Governance

Mitchell Nichter
Paul Hastings

1. Introduction

Over the past two decades, the hedge fund industry has experienced substantial growth and success, as well as many challenges. The industry has grown rapidly both in the number of funds and in the assets under management. In terms of market impact, hedge funds now account for a significant portion of all trading on the New York Stock Exchange. Hedge fund management is undergoing a fundamental transformation following a number of recent events.

Hedge funds are professionally managed pooled investment vehicles that historically have not been regulated under the US Investment Company Act of 1940, as amended. Many hedge fund managers have also relied on various registration exemptions to avoid registering with the US Securities and Exchange Commission (SEC) and state authorities as investment advisers.

Unlike mutual funds, hedge funds and their managers have fought to maintain (and until recently have been successful in maintaining) a relatively low public profile due to the generally unregulated private nature of the industry and their entrepreneurial desire to conduct business with few constraints. Because of these factors, hedge funds have historically provided less transparency for both investors and regulators than other financial products. The organisational and disclosure documents of many hedge funds establish broad objectives and investment strategies, and may authorise multiple and largely unconstrained strategies in order to provide managers with the flexibility to respond quickly to changing market conditions. Typically, fund documents also provide managers with very broad and absolute discretion in managing the funds, such as the discretion to determine when and how to implement an array of redemption mitigation tools, with no or very few objective guidelines. The mitigation tools include fund-level or investor-level redemption gates, redemption lock-ups, redemption suspensions, in-kind distributions and the use of side pockets.

Historically, hedge funds have sought maximum operational and investment flexibility and have been structured to enable fund managers to make most decisions without significant investor oversight or approval, and corporate governance has not been an important aspect of the hedge fund industry.

With this background, it is not surprising that the concept of governance as applied to hedge funds has been loose and relatively unstructured. However, this is changing, primarily due to two factors: increased regulation of hedge funds and their managers; and competitive pressures driven by the demands of institutional investors.

2. Regulatory pressures

Hedge funds and their managers are facing ever more significant regulation globally. The US Dodd-Frank Act,[1] and the rules and regulations made under it by the SEC, require many previously unregistered managers of hedge funds and other types of private investment funds to register as investment advisers with the SEC by March 30 2012. SEC registration imposes new burdens, responsibilities and realities on fund managers, and subjects them to increased SEC scrutiny (including periodic SEC compliance examinations). The EU's Directive 2011/61/EU on Alternative Investment Fund Managers[2] is another recent example of the regulatory noose tightening around hedge funds and their managers.

The US Investment Advisers Act of 1940, as amended (Advisers Act) imposes numerous obligations and restrictions on hedge funds and their managers that in the past were not viewed as applicable or relevant to funds with unregistered managers. In effect, these obligations impose a governance structure by governmental fiat – a structure that has been largely absent from the hedge fund sector.

2.1 Fiduciary duties and anti-fraud rules

Fund managers owe fiduciary obligations to their funds and to fund investors under the Advisers Act. Newly registered managers should prepare to operate in an environment that places a premium on regulatory compliance, and on effective compliance policies and procedures.

The primary US statutory basis for an investment adviser's duty to its clients is Section 206 of the Advisers Act. Under this section it is unlawful for an investment adviser (registered or not):

- to employ any device, scheme or artifice to defraud;
- to engage in any transaction, practice or course of business which operates as a fraud or deceit;
- acting as principal for its own account, knowingly to sell or purchase any security from a client, or acting as broker for a person other than such client to effect any sale or purchase for such client, without disclosing in writing the capacity in which it is acting and obtaining the consent of the client to such transaction; or
- to engage in any act, practice or course of business that is fraudulent, deceptive or manipulative.

On its face, Section 206 appears to be a standard anti-fraud provision, with some additional restrictions against principal transactions and cross-trading specific to the world of investment management. However, the SEC and the courts have interpreted the section to impose heightened fiduciary obligations on advisers; obligations that in some circumstances may not be waived or contracted away. Furthermore, the SEC has used Section 206, through regulation, no-action letters and enforcement actions,

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1 Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 (124 US Stat. 1376–2223) (Dodd-Frank Act).

2 See http://ec.europa.eu/internal_market/investment/alternative_investments_en.htm#directive.

to shape what it believes to be appropriate adviser conduct, in effect imposing a governance structure on hedge funds and their managers.

In *SEC v Capital Gains Research Bureau, Inc.*,[3] the US Supreme Court held that Section 206 imposes mandatory fiduciary duties on investment advisers as a matter of law. It stated that an investment adviser's fiduciary responsibilities include "an affirmative duty of utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients". This broad statement encompasses three general fiduciary obligations of fund managers:

- a duty of loyalty to act in the best interests of clients and fund investors, which includes the duty to disclose all material conflicts of interest;
- a duty of care when recommending securities or providing investment advice; and
- a duty to deal fairly with clients and fund investors.

These general statements provide little practical guidance to fund managers in meeting their fiduciary responsibilities to clients. However, more useful guidance exists in the form of SEC no-action letters, releases, enforcement actions and federal court decisions. For example, the SEC has stated that the fiduciary obligations of an investment adviser include:

- a duty to give impartial advice;
- a duty to make suitable recommendations to clients in light of their needs;
- a duty to exercise a high degree of care to ensure that adequate and accurate recommendations and other information are presented to clients; and
- a duty to have an adequate basis in fact for all performance information, representations and projections. A brief discussion of the various duties identified in the Capital Gains decision and how they might affect a fund manager follows.

