HEDGE FUND GOVERNANCE

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Abstract

This Article provides the first comprehensive scholarly analysis of the internal governance of hedge funds. Hedge fund governance consists of the funds’ underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs. Hedge fund governance is important because better governance can improve investor returns and help managers raise and retain capital. I argue that hedge fund governance is best understood as a type of responsive managerialism. It is a type of managerialism because applicable law and contracting structures give managers uniquely wide-ranging control over the fund and its operations. Hedge fund governance is also uniquely responsive, however, because managers must continually satisfy investors due to their ability to shut down a fund by withdrawing their capital.

In addition to their underlying legal regime, the primary components of hedge fund governance are investors with a strong propensity to exercise their short-term redemption rights, managers with high pay-performance sensitivity, investor demand for quality governance, and close monitoring by short-term creditors and derivatives counterparties. Overall, I find that hedge fund managers are not systematically ripping off investors because hedge fund governance devices keep agency costs relatively low.

Nonetheless, there is still plenty of room for hedge fund governance to improve. Accordingly, this Article provides a normative framework and principles for improving hedge fund governance by striking a better balance between governance devices that are investor-friendly and those that empower managers. My analysis suggests that the areas in which hedge fund governance needs the most improvement are performance reporting (valuation) and the timing of performance-fee calculations. Importantly, my analysis also suggests that investors are often better off with less transparency, higher fees, and less access to their capital.

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Table of Contents

Introduction ........................................................................................................................................... 2
I. Managerialism .................................................................................................................................... 8
   A. Hedge Fund Limited Partnerships ............................................................................................... 9
      1. Governance of the Manager ................................................................................................. 9
      2. Limited Investor Rights ........................................................................................................ 11
   B. Hedge Fund Corporations ......................................................................................................... 13
      1. Offshore Funds .................................................................................................................... 13
      2. Offshore Hedge Fund Directors ......................................................................................... 14
   C. Federal Law .................................................................................................................................. 15
      1. Prohibitions Against Fraud .................................................................................................. 17
      2. Disclosure and Business Conduct Requirements .............................................................. 18
II. Hedge Fund Agency Costs ........................................................................................................... 19
   A. Fraud and Misreporting ............................................................................................................ 20
   B. Fee-Based Incentive Misalignments ....................................................................................... 23
   C. Restrictions on Investor Redemptions .................................................................................... 25
   D. Overcompensation of Managers ............................................................................................ 26
   E. Favoritism of Certain Investors or Service Providers ............................................................ 27
III. Hedge Fund Governance Devices ................................................................................................ 29
   A. Investor Driven Governance .................................................................................................... 29
      1. Capital Inflows and Outflows .............................................................................................. 29
      2. Investor Demand for Quality Governance ......................................................................... 31
      3. Secondary Markets for Hedge Fund Shares ...................................................................... 35
   B. Performance-Based Governance ............................................................................................ 36
   C. Short-Term Creditors and Counterparties .............................................................................. 38
   D. Hedge Funds Produce Alpha .................................................................................................... 41
IV. Improving Hedge Fund Governance ............................................................................................ 44
   A. Governance and Firm Characteristics ...................................................................................... 44
   B. Fees ............................................................................................................................................ 45
      1. Performance-Based Compensation and Rate .................................................................... 45
      2. High-Water Marks and Hurdle Rates .................................................................................. 47
      3. Managerial Co-Investment ................................................................................................... 49
   C. Transparency ............................................................................................................................ 50
   D. Hedge Fund Boards of Directors ............................................................................................ 52
   E. Redemption Restrictions ............................................................................................................ 55
   F. Managed Accounts .................................................................................................................... 56
V. Conclusion ....................................................................................................................................... 57
HEDGE FUND GOVERNANCE

INTRODUCTION

Concerns about the internal governance of hedge funds have dramatically increased in recent years. During the financial crisis of 2008, investors became frustrated when numerous hedge fund managers suddenly prevented them from withdrawing their capital yet nonetheless continued to charge them fees. Since the financial crisis, concerns about hedge fund governance have centered on transparency, operational practices, and the growing view that fund directors do not effectively monitor fund managers. Exemplifying these governance concerns was the June 2012 enforcement action by the United States Securities and Exchange Commission (SEC) against the prominent hedge fund manager Phillip Falcone. The SEC alleged that Falcone misappropriated investor assets and granted favorable treatment to some investors without the knowledge of the fund’s directors or other investors. As a result of such developments, major institutions are increasingly refusing to invest in hedge funds that fail to meet their governance standards.

If hedge fund governance is not improved, investors may miss out on higher returns or suffer undue losses. Improved governance can also help managers raise and retain capital. Performance should be a particular concern to investors, since hedge fund returns have trailed the

1. A hedge fund is a private investment vehicle that is not subject to the full range of restrictions on investment activities, disclosure obligations, and other regulations imposed by federal law on investment companies, that compensates management in part with a fee based on annual profits, and typically engages in the active trading of financial instruments. Hedge funds are enabled by their underlying legal regime to use the trifecta of leverage, short sales, and derivatives in pursuit of an extremely wide variety of investment strategies. These strategies include investing in stocks and bonds, trading off of global interest rate and currency fluctuations, purchasing illiquid assets such as distressed debt, and making asset-based loans. See Houman B. Shadab, The Law and Economics of Hedge Funds, 6 BERKELEY BUS. L.J. 240, 241 (2009). Hedge funds globally managed an estimated $2.19 billion in assets as of the third quarter of 2012. ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION (AIMA), AIMA'S ROADMAP TO HEDGE FUNDS, 2012 EDITION at 17.


4. See Anastasia Donde, The Hedge Fund Report Card, Alpha at 33, Winter 2013 (“simply posting high returns is no longer enough to keep [hedge fund] investors happy”); AIMA, A GUIDE TO INSTITUTIONAL INVESTORS’ VIEWS AND PREFERENCES REGARDING HEDGE FUND OPERATIONAL INFRASTRUCTURES 7 (2011) (“Governance has become a ‘make or break’ area in the investment decision-making process.”).
stock market on an absolute basis since 2008. Due to disappointing returns, the new focus on governance, and an increasing number of hedge funds competing for capital, bargaining power over fees and other governance devices seems to have permanently shifted in favor of investors.

This Article provides the first comprehensive scholarly analysis of the internal governance of hedge funds. In doing so, this Article makes several contributions. First, this article contributes to the literature on corporate governance by conceptualizing the unique way in which hedge funds are governed and situating their style of governance within established paradigms. I argue that hedge fund governance is a type of responsive managerialism. In general, managerialism as a descriptive theory of corporate governance refers to control of a business enterprise resting in the hands of managers, with equityholders and directors playing a passive role. Managerialism is widely rejected as a descriptive account of public corporations by scholars, who correctly argue that directors have ultimate control over managers and other constituencies.


9. Id. at 10 (“[n]either shareholders nor managers control corporations”); Margaret M. Blair &
I argue that in the hedge fund context, by contrast, managerialism does provide substantial descriptive value. Hedge fund governance is a form of managerialism because the funds’ underlying legal regime gives managers near complete authority over the structure and operations of the funds they manage. Hedge fund managerialism arises from the fact that hedge funds are organized as privately-held limited partnerships (or their functional equivalents) that highly circumscribe equity investors’ rights with shares that have no voting rights nor any mechanism to replace managers or directors. Hedge fund managerialism gives hedge fund managers more control and authority over their firms than managers of public companies, mutual funds, and other private investment funds (e.g., private equity).

However, hedge fund governance is also uniquely responsive in the sense that to obtain and retain investor capital, hedge fund managers must be highly responsive to the preferences of equity investors (the limited partners). This responsiveness arises from a fundamental dynamic of hedge fund governance—the propensity of investors to “pull the plug” and cash out of a fund if they are dissatisfied. Although hedge fund investors usually face short-term redemption restrictions, they typically can disrupt the operations of a fund or even cause it to wind down in a few months to a year by withdrawing their capital. Indeed, even if a hedge fund is performing very well, potential governance problems may still cause the fund to become concerned about its survival. For example, in January 2013 the highly successful hedge fund SAC Capital reportedly had to “persuade investors to keep their money at the fund” in response to an ongoing insider trading investigation that had only implicated several employees, but not the firm itself or its manager.

The uniqueness of hedge fund governance stems from the fact that the exit rights of hedge fund investors puts hedge fund managers on
a much shorter leash than managers of public corporations and other types of investment funds. Corporate scholars recognize that an essential feature of the corporate form is that it permits a firm to have access to permanent, “locked-in” capital from equity investors.14 Private equity and venture capital funds likewise have access to long-term capital because investors in such funds are bound to them by contract for seven to 10 years.15 Managers with access to permanent or long-term capital do not have to be concerned about investors suddenly pulling the rug out from beneath them and causing their firms to shut down. Hedge fund managers do not have that luxury.16

In accordance with Larry Ribstein’s seminal theory of business organizations, hedge funds adopt a unique set of “uncorporate” governance devices.17 In addition to their underlying legal regime, I argue that the primary components of hedge fund governance consist of:

- investors with a high propensity to exercise their short-term redemption rights;
- managers with high pay-performance sensitivity due to being compensated with an annual performance-based fee and their own investment in the funds they manage;

14. See Margaret M. Blair, Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century. 51 UCLA L. REV. 387 (2003); Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 YALE L. J. (2000). Hedge funds do not use the governance devices of public corporations, which include not only independent boards, the shareholder voting franchise, and non-waivable fiduciary duties, but also a right of exit by selling shares in liquid stock markets.


17. LARRY RIBSTEIN, THE RISE OF THE UNCORPORATION 1-2, 38 (2010). See also Joseph A. McCahery & Erik P.M. Vermeulen, How Should We Regulate Private Equity and Hedge Funds? at 348, July/August 2007 (“One of the central features of the governance environment of [private equity and hedge] funds is the limited partnership structure . . . . Its popularity is due to its contractual nature which allows the internal and external participants to reduce opportunism and agency costs.”), http://www.mab-online.nl/pdf/599/McCahery_Vermeulen.pdf. Hedge funds do share a fundamental similarity with mutual funds in that mutual funds are also subject to short-term redemptions. Hedge fund governance is nonetheless unique because mutual funds do not face the same level of ongoing collapse-risk as hedge funds because hedge fund investors are more sophisticated and preemptively remove funds to avoid redemption restrictions. See Ben-David et al, supra note 10, at 3-6; William A. Birdthistle Investment Indiscipline: A Behavioral Approach to Mutual Fund Jurisprudence, 2010 U. Ill. L. REV. 61, 73-85 (2010) (discussing weaknesses in the ability of mutual fund investor exit rights to discipline managers). Mutual funds are also subject to a strict regime of federal regulation that makes the types of governance devices they must and may adopt very different from that of hedge funds.
• demand by sophisticated investors for quality governance; and

• close monitoring by short-term creditors and derivatives counterparties.

The hedge fund governance regime is also notable for what it lacks. Not only do hedge funds lack permanent or long-term capital, but hedge fund managers are also not subject to stringent board oversight, removal by investors, nor any market for corporate control. Unlike private equity and venture capital funds, hedge funds are not organized as “closed-end” funds for a finite (e.g., 10 year) duration, and hence are not subject to the discipline of being required to return capital to investors at the end of a specified investment lifecycle.

The governance regime that results from the interplay of hedge fund managerialism and investor-responsiveness may benefit investors by providing them with sufficient transparency and liquidity and by empowering managers to successfully pursue their investment strategies. On the other hand, hedge fund governance may permit managers to impose agency costs on investors in the form of fraud, performance manipulation, misaligned compensation incentives, and redemption restrictions that unnecessarily keep investor capital locked inside a fund. Hedge fund governance thus consists of the funds’ underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs.

The second primary contribution of this Article is to examine and assess hedge fund agency costs and the governance mechanisms used to reduce them. Although financial economists have studied numerous discrete aspects of hedge governance, this Article is the first to integrate their findings to provide a general assessment of the relative significance of hedge fund agency costs. Overall, I find that hedge fund managers are not systematically ripping off investors. This is because empirical studies do not find that fraud or other types of agency costs are

18. See also Paul Gompers & Josh Lerner, An Analysis of Compensation in the U.S. Venture Capital Partnership, 51 J. FIN. ECON. 3, 4 (1999) (noting that “[i]nvestors in venture [capital] funds, the limited partners, cannot utilize many of the methods of disciplining managers found in corporations, such as dismissal, the active involvement of boards of directors, and the market for corporate control”).


20. A related governance and agency cost literature exists in the study of private equity firms and venture capital funds. See Harry Cendrowski & Adam Wadecki, The Private Equity Governance Model, in PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS 117 (2012); William A. Sahlman, The Structure and Governance of Venture-capital Organizations, 27 J. FIN. ECON. 473 (1990); Douglas Cumming, Grant Flemming & Armin Schwienbacher, The Structure of Venture Capital Funds 155-176, in HANDBOOK OF RESEARCH ON VENTURE CAPITAL (2007). Although industry analysis is increasingly focusing on hedge fund governance, its value is limited because it is typically not informed by academic research.
pervasive and significant. In addition, empirical studies strongly suggest that hedge funds outperform stock and bond markets on a risk-adjusted basis even after managers are paid their fees. In other words, the market for hedge fund managers seems relatively competitive and well priced.

Thus, in contrast to the argument made in the *Yale Law Journal* by John Morley and Quinn Curtis that investor exit rights in mutual funds undermine good governance, I view the exit rights of hedge fund investors as the primary reason why hedge fund agency costs are low. And in contrast to prominent commentators such as Simon Lack who argue that the benefits of investing in hedge funds are a “mirage,” this Article underlines the view that the overwhelming majority of hedge fund investors would be better off investing elsewhere.

Nonetheless, hedge fund governance still has plenty of room for improvement. The third contribution of this Article is to provide hedge fund investors and managers with a normative framework and principles to improve hedge fund governance. In doing so, this Article follows the tradition of legal scholarship pioneered by Harvard Law School

21. See infra Section II.
22. See infra Section III.D.
23. Whether and to what extent the market for mutual fund managers is competitive is a subject of substantial debate and attention. See John Morley & Quinn Curtis, Taking Exit Rights Seriously: Why Governance and Fee Litigation Don’t Work in Mutual Funds, 120 Yale L. J. 84, 98-100 (2010).
24. See generally id. (arguing that “the net effect of exit on many [mutual fund] investors is ambiguous, because investors who do not use their rights to leave underperforming funds cannot expect activism by other investors to improve the funds”).
professors Lucian Bebchuk and Jesse Fried. That tradition establishes principles for investors to consider when making decisions about financial contracting in the organizational context, with public company compensation arrangements serving as the focus of Bebchuk and Fried’s work.\footnote{27 See Lucian A. Bebchuk & Jesse M. Fried, \textit{Paying for Long-Term Performance}, 158 U. PENN. L. REV. 1915, 1922 (2010).}

In the hedge fund context, my analysis suggests that the areas in which hedge fund governance needs the most improvement are performance reporting (valuation) and the timing of performance-fee calculations. I also argue, however, that investors should be careful what they wish for when choosing or negotiating governance structures. Although investors generally benefit from low fees and significant transparency and liquidity, if investor-friendly governance devices are improperly structured or taken too far, investors run the risk of undermining the unique performance-based incentives and other governance mechanisms that enable hedge funds to produce superior returns in the first place. Importantly, investors are often better off with higher fees, less transparency, and less access to their capital.

This Article proceeds as follows. Section I examines hedge fund managerialism and its legal origins. Section II discusses the most important hedge fund agency costs, and Section III details important hedge fund governance devices. Section IV contains my framework and principles for improving hedge fund governance. The final Section of this Article concludes.

