University of Kentucky

Gatton College of Business and Economics

Institute for the Study of Free Enterprise

Hedge Fund Boards and the Market for Independent Directors

- **The majority of directorships are held by extremely busy independent directors**
- **These directors are sought after by funds because they have more reputational capital at stake, making them independent and credible monitors whose presence can certify fund quality to investors**
- **Busy independent directors are more likely to be hired by high quality funds, and their departure from the board is associated with investor withdrawals**
- **Moreover, funds with busy independent directors are less likely to commit fraud, abuse discretionary liquidity restrictions, or engage in performance-based risk shifting**

Hedge funds face limited monitoring from regulators, and their complex investment strategies and opaque disclosures make it hard for their investors to monitor them. Moreover, share restrictions such as lockup periods make it difficult for investors to "vote with their feet" by withdrawing their capital. These characteristics provide fertile ground for agency conflicts to emerge between hedge fund managers and investors. Despite the fact that funds collectively manage over $3.4 trillion dollars in assets (SEC Division of Investment Management, 2015) and several recent studies document hedge fund misbehavior , we know relatively little about how funds are governed so as to assure investors can expect a return on their investment. In this paper, we examine the role that boards of directors play in the governance of hedge funds.

Hedge fund directors have a legal obligation to monitor the fund manager and serve as an advocate for investor rights. However, because directors are appointed by the fund manager, critics raise concerns that directors may simply be "rubber-stamps" that serve nothing more than a perfunctory role in fulfilling regulatory requirements to have a board. This view has gained popularity following a wave of scandals during the recent financial crisis, where several directors were accused of breaching their fiduciary duties to properly monitor funds that engaged in misconduct and fraud.2 Consequently, several media reports questioned the independence and monitoring capability of hedge fund boards.3 Despite this increased media attention, an empirical study of hedge fund boards is notably absent from the literature. This paper is a first step toward filling this gap. To do so, we take advantage of a recent disclosure law that forces hedge funds to electronically report their board membership to the Securities and Exchange Commission (SEC). We use these SEC filings to build a database comprised of 5,400 different directors for 5,126 hedge funds over the period 2009-2013.

We begin by documenting several stylized facts about hedge fund boards. Unlike public corporations and mutual funds, hedge funds face few governance regulations and thus offer an interesting setting to understand how market forces shape board structure. In most cases, a hedge fund's board would be compliant with regulations if it had just two inside directors (i.e., fund owners, employees, or related parties) and no outside directors. If the role of hedge fund boards was simply to comply with regulations, then we would expect to see limited variation in board structure, few outside directors, and significant clustering around regulatory minima. Strikingly, the data plainly contradict this "compliance" hypothesis. We find considerable cross sectional variation in the size and structure of hedge fund boards. In fact, despite the lack of independence requirements, outside directors are more common than inside directors and, though most boards have only three directors, nearly 80% have at least one outside director.

Another interesting pattern emerges when we examine the workloads of these outside directors. Namely, the majority of outside directors sit on relatively few boards, yet the majority of directorships are held by a relatively small yet busy cadre of professional directors, each of whom hold more than twenty directorships at one time. The media point to these busy directors as evidence that hedge fund board governance is perfunctory- such a heavy workload must preclude directors from devoting the time and attention necessary to protect investors. In this paper, we put forth an alternative explanation for the busyness of hedge fund directors based on the concepts of director reputation and certification.

Investor concerns over agency problems and withdrawal restrictions motivate hedge funds to hire credible, independent monitors to help certify their quality and encourage outside investment. However, because fund managers hire them, directors need an external source of credibility in order to help convince investors that they are appropriately monitoring the manager. The labor market should reward higher quality directors with more directorships, and busier directors have more reputational capital to lose if they neglect their fiduciary duties by "rubber-stamping" the decisions of the fund manager. Additionally, directors that work for many different fund advisers are less beholden to any single employer, making them more independent from fund management. Thus, we hypothesize that directors can derive their credibility from the director labor market, meaning that the busyness of a director can serve as a proxy for his quality, reputational capital, and independence from management

To test this theory, we first examine the relation between a director's reputation and his future job prospects. We find that the probability a director is appointed to a new directorship is strongly and positively related to the number of other directorships he holds. Additionally, directors are hired more often if they served on the boards of better performing funds and less often if they served on the board of a failed fund. Collectively, these results are consistent with the theory that funds are attracted to directors that have developed stronger reputations in the director labor market. In contrast, we find several results which are inconsistent with the rubber-stamp theory that funds prefer directors that are too busy to monitor them. Specifically, we find there is diminishing returns to director busyness, suggesting capacity costs are a real concern for directors. Moreover, funds are more likely to hire directors with more fund-specific human capital and lower monitoring costs, indicating funds and directors match in such a way as to mitigate capacity costs.