Every investment adviser owes a duty of loyalty to its clients, meaning that the adviser must put its client's interests above its own when those interests conflict. The duty of loyalty places on advisers an affirmative obligation to disclose to their clients all material information concerning any actual or potential conflicts of interest. Generally, an adviser may proceed with a conflicted transaction if it fully and completely discloses the conflict and obtains client consent (ie, the adequacy of the consent will depend on the fullness of the disclosure). As such, with proper disclosure, a client may contractually waive an adviser's fiduciary duty of loyalty.

A key component of the duty of loyalty is an adviser's obligation to provide unbiased advice to its clients. Conflicts arise when an adviser is tempted to provide advice that may ultimately benefit itself, although this often can be addressed through adequate and timely disclosure to affected clients or fund investors. For example, if an adviser has a financial interest in a securities transaction generated by its advice, it should disclose this interest or avoid the transaction. A client may

3 375 US 180, 194 (1963) (*Capital Gains*).

consent to such conflicts, but the consent must be independent and informed.

Every investment adviser has a duty to treat each of its clients fairly, meaning both that the adviser cannot benefit one client to the disadvantage of another and that the adviser cannot use its superior knowledge or expertise to obtain inequitably favourable contract terms. Unequal allocation of investment opportunities by an adviser may constitute a breach of fiduciary duty. This situation often arises when an adviser allocates a limited investment opportunity among its clients. Advisers should have written allocation policies and procedures that require impartial allocation of investment opportunities and that are designed to treat clients fairly over time.

The SEC also takes the position that Section 206 imposes an implied duty of care on fund managers. This includes the duty to investigate and the duty to provide suitable advice.

Advisers must be familiar with the facts on which they base their recommendations, and they have an obligation to verify those facts. While an adviser is not required to adopt a particular method of research analysis, the procedures used by the adviser must meet the expectations of reasonable investors. Similarly, an adviser may breach its duty to investigate if it does not confirm its investment advice from an independent source.

Advisers should only recommend investments that are suitable for their clients. To determine whether an investment is suitable for a client, an adviser must obtain information about the client's needs and situation. The adviser should provide the client with all relevant information about the suitability of the investment. In general, an investor may not generically and prospectively waive its right to receive suitable advice from an investment adviser, but may effectively consent to specific investments if provided adequate information about the investment. However, some courts have held that even if an investor claims fully to have understood the risks of a particular investment, the investor's consent may not be sufficient fully to protect the adviser from liability. As a fiduciary, an adviser may have an additional responsibility to make sure its clients do not make investments that are beyond their financial understanding or that make no economic sense in their situation. Where investors are not sophisticated, the adviser may be required proactively to explain the full risks of the investment and to disclose any unusual circumstances to the investors.

In addition to the general fiduciary obligations imposed by Section 206, fund managers are subject to more specific restrictions contained in that section and in the SEC's rules adopted under it. Of particular interest to fund managers are the Section 206 provisions covering principal transactions with clients and advertising.

2.2 Principal transactions

Under Section 206(3) and the rules made under it, an investment adviser, acting as principal for its own account, may not knowingly buy a security from, or sell a security to, its client unless:

- the adviser (or an affiliate of the adviser) has disclosed to the client its capacity in the transaction;
- the disclosure is made in writing before settlement of the transaction; and
- the client has provided consent "before the completion of each transaction".[4]

Before the completion of a transaction means the adviser must obtain the client's consent either before the execution of the trade or after execution but before settlement of the transaction.[5]

Blanket prospective client consents are not permitted under Section 206; only transaction-specific consents are acceptable, and the information disclosed to the client before the transaction must be sufficient to identify and explain the potential conflicts of interest.

2.3 Advertisements

Advertising by fund managers is governed by Section 206. Rule 206(4)-1 defines the term 'advertisement' as any notice, circular, letter or other written communication addressed to more than one person, or any notice or other announcement in any publication, or by radio or television, which offers:

- any analysis, report or publication concerning securities, or which is to be used in making any determination as to when to buy or sell any security, or which security to buy or sell;
- any graph, chart, formula or other device to be used in making any determination as to when to buy or sell any security, or which security to buy or sell; or
- any other investment advisory service with regard to securities.

In general, marketing brochures for distribution to prospective clients, materials designed to maintain investments by existing clients and materials containing investment performance information (eg, fund offering circulars, investor reports, investor presentations) are all considered to be advertisements. In addition, all information publicly posted online about an adviser's advisory business, including on the adviser's website and in social media, is considered to be an advertisement by the adviser and therefore subject to the restrictions of Section 206 and the rules made under it.

2.4 Testimonials

Rule 206(4)-1 prohibits use of any testimonial concerning an adviser or its advisory services, because testimonials tend to create an impression that all of the adviser's clients typically experience the same favourable results as the client providing the testimonial, and testimonials emphasise activities favourable to the adviser while ignoring those that are unfavourable. A 'testimonial' is generally understood to include any statements by current or former advisory clients, or fund investors, that endorse or speak positively regarding the adviser or its services. Partial client lists can be testimonials, unless performance-based data are not used to generate the list, each list contains a disclaimer noting that the clients listed do not necessarily approve of the adviser's services, and the list contains disclosure of the objective criteria used to generate the list (which may not be performance-based).

4 15 USC § 80b-6(3).
5 SEC Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Advisers Act Rel. No. 1732 (July 17 1998).