I. MANAGERIALISM

A “hedge fund” consists of three basic entities: the fund itself, the fund’s management company, and the fund’s equity investors. Organizing the fund either as a domestic U.S. limited partnership or offshore corporation affords the hedge fund manager overwhelming flexibility in managing its operational practices and carrying out its investment strategy. The general partner of a hedge fund limited partnership is responsible for managing all aspects of the fund’s business, including its investment portfolio.\footnote{28 DOUGLAS L. HAMMER ET AL., SHARTIS FRIESE LLP, \textit{U.S. REGULATION OF HEDGE FUND MANAGERS} 89, 94 (2005). For the purposes of this Article, the phrases hedge fund “manager” and “investment adviser” are used interchangeably to refer to the same business entity.} The hedge fund legal regime is best understood as a regime of managerialism due to the wide ranging discretion that applicable law and organizational structures give to managers. My analysis reveals that hedge fund managers have a greater level of control and authority than that of corporate managers and most other of types of investment funds.
A. Hedge Fund Limited Partnerships

1. Governance of the Manager

The general partner of a hedge fund limited partnership is the fund’s portfolio manager and investment adviser. The general partner of a limited partnership bears unlimited liability for any debts the partnership itself cannot satisfy. Accordingly, the general partner of a hedge fund is organized as a limited liability entity to prevent the manager from being subject to personal liability for the fund’s debts.

The general partner/management company is governed by its operating agreement that determines, among other issues, how the manager’s profits and losses are allocated, partner capital contributions, and withdrawal or expulsion. The hedge fund management company must determine through its operating agreement and company policies and practices who may act for the manager and the extent to which approval by owners may be required. In practice, hedge fund management companies typically establish a senior management structure that includes a chief executive officer, chief financial officer, chief compliance officer, and committees that oversee risk and valuation. Hedge fund management companies do not have an independent board of directors or equivalent supervisory body.

Fiduciary duties imposed on the management company stem from two sources. First, as an investment adviser, federal law imposes fiduciary duties of loyalty and care on hedge fund management companies to the funds they advise, but generally not to the fund’s own investors. These duties include providing independent investment advice that is suitable for the fund, putting the fund’s interests above its

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30. HAMMER ET AL., supra note 28, at 88 n.4, at 91-92. As control persons of the general partner entity, its owners may be personally liable for actions of the general partner as manager of the fund. Id. at 92. Organizing the fund as a limited partnership, and the general partner as a limited liability entity, is crucial to the fund, its investors, and the manager in minimizing tax burdens. As a limited partnership and LLC, respectively, neither the fund nor the general partner-manager would be taxed at the entity level. All income, gains, losses, and deductions “pass through” to the general and limited partners who report such items on their personal income tax returns. Id. at 88-89, 92.


32. HAMMER ET AL., supra note 28, at 93.


34. SEC v. CAPITAL GAINS RESEARCH BUREAU, INC., 375 U.S. 180, 194 (1963); SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 22, JAN. 2011. Only under limited circumstances have hedge fund managers been found to owe a duty to investors directly. U.S. v. Lay, 612 F.3d 440 (6th Cir. 2010); Retirement Program for Employees of Town of Fairfield v. Madoff, 2010 WL 2106654 (Conn. Super. Ct. Apr. 16, 2010).
own, disclosing any potential conflicts of interest between the adviser and the fund including the general nature of any preferential treatment to some investors. \(^{35}\) Second, default fiduciary duties are typically imposed upon managers by state-level limited partnership law. \(^{36}\) Although fiduciary duties are generally viewed as contractual in nature and may be eliminated entirely in the fund’s operating agreement, \(^{37}\) in practice hedge funds typically do not entirely eliminate fiduciary duties owed by the management company (general partner) to the limited partners. \(^{38}\) When fiduciary duties are so eliminated, investors’ claims against the manager are limited to breach of the limited partnership agreement or violation of the implied covenant of good faith and fair dealing. \(^{39}\)

Under the terms of the manager’s agreement with the fund it advises, the management company is compensated in part by a management fee. The management fee ranges from 1 to 2 percent of the fund’s net asset value and is calculated monthly or quarterly. \(^{40}\) The management fee generally covers expenses for operating and administering the fund—such as for overhead, personnel salary, office leases and physical capital costs. \(^{41}\) The manager is also compensated with a performance fee of approximately 20 percent of the annual profits of the fund. \(^{42}\)

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35. SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 22-28 JAN. 2011.
37. For example, Delaware’s limited partnership statute seeks “to give maximum effect to the principle of freedom of contract” by permitting the partnership agreement to eliminate the fiduciary duties of general partners to limited partners. Del. Code. tit. 6, § 17-101(b)-(c). The equivalent provisions allowing statutory waiver for the member of an LLC are located in Del. Code. tit. 6, § 18-101(b)-(c).
38. See Paige Capital Management, LLC v. Lerner Master Fund, LLC, C.A. No. 5502-CS, *42 (Del. Ch. August 8, 2011) (noting that the partnership agreement provided an investor with the right of withdrawal if the manager breaches a fiduciary duty). An empirical study of publicly traded limited partnerships and limited liability companies did find, however, that an overwhelming majority either eliminated fiduciary duties or waived manager liability arising from their breach. Mohsen Manesh, Contractual Freedom Under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs, 37 J. CORP. L. 555. 574 (2012).
39. See Lonergan v. EPE Holdings LLC, C.A. 5856-VCL *12 (October 11, 2010) (noting that plaintiff’s “complaint frames each of these theories using the implied covenant of good faith and fair dealing because the . . . LP Agreement eliminates default fiduciary duties”).
42. See infra Section III.B. For a more detailed explanation of hedge fund employee compensation structures, see THE 2011 GLOCAP HEDGE FUND COMPENSATION REPORT, SAMPLE EXTRACT, http://www.hfrdatabase.com/X84d__II1xz/glocap_sample_extract.pdf.
2. Limited Investor Rights

Under limited partnership law, the hedge fund manager (general partner) has the exclusive right to manage the company, except for a few extraordinary issues. In addition, a hedge fund’s limited partnership operating agreement defines by contract the rights and duties between the fund manager and the limited partner investors. The agreement empowers the management company with wide-ranging authority to manage all aspects of the hedge fund’s business, including its investment portfolio.

The limited partners provide capital as the fund’s equity investors. Limited partner investors are not liable for the fund’s debts, although they are subject to losing all of their investment capital and any undistributed profits. To avoid losing their limited liability and interfering with managerial control, hedge fund limited partners do not participate in investment decisions and are not empowered to do so by the operating agreement. Although limited partnership statutes permit a partnership agreement to grant voting rights to limited partners, hedge fund limited partnerships do not typically grant limited partners any voting rights or the ability to nominate directors. The hedge fund management company directly or indirectly owns all of the fund’s voting shares in a separate class with no economic rights.

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43. Uniform Limited Partnership Act (ULPA) § 406(a).
44. These extraordinary matters over which limited partners have consent rights include amending the partnership agreement and sale of at least substantially all of the partnership’s assets outside the ordinary course of business. ULPA § 406(b) (2001).
45. HAMMER ET AL., supra note 28, at 89, 94. For the purposes of this Article, the terms hedge fund “manager” and “investment adviser” are used interchangeably to refer to the same business entity, unless otherwise noted.
47. See, e.g., Del. Rev. ULPA § 17-303. Hedge funds typically only accept capital contributions at the beginning of each month, and may close themselves off to new contributions if the manager determines that additional capital may undermine the ability of the manager to carry out its investment strategy.
48. See Del. RULPA § 17-303(a).
49. See, e.g., Del. Rev. Unif. Ltd. Partnership Act (RULPA) § 17-302(b) (2007) (stating that “the partnership agreement may grant to all or certain identified limited partners or a specified class or group of limited the partners the right to vote separately or with all or any call or group of the limited partners or the general partners, on any matter”).
50. MANAGED FUNDS ASSOCIATION, SOUND PRACTICES FOR HEDGE FUND MANAGERS 11 (2009). Partnership statutes expressly allow for a partnership agreement to completely eliminate any voting powers of limited partners. See, e.g., Del. RULPA § 17-302(f) (“A partnership agreement may provide that any limited partner or class or group of limited partners shall have no voting rights.”). Those hedge fund investors that hold voting shares will be able to vote on material events such as “the appointment and removal of the investment manager; the election of directors; approval of directors’ fees; variation of shareholder rights; or a winding up of the fund at annual or extraordinary general meetings.” ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION (AIMA), A GUIDE TO INSTITUTIONAL INVESTORS’ VIEWS AND PREFERENCES REGARDING HEDGE FUND OPERATIONAL INFRASTRUCTURES 8 (2011).
51. See COALITION OF PRIVATE INVESTMENT COMPANIES, HEDGE FUNDS HOW THEY SERVE
investors thus do not have the right to vote for management that is inherent in corporate shares and typically available in other types of investment funds. As a result of the foregoing, limited partners of a hedge fund are extremely passive investors whose decision making is limited to deciding when and how much capital to contribute or redeem.

Hedge funds also place significant short-term restrictions on the ability of investors to redeem their capital and to resell or otherwise transfer their shares. A fund operating agreement typically restricts investors’ ability to withdraw capital to a periodic basis (typically monthly, quarterly, or semi-annually), and may permit the manager to completely bar withdrawals at its discretion. In addition, investors must typically give 30 to 90 days’ notice before being able to withdraw capital. Hedge funds may also implement an initial lockup period that prohibits a capital contribution from being withdrawn after it is first invested in the fund. Lockup periods range from less than one quarter to one year. Hedge funds may also use a contractual provision known as a “gate” to limit how much capital can be withdrawn on a given date. Gates usually limit investor redemptions to 10 to 25 percent of the value of the fund but they may also (or in the alternative) limit redemptions to a portion of the investor’s own capital. Hedge fund may also segregate

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52. See Phyllis A. Schwartz & Stephanie R. Breslow, Private Equity Funds: Formation and Operation, § 2:1.7, 2-10, June 2012 (noting that a main objective of private equity fund investors is to negotiate “an escape hatch from unsatisfactory management through use of for-cause (and in some cases also no-fault) general partner removal clauses”); Jamie Sklar, Liquidity, 5 Hedge Fund Law Report, Nov. 15, 2012 (“In contrast to private equity fund investors, hedge fund investors have not, in the majority of cases, pushed for the contractual right to remove the fund manager.”); Sahlman, supra note 20, at 490; Investment Company Act of 1940 §16(a), 15 U.S.C. § 80a-16(a) (providing for mutual fund shareholders to elect the fund’s board of directors).


54. Share resale restrictions are generally required for a hedge fund make a private offering under federal law. See infra Section I.C.2. Hedge funds also place restrictions on the trading of their shares so as to not be deemed a publicly traded partnership with its associated higher tax burden.

55. Hammer et al., supra note 28, at 3; Sober Look, Credit Hedge Funds Will Continue to Demand Appropriate Liquidity Terms From Investors, Jan. 19, 2013, http://soberlook.com/2013/01/credit-hedge-funds-will-continue-to.html. By comparison, publicly registered mutual funds are required to redeem shares to investors daily. 15 U.S.C. § 80a-22(e).


58. Id.

59. James R. Barth et al., Hedge Funds: Risks and Returns in Global Capital Markets 38-41 (December 2006) (finding that a majority of hedge funds have a lock-up period of less than one quarter). Hedge funds may also use “soft” lockups that allow investors to redeem during their lockup period by paying the fund a penalty fee for doing so. Sober Look, Credit hedge funds will continue to demand appropriate liquidity terms from investors, Jan. 19, 2013, http://soberlook.com/2013/01/credit-hedge-funds-will-continue-to.html.

a portion of an investor’s capital into an illiquid “side pocket” that prevents the investor from withdrawing their capital until the manager actually exits the investment.\textsuperscript{61}

Limiting the ability of investors to withdraw capital is the primary hedge fund governance device that arises in response to the ability and propensity of hedge fund investors to withdraw their funds. Redemption restrictions empowers managers because redemptions may interfere with the manager’s investment strategy, destabilize the fund’s liquidity, or otherwise disrupt the fund’s operations.\textsuperscript{62} The ability to exercise discretionary redemption restrictions may be limited by fiduciary principles, however. For example, a fund manager’s refusal to permit investors to withdraw capital pursuant to a contractually negotiated gate may violate its fiduciary duty of loyalty if done solely to earn additional fees and not protect the fund or other investors.\textsuperscript{63}

B. Hedge Fund Corporations

1. Offshore Funds

The two-thirds of hedge funds that are organized outside of the U.S. in an “offshore” jurisdiction such as the Cayman Islands or the British Virgin Islands are organized as corporations.\textsuperscript{64} U.S.-managed hedge funds are organized in offshore jurisdictions primarily to appeal to non-U.S. investors seeking confidentiality, to permit U.S. tax exempt investors (e.g., pensions and charitable organizations) to take advantage of potentially beneficial tax treatment from investing offshore, and to afford greater flexibility in being excluded from the U.S. investment company regulation.\textsuperscript{65}

From a governance perspective, management companies enjoy the same general plenary powers over offshore funds’ investments and other operations as they do with onshore funds.\textsuperscript{66} However, in response to tax disadvantages and restrictions on marketing, U.S.-based onshore

\begin{thebibliography}{9}
\footnotesize
\item[61.] Steven J. Tsimbinos & Scott H. Moss, Using Side Pockets for Illiquid and Hard to Value Securities, MFA REPORTER 1-2, May/June 2005.
\item[62.] See infra Section II.B.2.
\item[63.] See Paige Capital Management, LLC v. Lerner Master Fund, LLC, C.A. No. 5502-CS, at 4 (Del. Ch. August 8, 2011) (“The discretion granted to the hedge fund manager to determine whether to waive the Gates is a fiduciary authority that must be used for the benefit of those whom the Hedge Fund is intended to benefit, and not for the selfish interest of the manager.”), http://courts.delaware.gov/opinions/download.aspx?ID=158540.
\item[64.] AIMA, supra note 2, at 21.
\item[65.] HAMMER ET AL., supra note 28, at 99-101; Focus on Offshore Funds, HFMWeek.com, June 2011.
\item[66.] HAMMER ET AL., supra note 28, at 104.
\end{thebibliography}
funds impose significantly greater restrictions on investor redemptions, including longer lockups and redemption notice periods.\footnote{Bing Liang, George O. Aragon & Hyuna Park, Onshore and Offshore Hedge Funds: Are They Twins? At 4, Dec. 21, 2011, http://ssrn.com/abstract=2014402.}

2. Offshore Hedge Fund Directors

From a governance point of view, the most distinguishing aspect of offshore hedge funds is that, unlike most of their U.S.-based peers, offshore hedge funds typically have a board of directors.\footnote{Ernst & Young, Coming of Age: Global Hedge Fund Survey 2011 at 13 (noting that less than 15 percent of North American hedge funds have boards).} This is because offshore funds are typically organized as corporations (which must have boards as a matter of basic corporate law) or are located in jurisdictions such as the Cayman Islands that require funds organized in their jurisdiction to have boards.\footnote{See, e.g., \textit{Walker, BVI, Cayman and Jersey Hedge Funds} at 20, May 25, 2012 (the Cayman Islands Monetary Authority “requires a minimum of 2 individual directors for registered funds”); Jonathan Fitzgibbons, \textit{Cayman Islands: Starting a Cayman Islands Hedge Fund}, Monday, May 9, 2012 (noting in the Cayman Islands “[t]ypical hedge funds will be regulated funds and must therefore comply with the [Cayman Islands] Mutual Funds Law provisions”).} Offshore hedge funds also sometimes have their shares listed on stock exchanges that mandate independent directors as part of their listing requirements.\footnote{Mark Beames, \textit{The Role of Independent Directors in Offshore Hedge Funds}, \textit{EurekaHedge, Hedge Fund Monthly}, July 2004, http://www.eurekahedge.com/news/04july_archive_news_bearnes.asp.}

At a high level, the duties of hedge fund directors are similar to that of public company directors.\footnote{See \textit{Lhabitant}, supra note 56, at 91-92.} Hedge fund directors have a duty to act in the best interests of the fund without any conflicts. They must also independently “exercise reasonable care, skill, and diligence” in furthering the interests of the fund, which requires proactive supervision and information gathering. This oversight role includes monitoring the manager’s investment performance and adherence to its investment policy, the fund’s compliance with applicable laws and regulation, disclosures to and treatment of the fund’s investors, and oversight of third-party administrators responsible for preparing financial statements and determining the fund’s net asset value. In the 2011 decision in \textit{Weavering Macro Fixed Income Fund Limited v. Peterson}, the Grand Court of the Cayman Islands found two hedge fund directors liable to investors due to abdicating their oversight role in deference to the interests of the fund manager.\footnote{Weavering Macro Fixed Income Fund Limited (In Liquidation), Grand Court of the Cayman Islands, Financial Services Division, Aug. 2011 http://www.opalesque.com/files/20110826_Weavering_Judgement.PDF.}

In practice, the oversight role played by hedge fund directors is likely not substantial. This is because directors are appointed by
managers (as opposed to investors), typically sit on the boards of numerous funds, or lack the requisite financial expertise or independence from fund managers to provide independent oversight. And because hedge fund investors typically do not have voting shares, they do not have the ability to replace directors. Hedge fund boards do not provide the same level of oversight and responsiveness as do boards in public corporations.