Another way that hedge fund directors increase their workload capacity is by working for professional directorship firms that employ several directors and a support staff. The majority of directorships are held by affiliates of a directorship firm, and this institutional structure appears unique to the hedge fund directorship market. Firm-affiliated directors have access to shared resources and technologies that create economies of scale and reduce the marginal cost of monitoring each fund. Busier directors are substantially more likely to work for a firm and are also more likely to concurrently serve on the same board with a colleague from the same firm, reducing the joint workloads of both directors. Working for a firm can also convey additional reputational benefits to the director, as he is able to associate with the collective reputation of the firm and its employees (Tirole, 1996). Even when we control for the director's individual reputational capital, directors from directorship firms are more likely to be hired, and this effect is stronger when the firm is more reputable.

We also find evidence of positive assortative matching between high quality directors seeking to enhance and protect their reputation and high quality funds seeking certification from a credible outside monitor. Specifically, busier directors are more likely to join the boards of better performing funds and funds with fewer regulatory violations. Moreover, funds that lose the certification of a reputable independent director experience a 4.7% outflow of capital in the quarter of the director's exit. In contrast, we find no outflow of capital when a non-independent director exits or when the fund is able to replace a departing independent director.

We also find evidence that reputable independent directors are better monitors. Specifically, funds with reputable independent directors are 83% less likely to commit fraud. In addition, funds with reputable independent directors are less likely to abuse discretionary liquidity restrictions (commonly known as side pockets or gates) and engage in performance-based risk shifting. Collectively, our evidence suggests reputable independent directors play an important monitoring role in hedge fund governance.

As the first, large-scale study to examine hedge fund boards and the market for their directors, we contribute to the growing literature which examines the various governance mechanisms hedge funds use to manage agency conflicts.5 For instance, some studies have found a positive association between fund misconduct and the quality of internal controls such as signature processes governing cash transfers, pricing and disclosure practices, and the quality of service providers such as auditors or administrators (Cassar and Gerakos, 2010; Brown, Goetzmann, Liang, and Schwarz, 2012). Because the board is tasked with developing and monitoring internal control processes, understanding board quality is necessary to understanding the source of effective internal controls. Our findings suggest that the quality of a hedge fund's board can be measured by the reputation and independence of the fund's directors.

In addition, our study is related to the corporate board literature debating the costs and benefits of director busyness. Fama and Jensen (1983) contend that higher quality directors will be rewarded by the labor market with more directorships. Consistent with this reasoning, some studies have used the number of directorships held by a director as a positive indicator of his reputation(e.g., Kaplan and Reishus, 1990; Vafeas, 1999; Masulis and Mobbs, 2011; Field, Lowry, and Mkrtchyan, 2013). Our results are more consistent with this bright side view of director busyness.

However, there is also a potential dark side to director busyness. For example, in their theory of venture capitalist (VCs) involvement in their portfolio companies Kanniainen and Keuschnigg (2003) argue that because it is costly for venture capitalists (VCs) to provide advice to to their portfolio firms, there is an optimal level of busyness, and VCs that become stretched too thin can actually destroy firm value. Supporting this view, Cumming (2006) finds that VCs tend to have smaller portfolios when their portfolio companies require more intensive involvement by the VC. Moreover, Cumming and Walz (2010) find that busy VC managers tend to have worse performance. There is also evidence of a dark side to busyness for public corporations. Fich and Shivdasani (2006) find that firms with a high proportion of busy directors are associated with weak corporate governance and poor firm performance, and Yermack (2004) finds that the labor market is less likely to reward busier directors with additional directorships.

The discrepancies between the findings in our study and studies revealing a dark side to director busyness could be due to the fact that the latter studies focus on directorships for typical industrial corporations, which require high firm-specific workloads that dramatically lower a director's capacity to effectively manage multiple board positions. This makes a corporate director's busyness a poor proxy of his quality, because we do not observe the seats directors could obtain in the absence of these constraints (e.g., if they had more free time or could specialize in closely related firms). In contrast to industrial corporations, hedge funds are relatively homogenous, and the duties of their directors are relatively focused and standardized. These factors dramatically reduce the required time investment and increase the scalability of the director's human capital such that it can be employed efficiently across many funds.