its mandate (all other things being equal).

Use of Committees for Oversight in Hedge Funds

The governing body for small and large hedge fund managers is usually in the form of an internal executive oversight committee, which is comprised of senior executives and partners of the firm. The main benefits of such a governing body, when appropriately mandated and staffed, are that it provides a formal forum for management and decision-making. The committee is comprised of individuals with the appropriate expertise and access to the necessary information about the firm's operational and legal structure to effectively monitor its operations. More importantly, it makes the members of the committee formally accountable for their decisions. Another benefit is that these discussions and decisions are documented (and auditable) in the meeting minutes.

The main drawback, however, is that committee decisions may be made solely in the interests of the employees and stakeholders rather than in the interest of investors as committee members may be predominately, if not exclusively, from the hedge fund's management team[3]. Another potential negative is that risk takers, focusing solely on investment activities, may have more representatives or influence than infrastructure and risk management professionals within the internal governing body. The challenge for hedge fund managers, is therefore to ensure that the internal governing body is able to make well-informed and balanced strategic decisions by fully considering key investment and non-investment issues, which are in the best interests of the funds' investors.

[2] Alternative Investment Fund Managers' Directive

[3] Members could be sufficiently independent from a functional perspective, although typically being employees or partners of the manager, they lack real independence. This results in greater potential for conflicts of interest to arise between the committee members and investors in the fund.

Key Governance Factors

When assessing operational quality in hedge funds, Moody's looks at the key governance factors grouped by function[4] in Table 1. When evaluating a firm's hedge fund governance framework, Moody's places more emphasis on function over form. We examine whether the hedge fund managers' policies, procedures and control mechanisms adequately address sound principles of corporate governance including, but not limited to, accountability, fairness to investors and stakeholders, transparency and segregation of duties. Processes and procedures need to be detailed, consistently applied, monitored and documented. Important factors to consider also include the size of the firm, investor composition and the complexity of the legal entity structure.

TABLE 1
Key Governance Features by Function

OQ Rating Category	Key Governance Features
Operations	» Back-office function segregated from portfolio management function » Managed by senior officer who does not make trading or investment decisions » Area sufficiently well resourced, contingent on trade volumes, level of automation and asset type » Well-documented policies and procedures manual » Detailed and comprehensive monitoring and reporting, shared with senior management » Senior-level authorized signatories for cash movements
Valuations	» Valuation function segregated from portfolio management function, ideally third-party administrator utilized, and manager's fund accounting team "shadows"[5] the process » Compensation of staff not directly aligned with portfolio performance » Managed by senior officer who does not make trading or investment decisions » Controls and segregation of duties around modeling, assumption/input changes, static data capture, price change decisions and sourcing of broker quotes, among other things » Valuation committee, chaired by non-investment senior officer, to address valuation issues » Periodic review of hard-to-value and side-pocket investments with well-documented pricing model assumptions and valuation rationales » Well-documented policies and procedures manual
Risk Management Framework	» Risk management function segregated from portfolio management function » Managed by risk officer (preferably a partner), which does not make trading or investment decisions » Risk committee, chaired by the risk officer, with a clear mandate and appropriate composition including investment and non-investment staff » Well-defined risk framework that considers all risk areas appropriate for firm size and strategy, including a limit structure and guidelines for corrective measures » Comprehensive and granular reporting for internal risk management and risk committee and aggregated risk measures reporting and interpretation for investors in the fund » Compensation of staff not directly linked to portfolio performance » Periodic governing body review of risk reports and changes to risk framework
Corporate Functions (Human Resources, Compliance, Information Technology, Finance and Tax)	» Each function needs to be appropriately staffed for the size of the organization » Segregation of duties across function is important to ensure the limitation of conflicts of interest » Dedicated compliance officer, segregated from investment functions » Well-documented policies and procedures in each function » Disaster recovery and business continuity plans should be in place and tested regularly » Human resource practices, particularly staff recruitment and compensation structures, are appropriate to the requirements-specific functional areas
Service Providers	» Reputable and competent unaffiliated service providers » Service Level Agreements in place » Governing body periodic review of service providers' performance and service levels

[4] Functions are grouped in line with the OQ Rating Categories as outlined in Moody's "Operational Quality Rating Methodology for Hedge Funds", June 2009.
[5] "Shadowing" means that the accounting team runs the process in parallel and double checks the administrator's NAV calculations.

Challenges Faced by Small Firms

Many hedge funds are managed by relatively small investment managers which often do not have sufficient resources to implement a structured governance framework with all the bells and whistles one would expect of a large firm. In particular, adequate segregation of duties is often difficult for small firms to accomplish. However, assuming that the investment strategies being run are not overly complex, the management of these entities is typically much simpler. Constructing an appropriate governance framework with sufficient management information, controls and independence is often still achievable for small firms, often by outsourcing certain functions. Below, we list some of the considerations affecting the different sized managers.

Operations

While larger firms will have the budget to obtain ample operations personnel and infrastructure resources, smaller firms may be resource-constrained. Consequently, smaller firms may opt for an operating model based on manual processes and spreadsheet-based environments, as opposed to high levels of process automation, by purchasing or developing proprietary trade order, database and reconciliation systems. The challenge for smaller firms is to maintain a strong process control environment and accurate data capture and integrity, while ensuring that the segregation of data and file access permissioning between portfolio management and back-office staff is enforced.