C. Federal Law

In the United States, federal law indirectly impacts how hedge funds are governed by providing additional assurance to investors against fraud and by mandating certain disclosures and business conduct standards. The primary federal statutes that apply to hedge funds are the Investment Advisers Act of 1940 (Advisers Act), the Securities Act of 1933 (Securities Act), and the Securities and Exchange Act of 1934 (Exchange Act). Although hedge funds’ investing and trading activities are subject to the Investment Company Act of 1940, hedge funds limit their investor base by number and wealth-qualifications so as to be exempt from Investment Company Act regulation.

73. Frances Denmark, Hedge Fund Investors Doubt Director Support, INSTITUTIONAL INVESTOR, May 15, 2009; Frances Denmark, Directors Wanted, ALPHA, June 2008; Frances Denmark, Hedge Fund Directors Still Veiled in Secrecy, INSTITUTIONAL INVESTOR, June 3, 2011; Press Release, SEC Filings: Hedge Funds Far Behind Mutual Funds in Governance Practices, Fundgov, Jan. 7, 2013 (finding that “100 individuals hold 5,000 of the 9,000 board positions . . . of 2,800 different hedge funds”), http://fundgov.org/home/wp-content/uploads/2013/01/Press-release-from-Foundation-for-Fund-Governance-Jan-7-2013.pdf; SOUND FUND ADVISORS, FUND GOVERNANCE AT A CROSSROADS: CURRENT INDUSTRY DATA AND RECOMMENDED BEST PRACTICES, Feb. 2012 (“There are few external hedge fund directors with the requisite experience to effectively monitor changes in investment strategy or fund risk.”).

74. See supra note 50 and accompanying text; M. Corey Goldman, Mutiny? Good Luck, INSTITUTIONAL INVESTOR, Feb. 24, 2009 (reporting that hedge fund boards typically are not involved in monitoring management and that “the fine print in a hedge fund charter usually makes it almost impossible” for investors to replace directors or otherwise influence management decisions); Frances Denmark, Hedge Fund Investors Doubt Director Support, INT’L INVESTOR, May 15, 2009 (noting that only in rare occasions can hedge fund investors replace directors).


77. 15 U.S.C. §§ 78a et seq.


79. Hedge funds operate so as to qualify for at least one of two exclusions from the definition of an investment company. Under section 3(c)(1) of the Company Act, hedge funds are excluded from the definition of investment company so long as they have no more than 100 investors and sell their securities only through a private sale. 15 U.S.C. § 80a-3(c)(1). Under section 3(c)(7) of the Company Act, hedge funds are excluded from the definition of investment company so long as they only sell securities to “qualified purchasers” through a private sale. 15 U.S.C. § 80a-3(c)(7). Nonpublic offerings for the purposes of being exempted from the Company Act are generally interpreted to be the same as those as under section 4(2) of the Securities Act. SEC, IMPLICATION OF THE GROWTH OF HEDGE FUNDS: THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION 12 n.36 (Sept. 29, 2003) [hereinafter SEC STAFF REPORT]. Qualified purchasers include both natural persons owning at least $5 million in investments and certain companies with at least $100 million in

73. Frances Denmark, Hedge Fund Investors Doubt Director Support, INSTITUTIONAL INVESTOR, May 15, 2009; Frances Denmark, Directors Wanted, ALPHA, June 2008; Frances Denmark, Hedge Fund Directors Still Veiled in Secrecy, INSTITUTIONAL INVESTOR, June 3, 2011; Press Release, SEC Filings: Hedge Funds Far Behind Mutual Funds in Governance Practices, Fundgov, Jan. 7, 2013 (finding that “100 individuals hold 5,000 of the 9,000 board positions . . . of 2,800 different hedge funds”), http://fundgov.org/home/wp-content/uploads/2013/01/Press-release-from-Foundation-for-Fund-Governance-Jan-7-2013.pdf; SOUND FUND ADVISORS, FUND GOVERNANCE AT A CROSSROADS: CURRENT INDUSTRY DATA AND RECOMMENDED BEST PRACTICES, Feb. 2012 (“There are few external hedge fund directors with the requisite experience to effectively monitor changes in investment strategy or fund risk.”).

74. See supra note 50 and accompanying text; M. Corey Goldman, Mutiny? Good Luck, INSTITUTIONAL INVESTOR, Feb. 24, 2009 (reporting that hedge fund boards typically are not involved in monitoring management and that “the fine print in a hedge fund charter usually makes it almost impossible” for investors to replace directors or otherwise influence management decisions); Frances Denmark, Hedge Fund Investors Doubt Director Support, INT’L INVESTOR, May 15, 2009 (noting that only in rare occasions can hedge fund investors replace directors).


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Company law subjects regulated funds to wide-ranging and detailed regulation, including placing substantial limitations on a fund’s use of leverage and ability to engage in short sales and derivatives transactions.\footnote{Company Act § 1(b), 17 C.F.R. § 270.22c-1(b) (1993) (requiring registered investment companies to calculate net asset value at least daily).}

Hedge fund managers meet the definition of “investment adviser” under the Advisers Act, which is defined as any person in the business of advising others about whether to purchase or sell certain securities.\footnote{Advisers Act §§ 2(a)(11), 15 U.S.C. § 80b-2(a)(11) (2006).} All U.S.-based hedge fund managers must register under the Advisers Act unless they fall within an exemption, such as advising funds with less than $150 million in assets under management or qualifying as a foreign private adviser.\footnote{Advisers Act §§ 203(b), 203(l), 203(m); SEC, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3111 (Nov. 19, 2010). Although registered managers are prohibited from charging a performance fee to clients based solely upon the

\begin{itemize}
  \item See Company Act § 1(b), 15 U.S.C. § 80a-1(b)(1); Form N-1A Items 14-15, 10, 5, 3 (requiring disclosure of information including contact information of the fund’s investment advisers and portfolio managers, the history of the fund, its risk/return profile and investment objectives, the fund’s organization, and how the fees it charges to investors are calculated). Registered investment companies must also quarterly disclose portfolio holdings to the SEC and semiannually to investors. Company Act §§ 30(a), 30(b); Company Act Rule 30b1-1, 17 C.F.R. §270.30b1-1; Company Act Rule 30b1-5, 17 C.F.R. §270.30b1-5; Company Act § 30(e); Company Act Rule 30e-1, 17 C.F.R. §270.30e-1. Open-end registered investment companies must also daily calculate net asset value and allow investors to redeem shares within 7 days at that value. Company Act § 22(e); Company Act Rule 22c-1(a), 17 C.F.R. § 270.22c-1(a) (1993) (requiring registered investment companies to sell, redeem, or repurchase shares at net asset value); Company Act Rule 22c-1(b), 17 C.F.R. § 270.22c-1(b) (1993) (requiring registered investment companies to calculate net asset value at least daily).
  \item For example, to use leverage in the form of borrowing bank funds, a registered investment company must cover the debt by retaining assets equivalent to at least 300 percent of the borrowings. Company Act § 18(c) (debt restriction for closed-end investment companies), § 18(f) (debt restriction for open-end investment companies). In addition, under the Company Act an investment company that engages in a short sale or certain derivatives transactions must effectively hedge the investment position with an offsetting trade or hold liquid securities of an equivalent value in a segregated account. Emerald Management Co., SEC No-Action Letter (Jan. 21, 1978); Audrey Talley & James L. Love, Restrictions on Investments, in Mutual Fund Regulation, §§ 3:3.1(B)[3], 3-7—3-11 (2d ed. Clifford E. Kirsch 2007). Although the SEC has authority under Section 12(a) of the Company Act to prohibit registered investment companies from undertaking short sales or purchasing securities on the “margin” (which is a form of borrowing), it has not exercised that authority. The Company Act also imposes additional restrictions on open-end investment companies available to retail investors, commonly known as “mutual funds.” Mutual funds are prohibited from investing greater than 15 percent of the net value of their assets in illiquid securities, including the privately placed securities issued by hedge funds. Company Act Rel. No. 18,612. The SEC defines “illiquid” securities as those that cannot be sold at or near their net asset value within seven days. Acquisition and Valuation of Certain Portfolio Instruments by Registered Investment Companies, Investment Company Act Rel. No. 14,983, 51 Fed. Reg. 9,773 (Mar. 12, 1986); Investment Company Act Rel. No. 5,947, 35 Fed. Reg. 19,989 (Oct. 21, 1969). Mutual funds also may not utilize lock-ups because open-end investment companies must return capital to investors within seven days of a redemption request. Company Act § 22(e). In addition, mutual funds holding themselves out as “diversified” funds are prohibited, with respect to 75 percent of their assets, from holding more than 10 percent of the voting securities of any single issuer, or having the securities of an issuer constitute more than 5 percent of the mutual fund’s net asset value. Company Act § 5(b)(1). To minimize their tax liability, mutual funds must also comply with the diversification rule of the Internal Revenue Code, which requires mutual funds to meet the same diversification rule with respect to 50 percent of its assets. See Internal Revenue Code § 851(b)(3).
\end{itemize}
privately so as not to be subject to the mandatory registration and disclosure obligations required of companies making a public offering of securities under the Securities Act.  

1. Prohibitions Against Fraud

Registered and unregistered hedge fund managers are subject to the provisions of the Advisers Act prohibiting material misstatements, misleading omissions, and other fraudulent practices to investors or prospective investors. The Advisers Act prohibits any fund manager from making false or misleading statements regarding investment strategies, experience and credentials, risks associated with the fund, or valuation of the fund’s assets.

In raising capital from limited partner-investors, hedge funds are subject to the antifraud provisions of the Securities Act and the Exchange Act. Under section 17(a) of the Securities Act, it is unlawful for any issuer to make an untrue statement of material fact or to omit any fact so
that a statement that was made is misleading.\textsuperscript{88} Under section 10(b) and Rule 10b-5 of the Exchange Act, material omissions in connection with the sale of any security are likewise prohibited.\textsuperscript{89} Rule 10b-5-1 prohibits hedge fund managers from using material nonpublic information to purchase or sell securities (insider trading).\textsuperscript{90} In addition, under various provisions of the Exchange Act and Securities Act, hedge funds are prohibited from manipulating the prices of publicly or privately held securities.\textsuperscript{91} 

2. Disclosure and Business Conduct Requirements

The Advisers Act requires registered hedge fund managers to electronically file and keep current Form ADV with the SEC.\textsuperscript{92} All parts of Form ADV, except for an investment brochure, must also be made available to the public on the Investment Adviser Public Disclosure website.\textsuperscript{93} The brochure must be written in “plain English” and be provided to prospective clients and existing ones annually.\textsuperscript{94} Part 1 of Form ADV requires managers to disclose basic information relating to the firm and its business so as to assist regulators with oversight. Part 2 of Form ADV requires a manager to disclose information relating to potential conflicts of interest and other issues including about fees and how they are calculated, client referrals, disciplinary history, and the manager’s supervision of personnel.\textsuperscript{95} For the purposes of assisting regulatory authorities in preserving financial stability, registered hedge fund advisers with at least $150 million in assets under management must also disclose details about their funds’ investment positions, counterparties, and other information on Form PF to the Financial Stability Oversight Council.\textsuperscript{96} Hedge funds must also comply with other disclosure requirements under the Exchange Act arising out of any large equity investments in public companies.\textsuperscript{97}

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\textsuperscript{88} 15 U.S.C. § 77q(a).
\textsuperscript{91} LARRY D. SODERQUIST, UNDERSTANDING THE SECURITIES LAWS § 14:5 (4th ed. 2004).
\textsuperscript{92} Advisers Act Rules 203-1 and 204-1.
\textsuperscript{93} The Investment Adviser Public Disclosure website is located at http://www.adviserinfo.sec.gov.
\textsuperscript{94} SEC, STUDY ON INVESTMENT ADVISERS AND BROKER-DEALERS 18-20, JAN. 2011.
\textsuperscript{95} See Form ADV Part 2.
\textsuperscript{97} First, hedge funds must to disclose large shareholdings of public companies. To regulate the market for control of public companies, sections 13(d) and 13(g) require that hedge funds or their advisers must disclose beneficial ownership of greater than 5 percent in a class of voting shares of securities registered under the Exchange Act, and disclose whether the purpose of such ownership is
The Advisers Act also requires hedge fund managers to keep specific business and accounting records, to protect any client assets over which it has legal custody, and ensure that its own personnel to comply with federal securities law and regulation. Advisers Act Rule 206(4)-7 requires fund managers to establish a compliance program that includes written policies and procedures and a designated chief compliance officer.

II. HEDGE FUND AGENCY COSTS

Hedge fund managers are the agents of their investors. The wide-ranging powers that managerialism bestows upon hedge fund managers potentially allows them to impose significant agency costs on investors. Agency costs are the costs borne by investors due to misaligned incentives between managers and investors and from managers acting opportunistically when they are better informed than investors. Agency costs have the effect of reducing investors’ risk-adjusted returns either through losses or by depriving investors of better returns. Hedge


fund agency costs arise from five primary sources: fraud or misreporting with respect to a fund’s performance and other characteristics, incentive misalignments due to how hedge fund managers are compensated, overly long redemption restrictions, managers appropriating fund profits, and favoring certain investors or service providers. Empirical studies suggest that the most significant source of agency costs is the subtle manipulation of performance returns (valuation) by managers when it suits their interests.102

A. Fraud and Misreporting

The most basic type of hedge fund agency cost is the manager defrauding or misreporting some aspect of the fund’s returns, asset values, risk taking, or investment activities. This is in accordance with agency theory, which predicts that agents may try to manipulate the performance measures used by their principals.103 Hedge fund investors may potentially be subject to higher agency costs from misreporting than investors in government-registered investment companies. This is because hedge funds are not required by regulation to disclose their valuation policies or value their assets according to guidelines established by the SEC.104 And, unlike public companies generally, there is no market for hedge fund short sellers actively attempting to uncover and profit from hedge fund fraud.105

Hedge fund managers’ compensation and desire to attract investors gives them several incentives to misreport their returns. Hedge fund managers have an incentive to overstate performance to increase their performance-based compensation, to be able to charge higher fees to new investors attracted by prior high performance, and to attract and retain capital. Managers likewise have an incentive to overstate asset values to increase management fees. Managers also have an incentive to understate returns when an investor withdraws capital to increase the capital retained by the fund. In addition, managers have an incentive to understate the volatility a fund’s returns to increase its risk-adjusted performance.

