

Board observer rights – Is it a good idea?

By Leon den Exter & Vumi Dube

A professional director for a hedge fund might take an instinctive view that board observer rights are not desirable given the traditional view of separation of capital ownership and those responsible for fund governance. Professional directors confident in their abilities would, however, welcome the opportunity to show how seriously they take their fiduciary responsibilities and demonstrate their skills and knowledge of good governance under the scrutiny of a board observer.

A board observer can take different forms but the general idea is that an investor would have the right to attend formal meetings held in the context of a fund's governance structure and be able to review sensitive board documents and reports. This poses both opportunities and challenges for those charged with governance.

The investor might have a number of reasons for seeking observer status ranging from oversight of the governance process, to a genuine desire to offer advice where the observer believes value can be added, to having access to information not normally accessible to investors. This obviously does raise some issues similar to those for side letters, an issue well understood in the hedge fund industry.

Lessons from the financial crisis

During the 2008 financial crisis there were instances where investors found hedge funds to be lacking transparency and felt deprived of information as they relied on directors and investment managers to make decisions on their behalf without prior consultation with investors. Frequently, this situation led to surprise communications from fund managers to investors imposing gating provisions or suspending redemptions. Since that time, investors, especially institutional investors, have expanded the



Leon den Exter, Associate
Director at DMS Governance



Vumi Dube, Associate Director
at DMS Governance

scope of their operational due diligence on hedge funds and their managers (with ever expanding questionnaires) or even sought direct participation on boards. If it is believed that "The people in charge don't know much more than you" as observed in an 2013 article on the financial crisis in The Wall Street Journal, then why not take governance matters into your hands as an investor and be more directly involved in fund governance? This has led to the developing trend of institutional investors seeking board observer rights.

The challenges

Sitting on a board comes with responsibilities and challenges that investors may not be prepared to add to their risk profile. First, a director has fiduciary responsibility to a fund and has to represent the best interests of the fund which would include all the investors. By contrast, an investor having board observer rights will have access to board meetings and sensitive information without being bound by the same fiduciary standards governing directors. Second, board members should feel comfortable to discuss any issues that may be confidential in nature without revealing information that may afford an observing investor a strategic or tactical advantage over non-observing investors. This situation could give rise to significant conflict of interest issues if the observing investor gains access to negative news about the fund that could prompt the observer to act ahead of other investors in the fund. An additional issue is that legal privilege can also potentially be compromised if an observing investor participates in a meeting where communications from legal counsel to the fund or the manager are involved. In common law jurisdictions, legal privilege protects all communications between a professional legal adviser (a solicitor,



barrister or attorney) and his or her clients from being disclosed without the permission of the client. From an investor perspective, there are also potential challenges. Observer presence could be construed as an affirmation of decisions made by directors. Should investors find themselves in need of remedy via legal action against the fund, they may find their legal remedies weakened, given their involvement on the board and potential influence over board decisions.

The solution

For reasons discussed in this note, affording board observer status may give rise to inequitable treatment of non-observing investors in a fund. Therefore, allowing some investors access to certain information requires balancing the interests of those investors with equitable treatment of all investors. From a hedge fund perspective, an agreement or side letter could be a logical place to formulate the terms of board observer rights and set a range of parameters for an investor with such rights. Confidentiality clauses and minimums on the level of capital invested for the investor to be eligible for observer rights should be included. The governing principle of this agreement would be that the observing investor should act in a fiduciary manner similar to a director. In addition, the observer should commit not to act on information obtained through their status as an observer, similar to rules governing dealing with material non-public information for listed companies. Similarly, consideration should be made to disclosing in offering documents the possibility of a fund entering into observer agreements with strategic investors who meet the commercial requirements (such as minimum investment).

If the challenges of having observer rights outweigh the benefits, a few alternatives could be considered. One option, often seen in the industry, is for the investor to have its own managed account or fund of one, where it can enjoy freedom and access to any information about the fund without limitation. The downside of this solution is that the costs of such a fund might be a drag on return unless the AUM is sufficient as compared to a commingled fund. A second alternative would be to set up an advisory committee for a commingled fund governed by an agreement among the fund, the investment manager and the investor. This type of tri-party agreement would specify the areas of investor involvement and the type and form of information they will be provided with while managing the types of conflict of interest issues that may be associated with investor observer status. This could well be a preferred option if the investor's intention is to offer advice and expertise to the board without being bound by the formalities of board membership.

The future

The hedge funds industry is a dynamic and ever-changing landscape, always ready to present new challenges or opportunities. If you are a board member, brace yourself for more investor activism as investors continue to find ways to protect their capital through the governance process. While there are challenges that investor involvement could bring to boards, there are also benefits as board members will be more in touch with investor needs. If directors are open and transparent, it should become apparent that these types of directors would principally be in strong support of board observer rights. ■