PERSPECTIVES

OFFSHORE HEDGE FUNDS: DOES ABSOLUTE POWER CORRUPT ABSOLUTELY?

BY **DEBORAH HICKS MIDANEK**
> SOLON GROUP, INC.

The hedge fund market crossed $3 trillion in assets at the close of 2014, according to Evestment's Hedge Fund Asset Flows Report. These private funds, often incorporated in offshore jurisdictions as limited liability companies exempt from taxation, continue to attract investors seeking appealing absolute returns in a low interest rate world.

The results achieved by these funds and their managers remain, however, mysterious. The privacy that is attractive to these investors, many keeping their funds offshore as an accepted way to avoid taxes in their home jurisdictions, is a double-edged sword as there is little ability to hold the manager accountable.

Whose money is it?

With few mechanisms to independently assess the manager's actions, managers sometimes behave as if the funds under their stewardship are theirs to use as they see fit. Understanding the way these funds work therefore becomes very important for investors considering investments in this arena.

Since these funds are typically structured as companies with a perpetual life, there is nothing to inhibit the manager from constantly seeking new money from new investors to pay redemption requests from previous investors, with no day of reckoning so long as the new money keeps coming in. Unhappy investors, having asserted themselves

to be sophisticated enough to accept the risk associated with these private investments, have little recourse.

How are these funds organised?

The manager engages a law firm to draft the documents, which will vary according to the types of investors expected to participate. If tax exempt US investors are likely involved, an offshore vehicle may be created, as there are fewer regulatory restrictions offshore regarding concentrations of these assets than exist onshore.

To create the offshore vehicle, the US law firm contacts a law firm in the chosen jurisdiction. The required documents are prepared: the offering memorandum, the investment management agreement, and the various corporate documents. For offerings in the US to US based investors not tax sensitive, these typically take the form of a limited partnership agreement, in which the investment manager serves as the general partner and the investors become the limited partners. For the offshore version, a limited liability company is typically formed, and the memorandum and articles of association created.

Fund offering documents are often drafted in a broad and unspecific a manner to retain maximum flexibility for the manager. Offering documents also often list every possible risk factor, which has the effect of absolving the manager from responsibility under virtually all loss scenarios. The law firms' role becomes one of satisfying the manager, as the manager selects the law firm despite the fact that legal fees are charged to the fund and therefore ultimately paid by investors.

Under the US model, the limited partnership agreement makes explicit the responsibilities of the general and the limited partners, and does not include independent oversight within the partnership structure. Thus investors can have no expectation that there is a fiduciary charged with protecting their interests. The offshore model, which typically uses a corporate form, requires the existence of a board of directors, responsible as the governing body for overseeing the affairs of the corporation.

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However, in a wrinkle not broadly understood, the offshore company typically issues participating shares to the company's investors, who receive the economic benefits of investment, and management or member shares to the manager, which control the voting rights of the company, and the appointment and removal of directors. Thus the manager retains control of the board, perhaps to make the corporate form more closely resemble the limited partnership form as a method of appealing to the managers who initiate these vehicles. The board is typically comprised of manager appointees and professional directors supplied by affiliates of the offshore law firm or the offshore registered agent.

Why is this important when the US model offers no independent oversight at all? It is important because a number of the apparent safeguards there to protect investors depend significantly on the hegemony of the board of directors as the ultimately responsible party. At the same time, however, the board is fundamentally a creature controlled by the manager. Its ability to act as an independent fiduciary is thus illusory, and therefore dangerous.

Though various regulatory and industry organisations defer to the ultimate authority of the board when defining desired practices, the board cannot enforce such critical matters as independent pricing discipline, oversight of manager compensation and other use of investor assets, timely suspension of redemptions in the event of

insolvency, and ultimately, the hiring and firing of the manager without the agreement of the manager.

What are the responsibilities of the players?

Once these vehicles are formed and funded, the third party administrator goes through its onboarding process to allow it to keep the records it needs to determine and distribute the fund's net asset value to its shareholders. Many parties assume that, if a recognised administrator has accepted appointment, it will independently price the portfolio, keep the books and calculate the NAV.

From the administrator's point of view, however, responsibility for pricing lies with the board as governing body. Administrators increasingly accept manager prices for hard to value instruments, which are, of course, proliferating. These instruments, to which much of the alleged excess return is often attributed, are the very ones for which independent oversight is most critical. Administrators, however, want to avoid liability for mispricing hard to value instruments, and thus many have amended their contracts to allow them to accept prices from the hedge fund manager without further checks.

Therefore, though the investors, not the manager, pay the administrator since its fees are paid by fund assets, investors are not getting the benefit of the bargain they may believe they have struck: the administrator as independent watchdog is in many cases not calculating net asset value independent of the manager, and the board, were it able and inclined to ensure true third party pricing, has been rendered toothless.

What are the ramifications of this lack of independence?

Clearly, pricing of investments is the most critical function in the entire process of managing these funds, and often the most difficult. Many managers are diligent and honest, and many administrators do their best. Many boards undoubtedly work hard effectively to oversee the pricing process. Nevertheless, the manager holds substantially more information as to the value of the instruments it buys, and presumably understands the role that each plays in the portfolio to a degree that directors and administrators can never match. Were these funds not organised as companies with a perpetual life, discrepancies might not matter as the value would come clear at fund termination, when realised value would tell the tale.

These are, however, open ended vehicles with no finite life. And managers are typically paid a management fee as much as 2 percent of assets and an incentive fee as high as 20 percent of upside.

How do these compensation mechanisms work?

Firstly, the incentive fee is calculated based on positive performance, not performance above an agreed upon market hurdle rate, and there is

typically no cumulative feature that incorporates the effect of negative results.

Secondly, the manager receives the base and any incentive fee under the Investment Management Agreement on a fixed schedule, regardless of the time horizon of either the investor's commitment or the actual investment in question.

And finally, hedge fund managers are paid incentive fees on unrealised as well as on realised gains.

So, drawing an extreme example for the sake of illustration, we have managers controlling the board of directors not just *de facto* but *de jure*. We have administrators unwilling or unable to independently price the manager's portfolio, which is more and more often comprised of hard to value instruments. We have an open ended structure in which there will never be a day of reckoning to determine the realised value of those hard to value holdings selected by the manager.

Finally, we have managers being paid not only their fees but also their incentive compensation based on values that have been provided by the very same manager who is being paid on the basis of those values. And we are operating in a market in which there is no public visibility for results and no recourse for investors.

Many investors may have the ability to analyse these issues and determine that the results achieved by the manager are worth accepting these risks. Many investors, however, as well as other parties involved, may be unaware of the extent to which the manager is both in total control of these funds and incentivised to manage portfolio pricing for the manager's benefit. No matter how honourable the manager's intentions, the scale of the money involved and the lack of manager accountability create monumental temptation. Though $3 trillion says this is an attractive marketplace, that same $3 trillion and more might appreciate reform. RC

Deborah Hicks Midanek
President
Solon Group, Inc.
T: +1 (917) 853 3598
E: dhmidanek@solongroup.com