In a study comparing hedge funds’ reported stock holding valuations to the SEC with the stocks’ closing prices as reported in the widely used Center for Research in Security Prices, 25 percent of hedge fund managers were found to have reported economically significant

102. See infra notes 121 to 127 and accompanying text.
105. LACK, supra note 25, at 129.
valuation discrepancies (2.5 percent on average).106 The valuation discrepancies were likely not random, as they were found to be more likely where managers self-report to commercial performance databases, are domiciled in offshore jurisdictions, and have performed poorly in the prior year.107 Other studies have also found that hedge funds report higher returns in December by underreporting returns earlier in the year,108 increase the value of their stock holdings through end-of-month market purchases,109 and revise or delay poor past performance.110

Several studies also suggest that hedge fund managers may deliberately understate the volatility of their returns. These include funds holding illiquid assets or assets that otherwise give managers discretion in valuation,111 funds advised by managers with greater performance incentives,112 and funds with investors that are more likely to withdraw in response to return volatility.113 Other hedge funds with a greater tendency to misreport include those where managers have more to gain from misreporting, such as funds that have a stronger relationship between reported returns and capital inflows114 and funds that recently reported poor returns.115 A relatively common type of misreporting by managers is reporting small positive returns as opposed to small losses when the discretion inherent in valuing illiquid assets permits a manager

107. Id. at 4-5.
110. Mila Getmansky et al., An Econometric Model of Serial Correlation and Illiquidity in Hedge Fund Returns, 74 J. FIN. ECON. 529, 546, 589 (2004); Gavin Cassar & Joseph Gerakos, Hedge Funds: Pricing Controls and the Smoothing of Self-Reported Returns, 24 Rev. Fin. Stud. 1698 (2011) (“We find that funds using less verifiable pricing sources and funds that provide managers with greater discretion in pricing investment positions are more likely to have returns that are consistent with intentional smoothing.”), http://faculty.chicagobooth.edu/joseph.gerakos/PDFs/CassarGerakos_HedgeFundSmoothing.pdf.
to do so.  

Overall, hard-to-value illiquid investments give more discretion to managers in valuation and thereby pose a greater potential conflict of interest with and threat to investors.  

An important question is the economic significance and effects of fraud or misreporting. Empirical studies suggest they may be significant when they occur but that they are not pervasive in the industry. A study by Castle Hall, a hedge fund due diligence firm, estimated that through June 30, 2009, only about 3 percent of hedge management companies committed fraud and that the losses from hedge fund fraud totaled $15 billion, which was less than one percent of the total assets managed by hedge funds at the time (approximately $1.4 trillion). In their study of potential artificial smoothing of hedge fund returns, Bollen and Pool estimated that at most only 5 percent of a subgroup of hedge funds had returns that could indicate fraud.

However, other studies suggest that subtle manipulation of performance returns may impose significant costs on at least some investors. In a study by Bollen and Pool that focused on managers avoiding reporting small negative returns, they found approximately 10 percent of relevant returns to be misreported such that new investors overpaid by approximately $1 to $2 billion to the benefit of existing investors. Patton et al. found that over 15 percent of the over 18,000 hedge funds in their sample revised a previous monthly return by at least

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118. In general, fraud or misreporting reduces the wealth of existing investors by causing transfers of wealth and economic losses. The welfare effects among groups of investors may be ambiguous under certain circumstances, however. Existing investors may benefit from overstatements of performance because new investors will be overcharged for their shares when they buy into the fund. And if investors are withdrawing capital from a fund, understating returns benefits the investors that remain because too little will be paid out to departing investors. Petri Jylha, Hedge Fund Return Misreporting: Incentives and Effects 2 (November 10, 2011), http://ssrn.com/abstract=1661075.


1 percent. Cici et al. found that 25 percent of hedge fund managers make small, yet economically significant, misstatements about the value of their stock holdings. Feng and Getmansky’s study of hedge fund return smoothing finds evidence implying that on average hedge funds report only 84.9 percent of their monthly returns, with the 15.1 percent distributed over the next two months. Agarwal et al. find small but economically significant reported performance spikes in December, and Ben-David et al. find that hedge fund manipulation causes end-of-month stock prices to be inflated by an average of 0.3 percent for stocks in the top quartile of hedge fund ownership.

B. Fee-Based Incentive Misalignments

Agency costs also arise from the structure of hedge fund managers’ annual compensation. A basic agency cost arises from managers earning fees on an annual basis for investment positions or strategies that are longer-term in nature. In such a case, a manager may be able to earn performance fees in the early years of the strategy and then pass losses along to investors when the investment ultimately suffers losses. Paying managers on an annual basis may therefore give them an incentive to pursue strategies that have relatively short-term gains but more likely to have long-term losses, a strategy often described as selling disaster insurance (or deep out-of-the-money put options).

A second hedge fund compensation-based agency cost is similar to a general agency problem in the corporate context that stems from business managers increasing their risk taking after obtaining capital from investors. In particular, a firm’s equityholders have an incentive to increase risk at the expense of a firm’s creditors because equityholders have limited liability while nonetheless potentially benefitting from potentially unlimited upside. Creditors, on the other hand, generally do

123. Andrew J., Patton, Ramadorai, Tarun & Micahel Streatfield, Change You Can Believe In? Hedge Fund Data Revisions 2 (March 6, 2012).
128. AIMa, supra note 50, at 20. This incentive problem is a general one that exists throughout the corporate context. As noted by Lucian Bebchuck and Jesse Fried:
Consider an executive who expects to be rewarded at the end of a given year based on performance measures tied to the stock price at the end of that year. This compensation structure may lead to two types of undesirable behavior. First, managers may take actions that boost the stock price in the short run, even if such actions would destroy value in the long run. For example, executives may enter into transactions that improve the current bottom line but create large latent risks that could cripple the firm in the future. Bebchuck & Fried, supra note 27, at 1922.
not stand to benefit from a firm increasing its risk after credit is extended to the firm. The agency costs from this divergence of interests is known as “asset substitution” and is extensively studied in corporate finance literature.129

In the hedge fund context, a fund’s equity investors—as opposed to its debt holders—may likewise be subject to an asset substitution problem in the sense that managers change their risk-taking behavior after equity investors have contributed their capital. Hedge fund managers may have incentive to take on greater risk after obtaining investor capital because of the asymmetric payoff structure that results from their performance-based compensation arrangement. Because a performance fee is paid only if the fund profits, the manager shares in the profits of a fund but does not share in any losses. The potential for agency costs may be especially high because hedge fund managers have far more to gain from their performance-based compensation than the part of their compensation that is based upon assets under management (i.e., management fees).

Management fees may also create agency costs for investors. At least in the short term, a fixed management fee is not dependent on performance. This may result in compensation being earned by managers even if investors have suffered net losses. This especially includes “zombie funds,” which are funds that continue to operate and collect management fees even though their losses have been so large that they are unlikely to be ever be profitable for investors. For very large hedge funds, compensation earned pursuant to management fees far exceeds that necessary to pay for operating overhead, and thereby reduces the incentives to managers to earn profits for investors. As recently noted in a hedge fund trade publication,

For the 200-plus funds with $1 billion or more in assets, management fees alone can keep the lights on — and then some. One hedge fund honcho whose multibillion-dollar fund shut down in 2008 says that he got the biggest payday of his career that year, thanks to the management fees collected before the fund’s demise.130

Incentive misalignments from management fees may be exacerbated by the fact that, on average, management fees account

for a greater share of industry-wide manager compensation than performance fees.\textsuperscript{131}

C. Restrictions on Investor Redemptions

Redemption restrictions give hedge fund investments the quality of asset-specificity. According to transaction cost economics, asset-specificity gives rise to potential agency costs because investment-specific assets leave an investor vulnerable to unexpected changes in asset prices or opportunistic conduct by managers.\textsuperscript{132} In the hedge fund context, the use of lockups, notice periods, or gates temporarily reduce the ability of investors to withdraw their capital and may permit the manager to opportunistically use investor funds for its own benefit, thereby imposing an agency cost on investors. Moral hazard is also created in such a situation because when redemptions are restricted, the investor has little, if any, ability to discipline the manager. For example, in \textit{Paige Capital Management v. Lerner Master Fund}, a hedge fund manager acting pursuant to a contractual gate prevented an investor from withdrawing its capital. The court found that the gate was enacted solely to enable the fund to opportunistically collect management fees while doing little to attract new investors or pursue the fund’s investment strategy.\textsuperscript{133}

Redemption restrictions also impose agency costs to the extent not being able to withdraw capital imposes a foregone (opportunity) cost from not being able to use the capital elsewhere. This may especially be the case when redemption restrictions coincide with the fund experiencing losses, thereby increasing the risk of outright loss as well. Andrew Ang and Nicolas Bollen model the cost of hedge fund redemption restrictions by measuring how much a restriction reduces the value of an investor’s right to redeem at any time (a “liquidity option”).\textsuperscript{134} They conclude that for an investor with typical risk aversion preferences, the combination of standard lockup, notice, and gating provisions can impose an annual cost to investors equivalent to over five percent of the fund’s net asset value.\textsuperscript{135} In addition, a study of hedge funds from 2006 to 2011 found that funds that restricted redemptions through gates and side pockets underperformed comparable funds not


\textsuperscript{134} Andrew Ang & Nicolas P. B. Bollen, When Hedge Funds Block the Exits (January 14, 2010), http://ssrn.com/abstract=1916286.

\textsuperscript{135} \textit{Id.} at 2.
enacting the restrictions.\textsuperscript{136} However, because the study did not compare funds with different levels of redemption restrictions, it fails to show that funds with more restrictions are generally worse for investors.\textsuperscript{137}

D. Overcompensation of Managers

A potential hedge fund agency cost is investors paying more in fees than necessary to produce a given level or returns, and thereby allowing fund managers to capture a portion of the fund’s profits at the expense of investors. One way for managers to appropriate fund profits is for managers to increase fees after good performance. Although most hedge funds do not change their fees with respect to any particular investor, a study of 3,814 funds from April 2008 until June 2011 found that 7.8 percent of funds increased or decreased some aspect of their fees over a three-year period.\textsuperscript{138} The authors found that performance fees increases typically follow superior performance and funds with increasing capital flows increase management fees.\textsuperscript{139} Because performance typically decreases after fees are increased, the fee increases may indicate managers opportunistically taking advantage of high demand for their funds.\textsuperscript{140} Likewise, other studies find evidence suggesting that managers with abnormally high performance increase their performance fee rate (when starting new funds) to capture a larger portion of their above-average profits, which ultimately reduces investors’ returns to be average.\textsuperscript{141}

Even for managers that do not increase their fees for existing or new investors, the typical hedge fund fee structure may overcompensate hedge fund managers in the sense that investors could have obtained the same or greater returns by investing in vehicles with lower fees. In a 2011 study of the returns of nearly 11,000 hedge funds, Ilia Dichev and Gwen Yu used a “dollar-weighted” measure of performance to estimate the actual returns obtained by investors.\textsuperscript{142} Using a dollar-weighted approach, Dichev and Yu found that returns to hedge funds investors

\textsuperscript{136} Aiken et al., supra note 2, at 3-4.
\textsuperscript{137} Indeed, funds that place more restrictions on investors redemptions may perform relatively better. See infra Section III.E.
\textsuperscript{138} Vikas Agarwal & Sugata Ray, Determinants and Implications of Fee Changes in the Hedge Fund Industry 4-5 (Dec. 15, 2011).
\textsuperscript{139} Id. at 5-7.
\textsuperscript{140} Id. at 7.
from 1990 to 2008 were typically lower than the stock market and only slightly higher than the risk free rate earned by investing in government bonds.\footnote{Id.} An implication of their study is that any fees or other additional costs associated with hedge fund investing are agency costs that can be eliminated or substantially reduced by investors directly investing in the markets or in low-cost passive investment vehicles (e.g., index funds that track the performance of markets). The time-weighted measure of hedge fund performance, however, indicates that hedge funds provide value to investors even after fees are paid to managers.\footnote{See infra Section III.D.} In addition, a recent study found that nearly three-quarters of fund profits go to investors, not managers, which indicates that performance fees are not generally too high or structured to allow managers to be paid before losses are passed along to investors.\footnote{See CENTRE FOR HEDGE FUND RESEARCH, supra note 25, at 5.}

E. Favoritism of Certain Investors or Service Providers

Hedge fund investors may suffer from agency costs due to managers giving favorable treatment to some investors over others or to service providers at the expense of investors generally. Favoritism may exacerbate any preexisting incentive or tendency to commit fraud or misreport returns because favoritism may require the manager to misreport returns or some other aspect of the fund’s operations.

Through separate agreements known as “side letters,” certain hedge fund investors may obtain favorable terms for themselves that are not offered to all investors in the fund’s general offering documents.\footnote{Mark Perlow, Managing Hedge Fund Conflicts of Interest, REV. COMMODITIES & SECs. REG., April 4, 2007, http://www.klgates.com/files/Publication/27e6407a-807e-4940-901e-c76c3d3b1a938/Presentation/PublicationAttachment/bc4934e8-4437-4d3b-a2aa-7bcebc8c2e7e/Perlow_Review_of_Securities_Commodities_Regulation.pdf.} Managers may grant favorable terms to curry favor with certain investors because the size, timing, or nature of the investor’s investment makes their capital particularly important to the manager. Side letters may give investors favorable treatment regarding fees, disclosure, liquidity, and other terms.\footnote{Id. A “most favorable nation” side letter clause promises that an investor will be offered any superior terms offered to other investors. Id.} Favorable liquidity or disclosure terms may allow some investors to exit the fund ahead of other investors and thereby create a conflict of interest between the manager and the investors without the favorable terms. As a matter of law, side letters are permitted so long as giving favorable treatment to some investors does not violate the contractual rights of other investors or the manager’s fiduciary duty to generally avoid giving preferential treatment to some investors to the
detriment of others. These legal obligations can be complied with by disclosing the nature of the fund’s side letters or by establishing separate classes of investors with differential investment terms. Side letters likely do not impose significant costs on hedge fund investors, if any, when they are disclosed and their terms are complied with. However, undisclosed side letters granting preferential withdrawal rights may impose significant costs on some investors when they allow favored investors to exit a poorly performing fund.

Investors may also suffer from agency costs due to managers giving favorable treatment to service providers that come at the expense of investors. For example, prime brokers provide a wide array of services to hedge funds including trade execution, securities lending, investment research, and helping new hedge funds establish themselves through investor referrals. Hedge funds may pay for such services with “soft dollar” payments—by directing trades to their prime broker or affiliated third parties, or paying above-market rates for brokerage commissions. Soft dollar payments may impose an agency cost on investors if the services purchased by inflated commissions or trades directed to suboptimal brokers benefit the manager more than investors, who ultimately subsidize the soft dollar payments. Undisclosed soft dollar payments to prime brokers may also constitute a conflict of interest subject to an enforcement action by the SEC or other regulatory authority. Favoring certain service providers may also take the form of appointing service provider representatives to the fund’s board of

148. HAMMER ET AL., supra note 28, at 90; Susan Ferris Wyderko, Testimony Concerning Hedge Funds Before the Subcommittee on Securities and Investment of the United States Committee on Banking, Housing, and Urban Affairs (May 16, 2006).

