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RESEARCH SUMMARY

Hedge Fund Boards and the Market for Independent Directors

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Hedge funds collectively manage over $3.4 trillion dollars in assets for their investors, typically wealthy individuals or large institutions such as pension funds and university endowments. Media scrutiny of hedge funds—and their historically lax government regulation—has increased following recent scandals. So, why do their investors feel confident that their money is in good hands?

Clifford, Ellis, and Gerken demonstrate that hedge fund managers face market incentives to hire credible, independent board directors that will effectively monitor their funds. And, investors use the reputation of these directors to certify the quality of the hedge fund or they withdraw their money. It seems to be working. Hedge funds with reputable, independent directors are far less likely to commit fraud or partake in other "bad" behavior.

Why does it work?

- Directors use their reputation to get more work (directorships).
- These busier directors' reputations and careers are at stake if they neglect their fiduciary duties by "rubber-stamping" the fund managers' decisions.
- Directors that work for many different funds are less beholden to any single employer, and therefore act independently from fund management.
- Directors seek jobs at high quality funds and funds seek to hire high quality directors (creating assortative matching similar to the market for marriages).

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BACKGROUND

Hedge funds are private investment vehicles that face less regulation than most investment companies. In most cases, the hedge fund complies with government regulations for board structure if the board has two inside directors (i.e., fund owners, employees, or related parties) and no outside directors.

A hedge fund board of directors has a legal obligation to monitor the fund and the manager's decisions. They serve as an advocate for investor rights. However, because the fund manager appoints the directors, critics are concerned that directors simply "rubber-stamp" the manager's decisions.

This paper examines the role that boards and their directors play in the governance of hedge funds. Despite increased media attention questioning the independence and monitoring capability of hedge fund boards, this is the first empirical study of its kind.

A recent disclosure law forces hedge funds to electronically report their board membership to the Securities and Exchange Commission. The authors use filings from 2009 through 2013 to build a database comprised of 5,400 different directors for 5,126 hedge funds.

FINDINGS

Hedge fund managers voluntarily choose outside directors (those with no other connection to the fund) to certify their fund and monitor them—80 percent of boards have at least one outside director. Directors rely on the success of the funds whose board they have served on to build a positive reputation. A director relies on this reputation and credibility to get more directorships.

A relatively small set of professional directors hold a majority of hedge fund directorships—each sitting on more than 20 boards at once. These busier directors tend to work for professional directorship firms that employ several directors and a support staff. Directorship firms also rely on reputation to grow their business.

Investors rely on the director's reputation to certify the hedge fund quality. In fact, when a reputable director leaves a fund, investors withdraw from the fund—creating, on average, a 4.7 percent outflow of capital in that quarter.

A director's reputation is a good signal. Successful directors work for funds with fewer regulatory violations and that perform better. Hedge funds with reputable independent directors are 83 percent less likely to commit fraud, abuse discretionary liquidity restrictions, and shift risk to improve relative performance.