Independent directors on hedge fund and private equity boards – the Cayman trend

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It has become an established industry norm to see independent directors appointed to the boards of offshore hedge funds. It is no longer a 'check box exercise' to confirm independent directors have been appointed. Institutional investors are increasingly concerned about the composition of the board, the experience and skill set of its members and the day to day relationship between both the board members themselves and the board and the investment manager.

Historically, this has not been the case where funds are established as limited partnerships rather than companies (which is most typical in private equity fund structures but is also common for master funds in a master-feeder hedge fund structure). In the past, investors have commonly been happy to leave the general partner (usually controlled by the investment manager) to undertake all actions on behalf of the partnership and to hold all of the partnership’s property as trustee, without any independent oversight.

Over the last few years, however, there has been a gradual trend of independent directors becoming involved with Cayman limited partnerships. This has been particularly so in the hedge funds sphere. But as the trend continues for traditional hedge fund investors to spread their investment concentration towards private equity investments, and as traditional hedge fund managers venture into the private equity world to set up closed ended or hybrid structures, it is gradually becoming more common to see independent oversight put in place in private equity structures.

At a time when private equity funds are under an increasing legal and regulatory compliance burden, some sponsors are looking to independent directors who specialize in corporate governance to provide a means by which the fund can ensure it has in place a suitable corporate governance and compliance framework, whilst allowing the sponsor to focus on the management of the fund's underlying investments. Such independent directors are welcomed for their market insight, often sitting on the board of a broad cross-section of funds. This industry insight may be particularly useful to private equity funds that are currently grappling with their new obligations under the recently enacted Anti-Money Laundering Regulations, 2017.

In addition to growing compliance pressures, both hedge funds and private equity funds are under more pressure than ever from investors not only to have in place transparent and robust internal policies and procedures dealing with matters such as expense allocation, conflicts and valuations, but most importantly to ensure adherence to such polices. In the private equity world, where co-investment opportunities are big business, investors are often concerned about how investment opportunities are allocated given the potential competing interests with respect to co-investment vehicles and parallel funds. Introducing independent oversight of these polices provides investors with some comfort and increased confidence in their investment.

There are various ways by which independent oversight can be introduced to partnership fund structures, but the most common approach we see is for the partnership to establish an independent management committee. Such management committees must be distinguished from advisory committees, which are common in the private equity context. An advisory committee is a collection of limited partners or their representatives who want oversight of areas they may be particularly concerned about, for example, monitoring investment decisions. Limited partners serving on advisory committees are provided some protection under section 24 of the Exempted Limited Partnership Law (**Section 24**), which provides that limited partners serving on committees do not have fiduciary duties. This makes a lot of sense, since generally persons sitting on advisory committees are there to ensure the protection of their own interests and not those of the partnership as a whole.

In contrast, in the company context investors seek comfort from knowing that the independent directors appointed to the board owe fiduciary duties. It is therefore relevant to consider whether independent persons appointed to a partnership's management committee could rely on Section 24 to claim they are not subject to fiduciary duties. This is yet to be tested in the courts but it will likely depend on the express terms of the partnership agreement. Independent management committee members are bound by the terms of the partnership agreement, even if they are not party to the partnership agreement itself. If the partnership agreement expressly excludes fiduciary duties, that is likely to be conclusive. But if the partnership agreement is silent, that may not be enough to exclude fiduciary duties where the duties expressly imposed by the partnership agreement are fiduciary in nature as a matter of common law. Investors should be alive to the need to understand the role, obligations and duties of any management committee before they can be satisfied that it is providing them with similar protections as would be afforded by an independent board of directors in a company context. It will not be sufficient for an institutional investor simply to confirm that an independent management committee has been appointed; they must instead carefully review the fund documents to understand the role of the committee so they can evaluate how effective it will be to provide the comfort and oversight they require. Of course, the management committee does not serve as the operator of the partnership and so its role is necessarily more limited than the role of a board of directors of a company. However, if set up correctly, an independent management committee can provide valuable comfort to investors desiring independent oversight of the fund's operations.

The once rigid boundaries between the hedge funds industry and the private equity industry are becoming blurred. Traditional hedge fund managers are increasing investments in private equity opportunities such as real estate and illiquid private debt, we have seen a marked growth in the number of new hybrid fund launches, institutional investors and family offices alike are reallocating capital to private equity funds in search of higher returns, and new legal and regulatory burdens that apply equally across both industries are starting to level the compliance playing field. It is then perhaps not surprising that trends typically associated with one industry, such as independent oversight in the case of the hedge funds industry and side letters and co-investments in the case of the private equity industry, are now starting to be demanded by investors irrespective of the asset class in which they are investing. It makes sense that investors who are used to being afforded certain protections, rights and opportunities as a matter of course when investing in one asset class will expect the same when investing in another. To the extent investors maintain a strong bargaining position when negotiating their investment and the fund documents, there is no reason to expect this trend to change.

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