149. Perlow, supra note 146, at 77-78; SEC Form ADV, Part 2 (“As a fiduciary, you . . . must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all material conflicts of interest between you and your clients that could affect the advisory relationship.”) (emphasis in original), http://www.sec.gov/about/forms/formadv-part2.pdf.


directors. In such a case, the director may impose agency costs by providing relatively less independent oversight on managers.\textsuperscript{154} However, despite the potential for agency costs from service provider favoritism, they may not be substantial in practice. Soft dollar payments may reduce agency costs stemming from underinvestment in research.\textsuperscript{155} In addition, any problems associated with appointing service providers to boards may be mitigated by the benefit of having the provider’s expertise, or be overcome entirely through less reliance on boards in the first place.\textsuperscript{156}

III. HEDGE FUND GOVERNANCE DEVICES

Despite the managerialist foundations of hedge fund governance, managers adopt investor-friendly governance devices that reduce agency costs in response to investor demand and competition. In addition to the funds’ underlying legal regime and the contractual device of placing short-term redemption restrictions on investor redemptions,\textsuperscript{157} hedge fund governance devices fall into three categories: those that are driven directly by equity investors, those that arise from managers’ performance-based compensation, and those that are required by the funds’ short-term creditors. This Section reviews each of these types of governance mechanisms and concludes by assessing whether the investor-responsive aspects of hedge governance are sufficient to overcome the agency costs allowed for by managerialism.

A. Investor Driven Governance

1. Capital Inflows and Outflows

Despite being subject to short-term restrictions on their withdrawal rights, a primary governance mechanism over hedge fund managers is the high propensity of investors to withdraw or not commit their funds in response to poor performance or governance. Unsurprisingly, hedge fund investors decide to invest largely based on the fund’s past performance.\textsuperscript{158} Hedge fund investors are also quick to

\textsuperscript{154} See AIMA, AIMA’S OFFSHORE ALTERNATIVE FUND DIRECTORS’ GUIDE at 6, (2008 2d ed.) (“Best practice for any Fund would be to . . . avoid appointing Directors who represent the advisers or service providers to the Fund because of the potential for conflicts of interest.”).

\textsuperscript{155} See Horan & Johnsen, supra note 152, at 20-21.

\textsuperscript{156} See infra Section IV.D.

\textsuperscript{157} See supra notes 54-63 and accompanying text.

\textsuperscript{158} Vikas Agarwal et al., Flows, Performance, and Managerial Incentives in Hedge Funds 30 (July 22, 2004) (EFA 2003 Annual Conference Working Paper No. 501) (finding that “money-flows chase good recent performance”); Bill Ding et al., Market Volatility, Investor Flows, and the Structure of Hedge Fund Markets 3 (Working Paper, November 6, 2006) (finding evidence that hedge fund investors are “smart” such that they have skill in allocating capital to funds that perform
withdraw their capital from poorly performing funds. \(^{159}\) Hedge fund investors seem particularly sensitive to performance, and are more likely than mutual fund investors to withdraw their capital in sufficiently large amounts so as to jeopardize the survival of the fund. \(^{160}\)

In addition to performance, hedge fund investors care about governance. Institutional hedge fund investors typically demand some threshold level of quality with respect to governance before investing, and will withdraw their funds or refuse to invest in the first place if the fund lacks the desired quality. \(^{161}\) For example, in 2009 CalPERS stated that it would no longer invest in hedge funds that compensate managers with perceived fee-based incentive misalignments. \(^{162}\) Accordingly, maintaining a baseline level of governance is absolutely necessary for a fund to attract and retain investor capital. Satisfying the preferences of investors with respect to performance and governance is so important that hedge funds employ full-time professionals tasked with raising capital from investors and addressing their concerns so long as they are invested. \(^{163}\)

General financial industry trends are likely also putting additional pressure on managers to provide more investor friendly
governance terms. This is because, as the hedge fund industry has grown, the ability to outperform other hedge funds has likely become more difficult because more funds pursuing the same investment strategies generally reduces potential gains from the strategy.\textsuperscript{164} In addition, any superior returns obtained by a particular hedge fund trading strategy may be short-lived as rival managers and other traders discover and imitate the trading strategies of each other.\textsuperscript{165} Hedge fund managers as a whole may also be facing increasing pressure due to growing competition from other potential investment opportunities. This competition includes the growing market for cheaper and more liquid hedge funds alternatives, such as mutual funds that use hedge fund-like strategies, exchange-traded funds, and synthetic hedge fund “clones” potentially able to replicate the returns of hedge funds.\textsuperscript{166}

2. Investor Demand for Quality Governance

Given that investors base their investment decisions in part upon the perceived governance quality of hedge funds, it is important to note the specific governance (and operational) characteristics that investors consider to be high quality. Investor surveys indicate a substantial degree of uniformity and sophistication regarding the types of governance and operational characteristics they demand. Hedge fund investors’ demand for higher quality governance has increased in the past decade due to the increasing institutionalization and sophistication, negative experiences during the financial crisis of 2008, and reaction to the Bernard Madoff fraud.\textsuperscript{167}

Unsurprisingly, hedge fund investors have strong preferences when it comes to risk. Investors demand that portfolio-level risks be

\textsuperscript{164} William Fung et al., \textit{Hedge Funds: Performance, Risk and Capital Formation} 19 (July 19, 2006) (AFA 2007 Chicago Meetings Paper) (finding “that following significant inflow of capital in the industry, the level of alpha has come down substantially in recent years”), available at http://ssrn.com/abstract=778124.

\textsuperscript{165} RICHARD BOOKSTABER, \textit{A DEMON OF OUR OWN DESIGN: MARKETS, HEDGE FUNDS, AND THE PERILS OF FINANCIAL INNOVATION} 195 (2008).


subject to pre-defined limits, that new positions be simulated before adoption, and that operational, counterparty, and liquidity risks be measured, identified, limited, and tested. Although investors may demand lockups and other short-term redemption restrictions to preserve fund stability, they nonetheless prefer to be able to redeem most if not all of their capital within one year.

Investors also have strong preferences regarding transparency. Investors seek disclosures about risk that are comprehensive, intelligible, and anywhere from monthly to real-time. Investors desire detailed and frequent performance reporting, to have the fund precisely identify the fund’s investment strategy so as to monitor the manager’s investments and prevent a deviation from the fund’s stated strategy (style drift). In practice, an estimated 89 percent of hedge funds make at least monthly disclosures to investors. In addition to performance, these disclosures typically describe what returns were attributable to a given strategy and various measures of risk-adjusted performance. Since the financial crisis of 2008, hedge fund investors have been receiving greater disclosures and more transparency from hedge funds.

Investors also seek an alignment between performance fee payment period and investment horizon. Accordingly, investors express a desire for performance fees to be calculated on a multi-year basis to align incentives for long-term investments and prevent managers from being paid for investments that later result in losses. However, although there does seem to be a trend towards calculating performance fees on a multi-year basis, only a small portion of hedge funds actually

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169. Laurence Fletcher, Hedge Investors Ask For Lock-ups to Avoid Closures, REUTERS, Oct. 8, 2008.
172. AIMA, Institutional Investor Preferences, supra note 161, at 8.
176. AIMA, Institutional Investor Preferences, supra note 161, at 18-26; Letter From Kurt Silberstein, Senior Portfolio Manager, Global Equity Craig Dandurand, Portfolio Manager, Global Equity to CalPERS Hedge Fund Partners, March 11, 2009.
178. See Emma Cusworth, Hedge Fund Fees Under the Microscope by Investors as Performance Slides, HEDGE FUNDS REVIEW, Jan. 5, 2012.
do so.\textsuperscript{179} This discrepancy likely reflects the strong bargaining power that managers have over investors on this issue and a potential significant area for improvement in governance.

Investors expect that trade processing be automated as much as possible, that internal controls relating to trading be automated and documented, and that fund service providers be fully vetted and frequently interact with management.\textsuperscript{180} When it comes to valuation, to guard against fraud and performance smoothing, investors expect that managers have external oversight and well-documented practices and controls, especially with respect to illiquid assets.\textsuperscript{181} Overall, there has been a trend for funds to move away from using in-house capabilities or prime brokers towards using third party administrators and other less conflicted service providers, for valuation, asset custody, and other operational functions.\textsuperscript{182}

With respect to hedge fund board oversight and powers, investors prefer that boards have the power to replace managers, that service providers report directly to boards, and that boards (instead of managers) are ultimately responsible for valuation and decisions regarding suspending fund redemptions.\textsuperscript{183} Investors also prefer that hedge fund directors sit on no more than 30 boards, that hedge funds boards have no less than three directors (at least two of whom are independent), that the manager is represented on the board, and that directors be full-time professional directors.\textsuperscript{184} Investors in funds that do not have boards indicate that having a board would be a welcomed development.\textsuperscript{185} Investors may also seek to have the option to purchase shares with voting rights as to important events including fund dissolution or changing the investment manager and directors under limited circumstances.\textsuperscript{186} However, hedge fund investors do not typically demand the ability to remove managers.\textsuperscript{187}

Hedge fund investors also have preferences over a wide range of other specific governance issues. To align incentives, investors prefer

\begin{footnotesize}
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\item \textsuperscript{179} See Seward & Kissel LLP, Memorandum to Our Investment Management Clients and Friends, 2011 New Hedge Fund Study 2 (finding that relative to standard performance compensation measured annually “[l]ess than 10% of funds, in the aggregate, had modified high water mark provisions, hurdle rates or incentive allocation/fees measured over multi-year periods”).
\item \textsuperscript{180} Carne Investor Survey, supra note 161, at 34-37.
\item \textsuperscript{181} Id. at 37-40.
\item \textsuperscript{182} CASEY QUIRK, supra note 2, at 13-16.
\item \textsuperscript{183} AIMA, Institutional Investor Preferences, supra note 161, at 9.
\item \textsuperscript{184} Carne Investor Survey, supra note 161, at 19, 23-24, 27; AIMA, Institutional Investor Preferences, supra note 161, at 10-11.
\item \textsuperscript{185} Carne Investor Survey, supra note 161, at 33.
\item \textsuperscript{186} AIMA, Institutional Investor Preferences, supra note 161, at 8.
\item \textsuperscript{187} Jamie Sklar, Liquidity, 5 HEDGE FUND LAW REPORT, Nov. 15, 2012.
\end{itemize}
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that hedge fund managers co-invest in the funds they manage with the same liquidity rights as other investors.\textsuperscript{188} Investors desire clear communications regarding fund organizational structure and related entities, clear segregation between from and back office personnel, and documentation regarding internal controls and conflicts.\textsuperscript{189} Investors also expect disclosure of any legal issues, an independent and well-documented compliance function, and that any preferential treatment given to some investors be disclosed and approved by the board.\textsuperscript{190} Investors may also want assurances that the fund has a diversified and sophisticated client base,\textsuperscript{191} and that funds carry insurance to protect against legal claims.\textsuperscript{192}

High quality operational practices are a substitute governance mechanism for other mechanisms such as strict regulatory enforcement and reputation. Accordingly, hedge fund investors demand higher quality operational practices when they perceive a fund to be organized in a jurisdiction with lax enforcement or if the fund is less established.\textsuperscript{193} Investors also price in the risk of fraud and other operational problems by paying lower fees to funds with weaker operational practices.\textsuperscript{194}

Investor demand for quality operational practices may also be assisted by the fact that fraud and other operational risks and may detected by investors ex ante. There is an entire advisory industry dedicated to providing hedge fund due diligence services, which include books and other materials available to prospective and current investors to assist them in assessing the operational quality of hedge funds.\textsuperscript{195} There is also a growing body of academic studies that can help investors detect which hedge funds are more likely to commit fraud or suffer from other operational deficiencies.\textsuperscript{196} For example, one study finds that returns are more likely to be misreported as marginally positive (rather than zero or marginally negative) if managers advise more than one fund, where funds can be sold via distribution channels with relatively less third party scrutiny, in funds without lockups that prevent investors from

\begin{thebibliography}{99}
\bibitem{CarnesSurvey} Id. at 20.
\bibitem{CarneInvestorSurvey} Id. at 30.
\bibitem{Idat3133} Id. at 31-33.
\bibitem{Idat25} Id. at 25.
\bibitem{Kaulessar} Ricardo Kaulessar, Hedge Funds Face Higher Insurance Rates in 2012, March 15, 2012 (quoting an insurance advisory firm executive as stating that “[w]hat’s driven the need to carry the [hedge fund] insurance is investor demand ”).
\bibitem{Id} Id.
\bibitem{Ridley} See, e.g., MATTHEW RIDLEY, HOW TO INVEST IN HEDGE FUNDS: AN INVESTMENT PROFESSIONAL’S GUIDE (2004).
\end{thebibliography}
withdrawing capital, and that are subject to minimum capital requirements. 197 Another study found that regulatory investigations for fraud or misstatements are far more likely when the manager— as opposed to an independent third party—is involved in setting and reporting a fund’s net asset value. 198 Stephen Brown and various co-authors have also developed various measures to assist investors in predicting fraud and operational risk. 199 Investor demand for quality operational practices, and their ability to predict them, is important because losses are as likely to arise from operational risks as they are from financial ones. 200

3. Secondary Markets for Hedge Fund Shares

Hedge fund managers may also face market discipline due to the increasingly stable and liquid secondary market for hedge fund shares. Prior to the financial crisis of 2008, the secondary market was small, illiquid, and run by investment banks and one specialized intermediary between hedge fund buyers and sellers, Hedgebay. 201 During the financial crisis, hedge fund managers enacted gates to reduce the impact of redemptions by investors in a market where hedge fund asset values were plummeting and often locked up in illiquid investments. As a result, hedge fund investors increasingly sold their fund shares to raise cash, and typically did so at a deep discount to the fund’s net asset value. 202 By 2011, the secondary hedge fund market had matured to include broader market participation, several new trading intermediaries in the form of online brokers and interdealer brokers, and shares trading near or above their net asset values for highly sought after funds. 203

A secondary market allows buyers and sellers to engage in price discovery by attempting to determine the true value of what is being traded. 204 Given that hedge fund investors value quality governance, it follows that the secondary market price for a hedge fund share will

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198. Casar & Gerakos, supra note 196.
204. See, e.g., Reilly & C. Brown, supra note 201, at 101.
reflect the quality of the fund’s governance. \(^{205}\) Accordingly, the rise of hedge fund share trading creates an incentive for managers to improve, maintain, and demonstrate quality governance to prevent their shares from being sold at a discount and attract investors in the first place. \(^{206}\)

### B. Performance-Based Governance

A defining feature of hedge funds is that their management companies are also compensated based upon the performance of the funds they advise. \(^{207}\) Fund performance is typically calculated on an annual basis. \(^{208}\) Hedge fund performance-based compensation rates are estimated to average from 16 to 25 percent of profits in excess of prior losses and net of management fees. \(^{209}\) A fund manager’s compensation attributable to the performance fee is effectively the same as a payout from a call option with a “strike price” set at the value of the fund when each investor joins. \(^{210}\)

Performance-based compensation to hedge fund managers is typically limited by one or two types contractual provisions that each require a fund to exceed a threshold level of returns for investors before any compensation is allocated to the manager. One such provision is a “high-water mark” which limits the performance allocation to positive gains above the amount of the investor’s capital contribution. \(^{211}\) A high-water mark requires any losses from previous years to be recouped first, meaning that an investor must actually receive a net positive return on their investment before a manager is paid a performance fee. \(^{212}\) High-water marks are utilized by most hedge funds. \(^{213}\) When hedge funds use

\(^{205}\) See Viceira et al., supra note 202, at 5 (noting that the secondary market price for hedge fund shares depends in part upon the transparency of the fund’s assets).

