The **shirk** ethic

A landmark judgment in the Cayman Islands could force hedge fund directors to take their duties more seriously, or risk paying the price when things go wrong. **George Mitton** investigates

When Weavering Capital, a London-based investment firm, set up a hedge fund in the Cayman Islands in April 2003, the company's founder Magnus Peterson chose two directors. Stefan Peterson was his younger brother, a full-time employee of a Norwegian insurance company. Hans Ekstrom was the pair's stepfather. He was 79 at the time of his appointment (*Directors found guilty*, *Funds Europe, October 2011*).

The men did not do a good job. According to a legal judgment in the Caymans, they did little but sign the documents Magnus Peterson gave them, even the fictitious minutes of two board meetings that never took place. They provided the impression of corporate governance, said the judge, but they did not fulfil their legal duties of oversight or supervision.

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This laxity might have gone unnoticed, except that in early 2009 the $639 million (€461 million) Weavering Macro Fixed Income Fund collapsed, taking Weavering Capital with it. The company that is liquidating the London firm says investors have lost more than half a billion dollars.

The judge found the directors guilty of "wilful neglect and default" in their duties and ordered them to pay $111 million to the fund's investors.

The case has been described by one lawyer as a "wake-up call" for the directors of Cayman Islands funds. It is the first statement from the judiciary on the increasingly hot topic of hedge fund governance, and the message is clear: do your duty or pay the price.

What went wrong?

When the fund's liquidators came to examine the business, they found that a high proportion of the assets on the balance sheet were "fictitious", says the judgment. The balance sheet included $637 million of interest rate

Testing directors

Some simple questions can help determine whether a fund's directors are doing their jobs properly:

- How much are they paid? A fee of a few thousand dollars a year, or no fee at all, may indicate the director does not take the job seriously.
- How many other directorships do they hold? It is not uncommon for professional directors to hold several hundred directorships, with little time and energy to devote to each.
- How often do they meet? Boards that meet only once a year, or hold telephone meetings, may not provide proper oversight and supervision.
- Are the directors truly independent? If the directors are employees of the fund, and if board meetings are incidental to the day-to-day running of the business, they may not be doing their legal duties.

Unfortunately, under Cayman Islands law there is no obligation to include this kind of information in a fund's offering document, as there is in some other jurisdictions. Directors can legally refuse to reveal the information even if they are contacted directly by an investor in the fund.

However, institutional investors can increasingly put pressure on funds to provide more transparency.

swaps with a related offshore company also bearing the Weavering name. The upshot was that the fund's net asset value had been significantly inflated.

But the fund had already paid out to investors based on its inflated net asset value. When investors requested more redemptions in early 2009, the fund unwound in spectacular style.

As the man effectively managing the fund, Magnus Peterson was the first to face scrutiny. The UK's Serious Fraud Office arrested and released him, but dropped its investigation in September this year.

It is the case against the directors that could have more lasting implications.

The judge ruled that Stefan Peterson and Hans Ekstrom were personally liable because they failed in their legal duty to scrutinise the fund's accounts. If they had done their duty, they could have noticed and stopped the wrongdoing that caused the losses.

"There is a stark message that comes out of this case," says Peter Astleford, a partner at law firm Dechert. "If you only use written board resolutions, have a meeting once a year, or if a fund director's work is done as part of an investment manager's delegated duties, that's not good enough."

The case is interesting because the directors had clauses in their contracts that were designed to exclude them from liability, yet the directors were still deemed to be liable.

"The court held that if they'd been trying, and failed, those clauses should help the directors," says Astleford. "But, because they didn't try at all, those clauses couldn't help them."

The message seems to be that an exclusion clause will not save a director from the effects of negligence. If a director has not been doing his or her job properly, and the fund collapses as a result of wrongdoing, he or she is liable.

'It's not the investment manager who's running the hedge fund, it's the directors'

The case raises an important question: how many other directors of Cayman Islands hedge funds are failing to exercise as much care and attention as they should?

It is difficult for investors to know which boards are doing their jobs properly. There are some questions investors can ask (see box). But under Cayman Islands law, directors do not have to give answers.

Likewise, Cayman Islands funds have no obligation to reveal key information, such as how often their board meets, whether their directors hold other directorships, or how much their directors are paid. Lawyers say that if a director is unpaid it may raise questions about whether the director takes the job seriously. The Weavering directors were not paid.

The location of the company that operates the fund is another important factor. Astleford says that, for tax reasons, funds linked to UK-based firms must prove the fund has a functioning board outside the UK. This gives rise to a basic level of corporate governance in most cases. US tax law is less strict.

Another factor is the use of companies which supply professional directors to funds. The Alternative Investment Management Association, which publishes advice to hedge funds, says funds should be careful if they receive directors this way. "It is not uncommon for such candidates to have several hundred other directorships and very little time and attention to devote to another directorship," says the organisation, in its guide for offshore fund directors.

Pressing the flesh

There is hope for more transparency, though. The biggest push may come from institutional investors who are playing a bigger role in hedge funds, edging out high-net-worth individuals, who used to be the key clients for offshore hedge funds but who withdrew in large numbers after the 2008 crisis.

"Institutional investors are in the driving seat," says Andrew Rubio, chief executive officer at financial outsourcing firm Throgmorton. "They're saying, either clean up your act or we're not going to touch you."

This move could force directors to open up about their activities in ways the law cannot. Institutional investors can insist on meeting fund directors before they invest and directors are more likely to give information if a big mandate depends on it.

"Investors should be pressing the flesh and independent directors should be prepared for more of this questioning," says Rubio.

If the inflow of institutional investors does not force better practice, the Alternative Investment Fund Managers directive might. Under the incoming legislation, the Cayman Islands will have to show it is meeting European standards or risk losing business to other jurisdictions.

According to Matthew Feargrieve, a partner at law firm Appleby, the Weavering judgement is a crucial statement on the increasingly important issue of corporate governance.

"Before the financial crisis, when everyone was making tons of money, the precise nature of corporate governance of a fund was less important," he says. "Now, when a lot of funds are losing money, and after Madoff [2008] and other frauds have been exposed, corporate governance is a hot topic."

"The case will be a wake up call for those directors who might have cast a casual eye over papers coming from the investment manager and signed off on them because they think the investment manager will always be acting in the best interests of the fund," he adds.

"If the directors don't understand or don't agree with something, they've got to make that clear to the investment manager. It's not the investment manager who's running the hedge fund, it's the directors." fe