Comment: Amateur hour cancelled

By *mkitchen*
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Cayman Islands funds [1]

Don Seymour (pictured), founder and managing director of DMS Management and former head of investment services at the Cayman Islands Monetary Authority, says last week's judgement against directors of the Weavering Macro Fixed Income Fund, for failure to perform their duties adequately, was a long time coming – and that in future members of Cayman fund boards who fail to perform their duties and responsibilities properly will pay a heavy price…

It was bound to happen. There are more than 10,000 directors serving Cayman Islands funds – everyone from rank amateurs to serious professional firms – and fund governance has been one of the fastest-growing sectors within the hedge fund industry.

Questions had been raised in the press by institutional investors about the performance of some independent directors during the recent financial crisis, and now many of these questions have been decisively answered by the Grand Court of the Cayman Islands Financial Services Division in its August 26 judgment against the independent directors of the Weavering Macro Fixed Income Fund.

Substantial case law on directors' duties and responsibilities to trading companies already exists, but this is the first time that the court has dealt with a case specifically involving directors' duties to a hedge fund.

In a sound, well-reasoned decision, the court found the independent directors guilty of wilful neglect or default in their duties to the fund and ordered them to pay USD111m in damages. This blockbuster award should send a strong message to all recalcitrant directors either to perform their duties and responsibilities properly, or pay a heavy price.

This judgment may not end the discussion about whether amateur or professional fund governance is more effective – Luddite beliefs that are deeply ideological – but the court repeatedly confirmed its view that independent directors should perform a "high level supervisory role" in a "professional, business-like manner". Fair-minded people can form their own judgments about what "professional" and "business-like" mean when they see it.

To illustrate, the guilty directors fit the amateur model completely – retired and working from home; numerous years of investment management experience with reputable institutions; and no other directorships. The court found they "had appropriate professional credentials and met the [Irish Stock Exchange's] independence requirement."

For proponents of the amateur model, they could not have been more perfect examples – yet investors suffer devastating losses at their hands. It is highly doubtful that this catastrophe could have occurred in a professional fund governance firm, with professional full-time directors having vast fund directorship experience, ably assisted by professionally-qualified staff following established policies and procedures based on industry best practices.

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The decision reaffirmed what astute fund investors and sponsors already know – the professional fund governance model does far more work and is far more productive than the amateur model. I’ve operated both models and can tell you unequivocally that the professional model is far more effective.

The court made some meaningful observations in key areas that are instructive to the fund industry:

Board meetings. Some hold that that the number of board meetings is the litmus test for director performance; however, it is not uncommon for some directors to hold frequent meetings to go through the motions, believing that the more meetings the better (especially if the meetings are held in attractive locales) and that their obligations begin and end in the boardroom.

This spectacle is pure form over substance. Amateurs love this approach and scoff at the SEC’s recommendation to hire staff with appropriate skills to assist them in discharging their duties. Perhaps now they will heed the SEC’s advice and better understand the value of having professional staff and why they can’t simply attend a few meetings, pick up their check and hit the golf course.

The court exposed this charade and did not accept that the regular quarterly board meetings could be “relied upon as the single most important way in which they claim to have discharged their functions”. DMS has always understood that the board meeting, in itself, does not signify good governance, so we created a more substantive governance methodology – a process – a system of check of balances that goes beyond the board meeting.

For example, in addition to minutes of regular board meetings, DMS prepares an annual fund governance report for stakeholders that detail all the activities that we have performed for the fund during the year, to demonstrate in a specific, observable and measurable manner the level of oversight being delivered to the fund. Purely focusing on board meetings misses the big picture, as the court found, as they may be held merely to “create the impression that the directors were reviewing the affairs of the company on a regular quarterly basis”.

Duties and responsibilities. In confirming that director duties go beyond the board meeting, the court held that directors have “a continuing duty to acquire and maintain a sufficient knowledge and understanding of the company's business to enable them properly to discharge their duties as directors. They need to satisfy themselves, on a continuing basis, that the various professional service providers are performing their functions in accordance with the terms of their respective contracts, and that no managerial and/or administrative functions which ought to be performed are being left undone.”

The court was also critical of the directors in that they never prepared an agenda for the board meetings, never asked any of the service providers to participate in meetings and never inquired of the providers – yet another example of where the professional model excels. It is difficult to imagine any directors meeting the court’s expectations without employing a team of professionals with a broad range of deep hedge fund skills to assist the director in reviewing complex matters, researching issues and asking probing questions.

Fund operations. Fundamentally a hedge fund is different from a trading company in that it operates through delegates and not employees. The court repeatedly recognised the ability, indeed the necessity, for directors to delegate to competent service providers within the hedge fund structure, but also made very clear that such delegation does not absolve the directors of the duty to supervise such delegation, albeit at a “high level”.

Importantly, the Court confirmed that the “directors were not expected to supervise [the fund’s] trading activities”, making clear that a director is neither a shadow or pseudo investment manager, as some have promoted themselves.

Indemnification. Although these directors were indemnified in the typical manner under the articles of association, such indemnification did not protect their egregious conduct. Effectively the court’s decision proves the speculation that indemnification leads to directors behaving with impunity to be

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patently false. Indemnification is intended to protect conscientious, well-meaning directors from frivolous actions, and the court will not tolerate any misuse of indemnification provisions.

Crisis management. Historically independent directors responded to a crisis by resigning and distancing themselves from a fund. During the recent financial crisis, questions arose whether directors acted too precipitously in imposing gates or acted too slowly in liquidating positions.

Reasonable minds can debate these issues, but these directors found a way to do even worse – they did nothing. Despite not having any other directorships, these directors did not perform effectively.

Directors prove their worth in a crisis, and the 2008 financial crisis was the true stress test of a director’s capacity to perform effectively. The court agrees: “The way in which these directors behaved during this most serious financial crisis is, in my judgment, the most compelling evidence that they never intended to perform their duties as directors.”

Record-keeping. The court found that the directors were “not able to explain why he signed these agreements or how he thought that the arrangement could benefit the … fund.” Nor were they able to demonstrate the basis for approving certain side letters. The court observed: “There is no evidence that the directors made any enquiry or sought to understand whether or not the execution of side-letter agreements of this sort could impact adversely on the macro fund.”

The court further observed that “while it is common practice for Cayman Islands funds to enter into side letters of this sort, it seems to me that independent directors need to be alive to the issues which are likely to arise.”

While the case did not turn on this issue, the industry should find the court’s emphasis on documentation noteworthy. At DMS we carefully document how we apply our minds to every decision we take on behalf on a fund, and maintain that record in accordance with SEC and Cayman record-keeping requirements.

Overall, this is an excellent decision for fund investors and continued confidence in the Cayman fund and alternative investment industry. It proves that the system works effectively, and should blunt any criticism by those proposing extreme concepts and agitating for radical overhaul. Simply put, the Cayman Islands will hold directors accountable for their poor performance.

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