\(^{206}\) See Tullett Prebon, Secondary Hedge Fund Market Average Discount to NAV Grew in July, Aug. 8, 2011 (“As the secondary market has continued to mature with a growing number and range of buyers, general partners have allowed greater transparency to underlying assets remaining in illiquid hedge fund classes. This has generally helped to improve levels as buyers gain more pricing comfort and face wider competition for transactions.”).

\(^{207}\) See HABITANT, supra note 56, at 30.

\(^{208}\) HAMMER ET AL., supra note 28, at 94-95.


\(^{210}\) See HAMMER ET AL., supra note 28, at 329-330.

\(^{211}\) Id. at 329. William N. Goetzmann, Jonathan E. Ingersoll & Stephen Ross, High-Water Marks and Hedge Fund Management Contracts, 4 J. FIN. 1685, 1714-16 (2003); Mark J.P. Anson, Hedge Fund Incentives Fees and the “Free Option,” J. ALT. INVESTMENTS 43, 43-44 (Fall 2001).

\(^{212}\) Id. at 329. William N. Goetzmann, Jonathan E. Ingersoll & Stephen A. Ross, High-Water Marks and Hedge Fund Management Contracts, 4 J. FIN. 1685, 1686 (2003) (noting that “[h]igh-water mark contracts have the appealing feature of paying the manager a bonus only when the investors make a profit, and in addition, requiring that the manager make up any earlier losses before becoming eligible for the bonus payment”). To prevent individual managers from leaving the employment of a fund well below its high-water mark, some hedge fund operating agreements allow for a reduced performance fee allocation even if the high-water mark is not achieved, and other fund will reset the high-water mark at a level below that required for an investor to recoup losses.

\(^{213}\) Feng, Shuang, Getailsky, Mila and Kapadia, Nikunj, Flows: The ‘Invisible Hands’ on
high-water marks, they typically charge investors a performance fee five times higher than those funds that do not (15.3 percent), likely in exchange for investors not having to pay a performance fee until the fund produces a profit for them.\textsuperscript{214}

A second limit on managerial performance-based competition is a “hurdle rate” which prevents the manager from being paid unless a minimum rate of return is achieved.\textsuperscript{215} Hurdle rates may be calculated annually or on a cumulative basis, and may be fixed at an absolute rate or depend on some other rate or performance benchmark.\textsuperscript{216} High-water marks are more commonly used than hurdle rates. Hurdle rates are used in approximately 19 percent of hedge funds\textsuperscript{217} and, when hurdles are used, they are typically used in conjunction with high-water marks.\textsuperscript{218}

In addition to earning compensation from performance fees, hedge fund manager compensation may also be derived from the manager’s own investment in the fund. Managers often co-invest a significant portion of their own capital directly in the underlying funds they manage.\textsuperscript{219} Estimates range from 59 percent to 32 percent of managers having personal wealth in their funds.\textsuperscript{220} Managers with higher co-investment may be less likely to use a high-water mark since co-investment can be a substitute incentive alignment device.\textsuperscript{221}

Importantly, hedge fund manager compensation seems far more performance-sensitive than that of corporate managers.\textsuperscript{222} Empirical researchers use delta to measure the relationship between management

\textsuperscript{214} Gokce Soydemir, Jan Smolarski & Sangheon Shin, Hedge Funds, Fund Attributes and Risk Adjusted Returns (September 15, 2010), at 7. Because investors may invest at different times, a process known as share equalization must be undertaken to ensure that performance fees subject to high-water marks are properly calculated with respect to each investor. HAMMER ET AL., supra note 28, at 335.

\textsuperscript{215} HAMMER ET AL., supra note 28, at 330-31.

\textsuperscript{216} Id.


\textsuperscript{218} Id. at 30.

\textsuperscript{219} HAMMER ET AL., supra note 28, at 92.


\textsuperscript{222} Feng et al., supra note 131, at 2 (“With such a high rate of incentive fees, the pay-performance sensitivity of the hedge fund manager is higher than that of any other industry.”) (emphasis added).
pay and firm performance. Specifically, delta measures how much manager wealth increases if the value of their company increases by one percent.223 A higher delta indicates a higher sensitivity of pay to firm performance. For hedge fund managers, their performance incentives are based primarily upon their annual performance-based fees and how much they have invested in the fund.224 Based on a sample of nearly 5,000 hedge funds from January 1994 to April 2010, Feng et al. estimated the median hedge manager delta to be $1.98 million.225 By contrast, based on a sample of public corporations from 1992 to 2006, Liu and Mauer estimated that the median delta for Chief Executive Officers was only $205,000.226 Hedge fund managers thus seem to have much stronger incentives to perform well than corporate managers, indicating that their unique form of compensation serves as an important governance device.227

C. Short-Term Creditors and Counterparties

Hedge funds often obtain some form of short-term credit financing, or leverage, as part of their investment strategies.228 Hedge funds obtain leverage through several types of transactions including collateralized (margin) borrowing secured by their investment positions,229 raising cash through short-term sales and repurchases

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224. See Vikas Agarwal, Naveen D. Daniel & Narayna Naik., Role of Managerial Incentives and Discretion in Hedge Fund Performance, 64 J. Fin. 2221, 2223-2224 (2009), http://www2.gsu.edu/~fncvaa/Role%20of%20Managerial%20Incentives%20and%20Discretion%20in%20Hedge%20Fund%20Performance.pdf.

225. Feng et al., supra note 131, at 18.

226. Yixin Liua & David C. Mauer, Corporate Cash Holdings and CEO Compensation Incentives, 102 J. Fin. Econ. 183 (2011). See also David Larker & Brian Tayan, Seven Myths of Corporate Governance, STANFORD CLOSER LOOK SERIES at 2, June 1, 2011 (finding that on average a one percent change in firm value leads to a $54,000 increase in the equity-based compensation of public company Chief Executive Officers), http://ssrn.com/abstract=1856869. Notably, the Feng et al. paper estimates a much lower mean delta for hedge fund managers than public company CEOs than in the Liu and Mauer paper. This most likely reflects the fact that the population of hedge fund managers includes a significant portion of managers operating below their high-water mark such that an increase in firm value does not trigger performance-based compensation.


Hedge funds may also obtain leverage by borrowing securities (to short sell) or through synthetic leverage structures. See JPMorgan Alternative Asset Management, Hedge Funds, Leverage and Counterparty Negotiations (2008).

In margin financing, hedge fund investment positions are evaluated and marked-to-market on a daily basis by prime brokers; a fund must add additional margin to the extent the market value of the investment falls below a minimum threshold level (maintenance margin). Prime brokers have full transparency over the investment positions of hedge funds using their services and are quick to terminate their relation with funds failing to comply with the broker’s risk

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230. Lhabitant, supra note 56, at 15-16. In a repo, the amount of short-term cash a hedge fund is able to raise depends upon the haircut being applied to the asset used as collateral. A hedge fund will not be able to raise as much short-term cash through repos when the perception of risk increases, because as risk perceptions increases so does the haircut to the repo’s collateral and the willingness of repo lenders to fund the trade in the first place. See Gary Gorton & Andrew Metrick, Haircuts, Fed. Res. Bank St. Louis Rev. 512-516, Nov./Dec. 2010, http://research.stlouisfed.org/publications/review/10/11/Gorton.pdf.

231. Hedge funds may also obtain leverage by borrowing securities (to short sell) or through synthetic leverage structures. See JPMorgan Alternative Asset Management, Hedge Funds, Leverage and Counterparty Negotiations (2008).

232. See generally President’s Working Group on Financial Markets, Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management 7-10 (1999) (noting that hedge fund counterparties manage their exposures to hedge funds through safeguards including due diligence, disclosure, collateral practices, credit limits, and monitoring). The amount of credit extended in margin financing is typically less than the market value of the collateral. For example, to invest in a position worth $10 million, a hedge fund may only be required to post $6 million in cash, with the rest financed with a margin loan. The percentage of the position that the hedge fund is required by the lender to post is known as the initial margin (or haircut), and is greater the higher is the perceived risk of the investment position or risk in the general economy. The initial margin may increase over the life of a particular margin-financed transaction, and is also greater for borrowers considered to be more risky. David P. Belmont, Managing Hedge Fund Risk and Financing: Adapting to a New Era 124-125 (2011); Bank for International Settlements, The Role of Margin Requirements and Haircuts in Pro cyclicality 2 (2010). In addition, additional “variation margin” is typically required to be posted as the market value of the financed investment decreases (this is known as a margin call). Lhabitant, supra note 56, at 124-125. Margin financing is provided by hedge fund prime brokers.


234. JPMorgan Alternative Asset Management, supra note 10, at 15-16.


management protocols. Prime brokers’ relationships with hedge funds are also monitored by their own banking or securities regulators.\(^{238}\)

Hedge fund repo counterparties are also generally prudent about their short-term exposures to the funds, and consider hedge funds among the riskiest type of counterparties such that the funds receive a larger haircut than other counterparties.\(^{239}\) Hedge fund derivatives counterparties typically require the funds’ trades to be supported by substantial amounts of collateral.\(^{240}\) Hedge fund derivatives transactions require the fund to post margin (collateral) at the inception of the trade and additional collateral if the market value of the trade decreases. The special discipline imposed on hedge funds likely in part stems from the funds not being viewed as “too big to fail” and hence as not being eligible for government aid if they pose systemic risks to their creditors or counterparties.

However, discipline by creditors and counterparties may be inadequate to protect hedge fund investors. For example, hedge funds often use multiple prime brokers to finance their positions, which deprives any single broker from knowing a fund’s total leverage.\(^{241}\) In addition, competition for hedge fund clients may lead prime brokers to ease their terms of credit to or oversight of the funds.\(^{242}\) Given the experience of prime brokers during the financial crisis of 2008, these actual or potential inadequacies do not seem substantial. Over a year before the financial crisis, and in response to the collapse of Bear Stearns in March of 2008, prime brokers already began to demand tighter credit terms to hedge funds in financing mortgage-related securities.\(^{243}\)

\(^{237}\) GAO, supra note 233, at 30-31.

\(^{238}\) Id. at 23 (“Bank regulators (the Federal Reserve, OCC, and FDIC) monitor the risk management practices of their regulated institutions’ interactions with hedge funds as creditors and counterparties”); Id. at 18 (the “SEC also conducts oversight over hedge fund activities through the supervision of the regulated securities firms that transact business with hedge funds as brokers, creditors, and counterparties.”). See also COMPTROLLER OF THE CURRENCY, OCC’S QUARTERLY REPORT ON BANK TRADING AND DERIVATIVES ACTIVITIES 5, FOURTH QUARTER 2008 (stating that for U.S. commercial banks “large credit exposures from derivatives, whether from other dealers, large non-dealer banks or hedge funds, are collateralized on a daily basis”).


\(^{240}\) ISDA Counterparty Credit Exposure among Major Derivatives Dealers, May 2007, (“[V]irtually all hedge fund exposures are more than fully collateralized with independent amounts posted up-front and variation margin posted subsequently as exposures change.”). http://www.isda.org/statistics/pdf/ISDA-Concentration-Survey2007.pdf.

\(^{241}\) GAO, supra note 233, at 32.

\(^{242}\) Id. at 33; FITCH RATINGS, HEDGE FUNDS: THE CREDIT MARKET’S NEW PARADIGM 4-5, June 6, 2007 (“Most prime brokers agreed that there was continued pressure to provide more relaxed credit terms to funds — through higher leverage or other lending terms — due to growing competition to attract hedge fund clients.”). http://mountainmentorsassociates.com/files/Hedge_Funds_The_Credit_Market_s_New_Paradigm_Fitch_5_June07.txt.pdf.

hedge fund leverage from prime brokers and other sources began to significantly decrease in mid-2007, likely due in part to the funds’ own prudent risk management and the discipline provided by hedge fund prime brokers, repo creditors, and derivatives counterparties. As prime brokers’ oversight of hedge funds has become more robust since the collapse of hedge fund Long-Term Capital Management in 1999, hedge fund leverage has also decreased.

The close monitoring of hedge funds by their short-term creditors and counterparties is another distinguishing aspect of hedge fund governance. Private equity funds, venture capital, and mutual funds typically use little to no short-term leverage or derivatives. In addition, while corporations are certainly subject to discipline by their creditors and counterparties, it likely is not as intense as it is with hedge funds. Although corporations take on as much debt as hedge funds in total, it is from a mix of short-term and long-term sources that does not provide the same type of targeted monitoring of corporate assets and activities as does short-term-only hedge fund debt. In addition, corporations that use short-term borrowing typically do so on an unsecured basis, are financially stable, and use the short-term borrowings to fund relatively safe working capital needs such as making payroll and purchasing inventory. Finally, corporations have access to permanent capital and, relative to hedge funds, a wide variety of financing sources that alleviates the need for intense monitoring by any particular group of creditors.

D. Hedge Funds Produce Alpha

One way to assess whether hedge fund governance mechanisms are effective in reducing managerial agency costs is to determine to what extent hedge funds produce superior returns, or alpha, relative to investing in the stock market or investing in other active investment vehicles. This is because the production of alpha indicates that any costs imposed upon hedge fund investors are more than made up for by the creation of investment returns that are superior to alternatives.

244. Andrew Ang, Sergiy Gorovyy & Gregory B. van Inwegen, Hedge Fund Leverage, 102 J. FIN. ECON. 102 (2011).
245. Michael R. King & Philipp Maier, Hedge funds and Financial Stability: Regulating Prime Brokers Will Mitigate Systemic Risks, 5 J. FIN. STABILITY 283, Fig. 1 (2009).
246. See Ang et al., supra note 246, at 35 (estimating the mean gross leverage of hedge funds to be 2.13); Sebnem Kalemli-Ozcan, Bent Sorensen & Sevcan Yesiltas, Leverage Across Firms, Banks, and Countries, NBER Working Paper No. 17354 at 14, Feb. 2012 (“Mean firm leverage for listed U.S. firms is . . . around 2.3-2.4 while the leverage ratio is slightly larger for non-listed firms”), http://www.uh.edu/~bsorense/leverage_feb28d_12.pdf.
The best method for measuring hedge fund performance from an agency cost perspective is to examine fund performance after fees are paid to managers, as opposed to the actual returns earned by investors after adjusting for how they invest in hedge funds. Most empirical studies of hedge fund returns, which are based on the former approach, find that at least a significant portion of hedge funds produce alpha. Numerous studies that analyzed hedge fund performance prior to the financial crisis of 2008 find that hedge funds produce superior risk-adjusted returns (alpha) relative to traditional long-only investments.