Valuations

Larger firms will readily be able to engage a reputable top-tier external administrator to perform full service monthly valuations and often use valuation agents to independently price hard-to-value and illiquid securities. In addition, they will have sufficient staff to fully shadow the monthly NAV and pricing duties that the administrator performs. Smaller firms, however, which are unable to afford or otherwise obtain the services of top-tier service providers, may opt for less expensive, potentially weaker administrators, or may engage their administrators to perform only high-level and less-detailed reviews of the monthly fund valuations in a process called "NAV light". In either case, their challenge will be to illustrate to investors, by way of well-documented policies and procedures, that their monthly valuations process features objectivity, consistency and transparency.

Risk Management

A hedge fund manager's risk management framework is determined by its investment philosophy, firm structure and the complexity of the investment strategies being employed. As experienced and appropriately qualified risk management personnel are difficult and expensive to recruit, many smaller funds may choose to appoint senior risk management oversight to another senior officer within the firm. Although risk management and portfolio management functions go hand-in-hand, smaller firms must ensure that the appointed risk manager does not have direct trading/investment responsibilities and is correctly aligned with the risk objectives of the portfolio.

If limitations make this impractical, the smaller firm will need to show that risk management decisions were carried out with objectivity despite the lack of independence. While larger firms will have ample resources to purchase or build robust and sophisticated risk management and investor reporting platforms, smaller firms may not be able to do the same. The challenge for smaller resource-

constrained firms will be to maintain robust risk monitoring, measurement, and investor reporting with less automated or sophisticated systems.

Corporate Functions

For small firms that do not have a dedicated chief compliance officer, the key to maintaining a strong governance framework is to ensure that the individual chosen to perform compliance duties has the appropriate knowledge of regulations, there is a segregation of duties from all investment functions and the firm maintains a comprehensive set of policies and procedures.

An experienced chief operating officer (COO) or business manager may be tasked with overseeing the governance of other corporate functions such as information systems (including business continuity and disaster recovery), tax and financial statement reporting and human resources. For larger firms, the COO may manage a team of department heads with qualifications and training in these specialized areas, but for smaller firms, without this luxury, the governance challenge is to ensure that all areas are addressed in a timely and appropriate manner. With smaller firms, the COO must be able to recognize when the operational risks associated within each functional area are beyond the capabilities of the firm and may require the engagement of project-based external consultants or outsourcing firms.

Service Providers

Engaging the services of a reputable and competent administrator, auditor and multiple prime brokers is standard practice for large firms. Smaller firms may be unable to allocate the time, money and resources needed to select and fully integrate the processes of top-tier service providers with their operations. The challenge for the smaller firm is to supplement shortfalls in service provider coverage by demonstrating how its governance framework, by way of internal checks and balances, is able mitigate operational weakness or risk.

The Corporate Governance Paradox of "Offshore" vs. "Onshore" Hedge Funds

Hedge funds marketed to U.S. taxable investors are usually set up as onshore limited partnerships, with the investment manager designated as the General Partner. In this type of fund structure, there is no legal requirement for a separate fund board. In contrast, hedge funds that are marketed to non-U.S. or U.S. tax-exempt investors are usually set up as corporations in offshore jurisdictions such as the Cayman Islands. These offshore funds are required by law to have a board of directors, which are typically comprised of the officers of the hedge fund firm and independent directors.

At first glance, it may appear that offshore funds have stronger governance than the onshore funds. However, in the day-to-day management of a fund, this may not necessarily be the case, as board members often lack the information and/or decision-making power to effect meaningful change or prevent a potentially detrimental management initiative from being implemented. Also, in practice, these boards often include (professional) independent directors who have no limitations on the number of boards in which they can participate and often end up being spread too thin.

Where offshore boards have proven to be beneficial to investors is in crisis management scenarios, when the funds need to be liquidated or restructured (as was the case in the recent financial crisis). In such cases, the fund boards were often able to take control of the funds away from the managers and act in the best interests of investors. Nonetheless, although offshore fund boards sit at the top of the

governance structure of many hedge funds, the governance structure implemented at the investment manager-level remains, in our view, the most important governance feature for hedge funds.

Looking Ahead

As large institutional clients become the major investors in hedge funds and regulations come into effect, hedge fund firm governance and oversight should continue to evolve and improve. Although many governance standards can be readily put into place, the costs associated with establishing segregated teams, dedicated senior-level department heads for several key functions and engaging reputable top tier-service providers may put smaller hedge funds at a disadvantage due to financial constraints. In addition, as the level of scrutiny and regulatory oversight increases, the associated administrative costs required to implement strong governance frameworks will likely continue to increase in the short to medium term. Although larger firms with more financial resources than smaller firms will clearly be better positioned to adapt, Moody's believes that appropriate hedge fund governance can be achieved for all firms regardless of fund size. This will be a necessity for hedge funds trying to attract investors in the foreseeable future.

Moody's Related Research

Rating Methodologies:

» Operational Quality Rating Methodology for Hedge Funds, June 2009 (116772)

» Assigning Unsecured Credit Ratings to Hedge Funds, April 2007 (102552)

» Moody's Approach to Rating Collateralized Funds of Hedge Funds Obligations, July 2003 (SF77411)

Special Reports:

» Market Turmoil Increases Stress on Hedge Fund Operations, January 2009 (113953)

» Hedge Funds: 2009 Review and 2010 Outlook, January 2010 (122367)

» Hedge Funds: Investing through Managed accounts, May 2010 (124309)

» Fund Governance: Key Analytical Considerations and Implications, November 2010 (127079)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

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