249. This approach goes by various names such as the dollar- or money-weighted rate of return. See Mayo, supra note 248, at 358-59; Albridge, supra note 248. One study applying the dollar-weighted approach to hedge fund returns found that investors in hedge funds were worse off than investing in the S&P 500 and only slightly better off than investing in the risk-free bond market. See Ilia D. Dichev & Gwen Yu, Higher Risk, Lower Returns: What Hedge Fund Investors Really Earn, 100 J. Fin. Econ. 248, 261 (2011). The dollar-weighted measure of returns is not a good measure for estimating agency costs because it incorporates how well hedge fund investors time their investments into funds—something the manager has no fundamental control over. For a criticism of the dollar-weighted approach, see Simon Hayley, Measuring Investors’ Historical Returns: Hindsight Bias in Dollar-Weighted Returns, Working Paper, March 12, 2012, http://ssrn.com/abstract=1698088. Another approach to measure the returns actually earned by hedge fund investors is that of financial economists William K.H. Fung and David A. Hsieh, who examine the returns to funds that invest in hedge funds because such funds “are actual pools of hedge funds, and, as such, they directly reflect actual investment experience in hedge funds.” William K.H. Fung & David A. Hsieh, Hedge Funds: An Industry in Its Adolescence, 91 Econ. Rev. 1, 15 (2006). Studies of funds of hedge funds are mixed but generally find that the funds produce alpha. See Yigit Atilgan, Reward-to-Risk Ratios of Fund of Hedge Funds, in, RECONSIDERING FUNDS OF HEDGE FUNDS: THE FINANCIAL CRISIS AND BEST PRACTICES IN UCITS, TAIL RISK, PERFORMANCE, AND DUE DILIGENCE 275 (Greg N. Gregoriou ed. 2013) (“[f]inding] that the fund of funds index has higher reward-to-risk ratios compared to several stock and bond market indices”); Raphaëlle Chappe, Christian Proaño & Willi Semmler, “Seeking Alpha”: The Performance of Funds of Hedge Funds, id. at 303 (finding that less than 10 percent of funds of hedge funds deliver alpha); Daniel Edelman et al., Funds of Hedge Funds: Performance, Risk and Capital Formation 2005 to 2010, 26 Fin. MKTS. PORT. MGMT. 87 (2012) (finding “a dramatic decline in the population of alpha producing funds of hedge funds post 2008 compared to the FHN summary findings”); Adam L. Aiken et al., The Value of Funds of Hedge Funds: Evidence from Their Holdings, Working Paper, Nov. 26, 2012 (“a primary source of FoF value comes via skillful monitoring of their underlying hedge fund investments after the hire date”), http://ssrn.com/abstract=2181074; Thomas Heathorn, Dieter G. Kaiser & Christoph Roder, The Risk of Funds of Hedge Funds: An Empirical Analysis of the Maximum Drawdown, 12 J. Wealth Mgmt. 89 (2009) (“the advantages of FHFs are more likely to be in their low long-term correlations with traditional asset classes, as well as in their low volatility”); Serge Darolles & Mathieu Vaïssière, Do Funds of Hedge Funds Really Add Value? A Post Crisis Analysis, Working Paper Sept. 20, 2010, http://ssrn.com/abstract=1670571 (“funds of hedge funds appear to succeed in overcoming their double fee structure, and add value across market regimes, although to varying degrees and in different forms”); Benoit Dewaele et al., Assessing the Performance of Funds of Hedge Funds, Midwest Finance Association 2012 Annual Meetings Paper, http://ssrn.com/abstract=1929097 (“we find that, after fees, the majority of FoHFs do not channel alpha from single manager hedge funds”); William Fung, David A. Hsieh, Narayan Y. Naik & Tarun Ramadorai, Hedge Funds: Performance, Risk, and Capital Formation, 63 J. Fin. 1777 (2008) (finding that “the average fund-of-funds delivers alpha only in the period between October 1998 and March 2000”).

Studies covering hedge fund performance throughout and after the financial crisis also find that hedge funds have alpha. For example, a study of hedge fund performance from January 1994 to September 2008 found that most hedge fund investment strategies returned alpha and that alpha did not decrease on an industry-wide level over that time. Another study of hedge fund returns, which included data regarding over 20,000 funds from January 1994 to December 2010, found significant hedge fund alpha of 5.2 percent per year (using the study’s most conservative estimate). Two recent studies of hedge fund returns, each using a dataset from January 1994 to December 2011, found that hedge funds outperformed stock and bond markets. Most studies that do not find hedge fund alpha are limited to small and unrepresentative pool of funds.

In addition to outperforming on a stand-alone basis, numerous studies find that hedge funds can help to diversify, and hence improve, the performance of a traditional investment portfolio of stocks and bonds. For example, a study of successful university endowments

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255. Dichev & Yu, supra note 249, at 250.

attributed their superior investment returns in part to their hedge fund investments.  

These findings are the most important for hedge fund investors, since most investors include hedge funds a part of broader investment portfolio. These studies strongly indicate that the typical hedge fund, or at least a large minority of hedge funds, provide unique value to investors by helping them improve their returns.

IV. IMPROVING HEDGE FUND GOVERNANCE

A. Governance and Firm Characteristics

As investors seek to improve hedge fund governance, they should seek to strike the right balance between governance devices that empower managerialism and those that provide protection for investors. There are likely several baseline corporate governance devices that, if adopted, would help strike the right balance and lead to better returns for all hedge fund investors. Such governance devices include a substantial level of transparency, some type of performance-based compensation, and effective operational controls. However, beyond a baseline set of general governance devices, there is likely no universal set of specific governance mechanisms (e.g., fee rates, redemption terms) that will optimize investor returns for investors in all hedge funds. This is because a general lesson from empirical corporate governance research is that whether a particular governance mechanism is associated with better performance depends on the specific economic characteristics of the firm.

Hedge funds pursue an extremely wide variety of investment strategies and hence have a wide range of economic characteristics. Accordingly, the adoption of any governance mechanisms often involves tradeoffs related to the firm’s characteristics. In the hedge fund context, these governance-relevant characteristics include the duration fund’s investment strategy horizon, the strategy’s risk and return properties (including its correlation with broader markets), and the redemption terms provided to investors. Improving the governance of a hedge fund therefore requires considering any inherent tradeoffs involved in choosing a particular governance device and the fund’s governance-relevant characteristics. For example, reducing the redemption restrictions of a fund with a relatively long-term investment

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258. See Philip Brown, Wendy Beekes & Peter Verhoeven, Corporate Governance, Accounting and Finance: A Review, 51 ACCT. FIN. 96, 118 (2011) (“The consensus view in the literature is that the relationship between firm performance and [corporate governance] is endogenous and may depend on other (unobserved) firm characteristics as well . . . . Overall, research that takes the endogenous relationship into account finds at best only weak support for the proposition that better [corporate governance] practices create value.”).
horizon may, at some point, interfere with the ability of the manager to carry out the fund’s strategy.

B. Fees

1. Performance-Based Compensation and Rate

There is a general tradeoff in paying managers performance-based fees. Performance fees may benefit investors to the extent that they incentivize managers to improve their performance and attract higher talented managers to the industry. However, performance fees are a cost to investors in that they are deducted from increases in the value of their assets. Empirical evidence supports the theory that performance-based compensation improves investors’ net-of-fees returns. Studies find that hedge fund performance fees in part account for their outperformance of mutual funds (which by law cannot charge asymmetric performance fees), and that private investment funds that do not charge performance fees underperform those that do. In addition, most studies examining the issue find a positive association between fee level charge by a hedge fund and its returns. Charging higher performance fees


261. Cecile Le Moigne & Patrick Savaria, Relative Importance of Hedge Fund Characteristics, 20 FIN. MARKETS PORTFOLIO MGMT. 419, 424 (2006). But see Kouwenberg & Ziamba, supra note 288, at 3308 (finding that “hedge funds with incentive fees have significantly lower mean returns (net of fees) and worse risk-adjusted performance”).

(and lower management fees) may also serve as a signal of superior managerial ability to investors.\textsuperscript{263}

Accordingly, investors’ desires for lower fees should be tempered by the potential for higher fees to induce greater (and more skilled) managerial effort. Although lower fees may increase the portion of returns allocated investors, they may also decrease the incentives for managers to expend the kind of effort required to produce better returns. Higher fees may also allow a hedge fund to attract and retain the best talent in the industry. A combination of high performance fees and low management fees may be optimal for investors.

Investors should also focus on having performance-fee compensation match the time horizon of the manager’s investment strategy. Doing so would prevent managers from getting paid in the short run while investors suffer losses in the long-run. It would also allow investors to make more informed decisions regarding which managers are able to consistently perform well over time rather than those that are lucky in the short run.\textsuperscript{264} Moving towards a multi-year compensation structure for managers may be a significant area for improvement. Currently, less than an estimated 10 percent of hedge funds measure manager performance over multi-year periods.\textsuperscript{265} However, at least of quarter of hedge funds pursue investment strategies that likely extend past an annual period and hence should most likely adopt a multi-year performance fee measure.\textsuperscript{266}

One way of accomplishing a better intertemporal alignment may be to implement a rolling and deferred performance fee arrangement that calculates performance fees over a multi-year period to match the actual realized gains from an investment strategy.\textsuperscript{267} Another method would be to place a portion of the annual performance fees in an escrow account.

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\textsuperscript{264} See Cusworth, supra note 178 (stating that “[c]alculating performance fees over longer periods would make the market more efficient at pricing hedge fund talent”).

\textsuperscript{265} See Seward & Kissel LLP, supra note 179, at 2.

\textsuperscript{266} See AIMA, supra note 1, at 19, 97-98 (noting that 27.1 percent of hedge funds pursue “event driven” strategies including investing around mergers and acquisitions and in illiquid distressed debt instruments).

\textsuperscript{267} CASEY QUIRK, supra note 2, at 32-33; Utah Retirement System, Summary of Preferred Hedge Fund Terms at 2.
that allows investors to clawback and retrieve the fees if there is underperformance in subsequent years.268

2. High-Water Marks and Hurdle Rates

With respect to high-water marks, empirical studies have found that funds with high-water marks perform better than those without, which suggests that managers respond positively to the incentive. Using a sample of 8,752 hedge funds from January 1990 to December 2005, Indraneel Chakraborty and Sugata Ray found that high-water marks seemed to induce managers at or just below the mark to expend more effort.269 High-water marks have generally been found to reduce the incentive of managers to increase risk after performing poorly due to their aversion to falling even further below the mark.270 High-water marks also create incentives for managers to close or continue to operate poorly performing funds when doing is in the best interest of investors.271 Excessive risk-taking has been found in empirical and theoretical studies to be constrained by a desire to prevent the fund from collapsing, losing co-invested funds, or ending up far below the high-water mark in the first place.272 Using a sample of 4,990 hedge funds from January 1994 through December 2007, Andrew Clare and Nick Motson found that hedge fund managers well below their high-water mark do not “put it all on black” and increase their risk-taking activities even though doing so may jeopardize earning performance fees.273


However, there is evidence that compensating a manager with an annual performance fee subject to a high-water mark may cause an incentive misalignment between investors and managers when a fund’s performance drops significantly below its high-water mark. In these situations, earning a performance fee requires a substantial gain by the end of the year, thereby giving the manager an incentive to substantially increase risk because either coming in at just below or far below the high-water mark will equally result in the manager not being paid a performance fee.274 There is evidence of this “swing for the fences” effect: one study found that returns for funds 10 percent below their high-water mark were more volatile than those at the mark, and funds further from the high-water mark took more and relatively poorer risks.275 Yet another found that evidence that as hedge funds fall below their higher-water mark they increase risk, have lower expected risk-adjusted returns, and are more likely to close due to not being able to ever recover losses to get “above water” (and hence allow managers to be paid performance fees).276 For this reason, industry commentators have called for abolishing high-water marks altogether.277

High water marks may also reduce returns in another way. Hedge fund managers have an incentive to reduce their risk-taking after surpassing a high water mark to lock-in profits. By doing so, managers may deprive investors of the forgone gains from the manager pursuing the same strategy that allowed them to surpass the high water mark in the first place.278 Hedge fund investors should accordingly consider investing in funds that have attractive characteristics but do not use high-water marks, or in funds that remove or reset their high-water marks if the fund drops substantially below the mark. The latter will remove the incentive for managers taking on undue risks to reach the high water mark and prevent employees from leaving a fund that is substantially under water.

Although hurdle rates are relatively uncommon, they are more likely to be found in hedge funds the higher the performance fee, and less likely to be found the higher are management fees or hedge fund leverage.279 Soydemir, Smolarskiand, and Shin argue that hurdle rates are

277. CASEY QUIRK, supra note 2, at 29, 33-34.
279. Gokce Soydemir, Jan Smolarskiand & Sangheon Shin, Hedge Funds, Fund Attributes and Risk Adjusted Returns (September 15, 2010), at 18.
offered in an attempt to compensate investors for investing in certain funds they find relatively risky or otherwise unattractive from a risk-return standpoint.\(^{280}\) The authors view hurdle rates primarily as marketing tools, however, because they find no correlation between fund performance and offering a hurdle.\(^{281}\) Hurdle rates are most likely to benefit investors in hedge funds whose returns are highly correlated to stock, bond, or other broad markets.\(^{282}\) Accordingly, investors should probably only demand hurdle rates in funds that run the risk of giving investors the same risk-adjusted returns they could have obtained through a cheaper, passive investment vehicle (such as a stock index). Investors should also consider having the hurdle rate be based upon a specified level of correlation instead of an absolute level of return.\(^{283}\) That way, investors will not have to pay fees for returns that they sought to avoid by investing in hedge funds in the first place (i.e., returns correlated with broader markets).

3. Managerial Co-Investment

Managerial co-investment unsurprisingly seems to align incentives and increase performance. A study by Agarwal et al. of a representative sample of 7,535 hedge funds from 1995 to 2004 found a positive and statistically significant relationship between co-investment and performance.\(^{284}\) Other researchers have also found that managerial co-investment overcomes incentive misalignments that may exist if managers if paid are only with a performance-based feed constrained by a high-water mark or hurdle rate.\(^{285}\) Co-investment may also increase the incentives for manager to close poorly performing funds when doing so is best for investors.\(^{286}\) After taking into account the incentives facing hedge fund managers from a wide variety of factors, Agarwal et al. found that hedge funds perform better when overall incentives are higher—in the presence of higher performance fees, more managerial co-investment into the fund, and higher high-water marks.\(^{287}\)

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280. Id. at 12-13.
281. Id. at 15-17.
282. CASEY QUIRK, supra note 2, at 33; Andrew D. Beer, A Lack of Rigor in ‘The Hedge Fund Mirage,’ AllAboutAlpha.com, Nov. 15, 2012 (arguing for industry-wide hurdle rates).
284. Agarwal et al., supra note 269 at 2224-2225. See also Le Moigne & Savaria, supra note 261, at 424 (finding in a sample of 3,775 funds from 1989 to 2005 that funds with the personal capital of managers invested had higher returns).
287. Agarwal et al., supra note 269 at 2224-2225. See also Liang, supra note 262, at 74
Nonetheless, there is likely a governance tradeoff with co-investment. Co-investment beyond a certain level may decrease performance to the extent that high co-investment could result in the fund manager becoming too cautious.\textsuperscript{288} Although the optimal range of co-investment is an issue yet to be analyzed in-depth, investors should require at least some significant amount of co-investment by managers in the funds they manage, including a requirement that managers reinvest profits into the fund to help assure long-term incentive alignment.

C. Transparency

Transparency in the hedge fund context refers to the extent and frequency of disclosures about a fund’s or manager’s performance, operations, and structure. Even prior to the Dodd-Frank Act of 2010 effectively mandating that all hedge fund managers publicly disclose information on Form ADV, the typical established fund disclosed a significant amount of information about its investments, performance, and other characteristics.\textsuperscript{289} However, the level of transparency differed significantly among hedge funds, and ranged from funds providing only summary statistics of returns to full position-level transparency.\textsuperscript{290} Since the 2008 financial crisis, investors have demanded more transparency and hedge funds have responded by increasing their disclosures and reporting. Nonetheless, investor surveys indicate that transparency remains a top concern.\textsuperscript{291}

Investors can generally make more informed investment decisions the more frequent and expansive are hedge fund disclosures. Greater disclosures also likely lower a hedge fund’s cost of capital and increase the liquidity of its shares in secondary markets by giving investors more information about the fund and the manager’s activities.\textsuperscript{292} However, there are some nuances that qualify the more-transparency-is-better principle. The first is that investors may suffer from information overload and not be able to process vast amounts of

\begin{itemize}
  \item (finding that funds with high-water marks outperformed funds without). In a separate study, Agarwal et al. found that hedge fund managers with higher incentives and opportunities to artificially manage their earnings may be doing so to improve performance results. Vikas Agarwal, Naveen D. Daniel & Narayan Y. Naik, \textit{Why is Santa So Kind to Hedge Funds? The December Return Puzzle 1-3} (Working Paper March 29, 2007).
  \item Roy Kouwenberg & William T. Ziemba, \textit{Incentives and Risk-Taking in Hedge Funds}, 31 J. BANKING FIN. 3291 (2007) (concluding that “if the manager’s own stake in the fund is substantial (e.g. > 30%), risk taking will be reduced considerably”); \textit{LHABITANT, supra} note 56, at 33 (noting that “a successful fund manager at the end of his [or her] career will have so large a commitment in the fund that he [or she] will refrain from taking risks, even though these are well remunerated”).
  \item Gibney & Leu, \textit{supra} note 174.
  \item \textit{FRANK J. TRAVERS, INVESTMENT MANAGER ANALYSIS: A COMPREHENSIVE GUIDE TO PORTFOLIO SELECTION, MONITORING AND OPTIMIZATION} 371 (2011)
  \item KPMG, \textit{TRANSFORMATION: THE FUTURE OF ALTERNATIVE INVESTMENTS} 5 (2010).
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information effectively. For example, complete transparency into a fund’s specific investment positions may be overwhelming and not provide a basis for investors to make a meaningful comparison between managers. Even sophisticated investors may have difficulty distinguishing between the unique aspects of different hedge fund disclosures. For hedge funds that hold illiquid securities or complex instruments, transparency into the fund’s investment positions is unlikely to give investors significant insight into the fund’s investment strategy due to the numerous potential ways the manager may be seeking to profit from the relationship between the positions. Periodic short-term disclosures (e.g., weekly) about the investment positions in long-term strategies are also unlikely to offer investors much value. The fact that investors typically do not seek full position-level disclosures from managers or require managers to report performance in a way that mitigates performance-smoothing suggests that, beyond a certain point, transparency is not necessarily beneficial.

In addition, at some point increasing disclosure may erode a manager’s competitive advantage and hence decrease returns. If another investor or trader obtains knowledge about a hedge fund’s investment positions, the competitor may be able to enter into offsetting trades that reduce the value of the fund’s investments.

A related issue is what information about the fund is most important to investors in making investment decisions. Already, sophisticated hedge fund investors have well defined preferences

regarding what information and level of transparency they seek. In addition, a large practitioner literature exists on hedge fund disclosures, and typically differentiates between what information investors should look for prior to making an investment (due diligence) and what should be the subject of their ongoing monitoring once they have invested with a fund. Studies by financial economists also suggest that investors should focus on a particular fund’s risk, including operational risk. In particular, investors should focus on transparency about the uniqueness of the fund’s investment strategy and lack of its correlation with broad market risk factors.

The foregoing analysis of transparency suggests that hedge fund investors should not seek real-time, position-level disclosure across the board or for every type of fund. Rather, investors should focus on disclosures that provide the right level and frequency of meaningful information about the manager’s strategy, investment risks, and operational controls.

D. Hedge Fund Boards of Directors

Investors should be skeptical of the value of boards in hedge funds. In the corporate context, boards provide value due to shareholder capital lock-in. Because equity investors in corporations make a permanent contribution of capital to the firm, a board is needed to oversee management to ensure that the capital is used productively. In the hedge fund context, by contrast, investor capital is not locked-in and can be redeemed at any time, subject to relatively short-term and limited redemption restrictions. As a result, hedge fund investors may not need an intermediary board to protect their interests since they can protect themselves by simply cashing out of the fund. This likely explains why 85 percent of hedge funds based in North America do not have boards and why there is no evidence that funds with boards perform better than those without them.

300. See supra notes 173 to 175 and accompanying text.
301. See, e.g., FRANK J. TRAVERS, INVESTMENT MANAGER ANALYSIS: A COMPREHENSIVE GUIDE TO PORTFOLIO SELECTION, MONITORING AND OPTIMIZATION (2011); I'HABITANT, supra note 56, at 569-78.
305. See also Jerry W. Markham, Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments, 3 Hastings B. L. J. 67, 154 (2006) (noting that “hedge funds have conflicts of interest but have dealt with them adequately without a mandated number of outside directors”).
Likewise, for hedge funds that have boards, investors should hesitate before pressuring managers to adopt boards with governance characteristics that appear to serve their interests. Empirical studies of corporate governance do not find that “good governance,” including director independence, increases performance. Hedge funds may be particularly ill served by independent directors because outside directors because the funds’ investment strategy and risks are relatively difficult for outsiders, such as independent directors, to understand. Nonetheless, one study of hedge fund boards found that for funds that do have boards, (risk adjusted) performance is better where boards are independent and have directors with risk management experience. Investors should, accordingly, approach the reform of any particular hedge fund board on a case-by-case basis. Compensating hedge fund directors with equity interests in the fund as a way to align incentives should be considered due to its association with better performance in public companies. Alternatively, compensating directors with structured notes tied to the performance of the director’s fund may be another way to align the director’s incentives.

Investors should be mindful that their efforts to reform hedge fund boards may also be problematic given that financial institution governance seems particularly prone to difficulty. Reliance on boards to monitor managers in banks has proven to be an ineffective model of governance due to the inherent complexity of the financial world. Heavily regulated mutual fund boards also seem generally ineffective in furthering investors’ interests and introduce their own layer of agency costs into governance. A hedge fund board may do little more than

307. See Ran Duchin, John G. Matsusaka & Oguzhan Ozbas, When Are Outside Directors Effective?, 96 J. FIN. ECON. 195 (2010) (finding that “when the cost of information [about a firm] is high, performance worsens when outsiders are added to the board”).
309. See generally CASTLE HALL ALTERNATIVES & ORCHARD HARBOUR, REDEFINING CORPORATE GOVERNANCE: TOWARDS A NEW FRAMEWORK FOR HEDGE FUND DIRECTORS (2012).
313. See John Morley & Quinn Curtis, Taking Exit Rights Seriously: Why Governance and Fee Litigation Don’t Work in Mutual Funds, 120 Yale L. J. 84, 123-126, 136 (2010); Jerry W. Markham, Mutual Fund Scandals—A Comparative Analysis of the Role of Corporate Governance in the Regulation of Collective Investments, 3 Hastings B. L. J. 67, 153 (2006) (concluding that the “the use of outside directors to guard against conflicts of interest on the part of investment advisers to mutual funds has proven to be ineffective”); Alan R. Palmeter, Mutual Fund Boards: A Failed Experiment in Regulatory Outsourcing, 1 BROOK. J. CORP. FIN. & COMM. L. 161 (2006) (arguing...
create a false sense of security among investors and impose significant costs.\(^{314}\)

None of the foregoing suggests that hedge investors should be the primary or direct monitors of hedge fund managers, however. Instead of relying on a board, investors should require funds to establish committees relevant to their areas of concern and rely on independent third-party service providers. This is because internal committees can require a fund to commit to pre-established policies and procedures and are more focused on specific issues as opposed to a wide variety of governance tasks. In addition, third-party service providers have their own reputational incentives to provide a check on managers, and are likely in a better position to effectively do so.\(^{315}\) For example, when it comes to the important issue of valuing fund assets, a valuation committee can establish applicable valuation policies and procedures and address the conflicts of interest in doing so.\(^{316}\) In addition, third party administrators should be hired to conduct their own valuation of fund assets to the extent possible. So long as practices ensure that administrators are independent from managers, administrators can provide investors with valuations that are free from conflicts of interest, a signal that managers are committed to accurate reporting, and a valuable “second opinion” when reliance on the manager to value illiquid assets is necessary.\(^{317}\) Relying on service providers has become more commercially feasible due to innovations that have reduced their cost and increased their ability to integrate into a fund’s operations.\(^{318}\)

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that mutual fund boards are overly reliant on management and not subject to proper oversight), http://ssrn.com/abstract=1084876; Anita Krug, Corporations Beyond Corporate Law, 86 S. Cal. L. Rev. (forthcoming 2013), draft Section III (arguing that mutual fund managers have incentives to keep information from directors and that directors are insufficiently independent), http://ssrn.com/abstract=2131461.


315. See CASEY QUIRK, supra note 2, at 16.

316. See Banzaca, supra note 117.


E. Redemption Restrictions

Although redemption restrictions may impose agency costs on investors to the extent they do not help a fund’s performance, they may also allow investors to access funds with higher returns. In general, relatively long-term, illiquid investment strategies are a source of higher returns because such strategies are offered at a discount to compensate investors for giving up the ability to quickly exit the investment. Long-term investment strategies may also allow investors to access unique sources of value not present in more widely available, short-term investment strategies. As a result, investors in hedge funds with illiquid strategies are compensated for illiquidity risk with higher returns. Illiquid hedge fund investment strategies may be undermined with frequent investor redemptions, however, because illiquid investments require more time than liquid investments for gains to be realized. Indeed, empirical studies confirm that investors generally benefit when hedge funds use redemption restrictions that allow managers to realize gains from illiquid investments. Lockups may also have the benefit of preventing a fund from collapsing due to temporary poor returns by giving the manager enough time to recover losses.

Accordingly, investors should be willing to accept redemption restrictions when doing so is consistent with the goals of a long-term investment strategy. Investors should not to place too high a value on liquidity given that the premium investors receive for accepting restrictions on withdrawals is likely one of the main reasons why hedge funds outperform other investments.

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319. See supra Section II.D.
324. See CASEY QUIRK, supra note 2, at 30-31.
increasingly liquid secondary markets for hedge fund shares should decrease the importance of short-term liquidity because a secondary market provides investors with an additional means of exit.

F. Managed Accounts

One hedge fund structure that may reflect an optimal governance arrangement for some investors is a managed account. A managed account is a structure in which an investor retains full ownership of their funds and hires the fund manager to invest the funds as a third party.\textsuperscript{326} In a managed account, it is the responsibility of the investor to hire independent third party service providers and undertake the account’s operations (such as risk management and reporting).\textsuperscript{327} Managed accounts have become increasingly popular with investors since the financial crisis of 2008.\textsuperscript{328}

The benefits of managed accounts relative to traditional hedge fund structures are that managed accounts give investors greater transparency (with up to real-time, position-level transparency), at least some degree of direct control over how the assets are managed, a high degree of liquidity, and greater control over how fees and taxes are allocated.\textsuperscript{329} Managed accounts, however, have several disadvantages. One disadvantage is higher administrative costs which necessarily arise from establishing and operating numerous distinct accounts.\textsuperscript{330} Managed accounts also limit access to certain investment strategies such strategies such as those that invest in hard-to-value illiquid assets that make it difficult to allocate the positions across different accounts.\textsuperscript{331} Managed accounts may also suffer from an agency cost in the form of adverse selection. Because managed accounts are a structure with governance devices very much in the investor’s favor, the most sought-after or skilled managers are generally not willing to accede to their terms.\textsuperscript{332} Investors also have a higher monitoring burden with managed accounts to ensure that the manager does not stray from its strategy, does not favor the funds it manages over its managed accounts, and adequately shadows

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\item \textsuperscript{327} Peter Dom and Jasper Haak, Managed Accounts: The Answer to the Trend of Institutionalization in Hedge Fund Investing? Nov. 13, 2012.
\item \textsuperscript{328} Towers Watson, Hedge Fund Investing: Opportunities and Challenges 6, April 2012.
\item \textsuperscript{330} Towers Watson, supra note 328, at 8-9.
\item \textsuperscript{331} Id. at 8.
\item \textsuperscript{332} Id.
\end{itemize}
any underlying fund it is meant to track. Finally, managed accounts also lack co-investment by managers, which is an important governance device and underlies managers’ high pay-performance sensitivity.

The disadvantages of managed accounts reflect the inherent limitations investors face when they attempt to obtain investor-friendly characteristics. Indeed, the limitations on managed accounts are precisely the reason why hedge fund investors may be better off with less transparency, higher fees, and less access to their capital. Agreeing to those terms has their own set of disadvantages but has the benefit of allowing investors to access a wider variety of hedge fund strategies and more likely higher skilled managers.

V. CONCLUSION

Hedge fund governance consists of the funds’ underlying legal regime and the practices they adopt in response to lacking permanent capital and to reduce agency costs. The analysis in this Article suggests that hedge fund governance devices are generally successful in disciplining and incentivizing managers to generate valuable risk-adjusted returns for investors.

Nonetheless, investors should seek to improve hedge fund governance by striking the right balance between governance devices that empower managers and those that provide protection for investors. Although lower fees, greater liquidity, and more transparency may generally improve governance and returns, investors should take a measured approach in negotiating for such outcomes. Indeed, investors are often better off with less transparency, higher fees, and less access to their capital.

With respect to fees, investors should seek relatively low management fees in particularly large funds to prevent paying substantial fees to managers that go above their operating costs and are not tied to performance. Lower performance fees, however, may reduce the incentives of managers to perform well and reduce the ability of a fund to attract skilled managers. Nonetheless, greater use of performance fees calculated over a multi-year period is likely an area where governance can be substantially improved.

333. MOODY’S INVESTOR SERVICE, supra note 326, at 6.
334. TOWERS WATSON, supra note 328, at 8.
Investors also should not always attempt to negotiate greater redemption rights. Instead, investors should focus on performance fees and liquidity terms matching the time horizon of the manager’s investment strategy so that managers are paid when actual investment gains are realized and investors do not withdraw their capital until the strategy has been implemented. Redemption rights will also matter less as secondary markets for hedge fund shares develop. Investors should also question the use of high-water marks and hurdle rates in certain contexts and attempt to have the manager invest a substantial portion of their own wealth, and a portion of fund profits, in the funds they manage.

In terms of transparency, real-time, position-level transparency may do little to produce more valuable information for investors. Such a high level of transparency may, however, unduly burden managers and reduce their competitive advantage. More important than real-time, position-level transparency is transparency about the strength of a hedge fund’s operational controls and the correlation of the fund’s returns with stock and credit markets. Investors should also not pressure hedge funds to adopt boards nor necessarily increase their reliance on, or expectations of, existing fund directors. Hedge fund investors should instead pressure managers to establish proper internal committees and rely more on administrators and other third-party service providers to serve as an independent check, especially in the area of performance reporting and valuation. To the extent boards are relied on, equity-based compensation for directors may make them more effective.

In providing the first scholarly analysis of the internal governance of hedge funds, this Article establishes a framework for future research. It identifies the primary types of hedge fund agency costs and governance devices, and the various choices that managers and investors face in attempting strike the right balance between managerialism and investor-responsiveness. Future research should focus on issues such as the impact of specific governance devices and structures. These may include managerial co-investment and managed accounts, how to properly align fees and redemption terms with investment strategy, and the proper role of independent third party service providers.