AUDIT COMMITTEES FOR ALTERNATIVE INVESTMENT FUNDS: ALL STAKEHOLDERS WIN

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Corporate governance is vitally important to both public company shareholders and mutual fund investors alike. The audit process is a cornerstone to that governance process and the comfort added by audit committees is valued by all stakeholders; investors, management, administrators, regulators and auditors. Perhaps the time has come for alternative investment funds to embrace the concept of audit committees?

Could this be an opportunity for alternative investment managers to differentiate themselves with potential institutional investors? An audit committee could provide CFOs with an effective resource to ensure audit efficiency. For auditors it provides an independent party to ensure commitments and deadlines are met, not just by the audit firm but also by the client and thus reducing the likelihood of significant unbillable cost overruns. If independent audit committees had been in place for investment management frauds such as Madoff, Weavering and Bayou, investors would have benefitted from a very different outcome. In short, all stakeholders would benefit from this evolutionary change in the alternative investment industry and what makes it such a no-brainer is that the marginal cost to those stakeholders is negligible and in some cases negative. It's a classic win-win.

Shouldn't alternative investment fund investors and other stakeholders gain the same benefits and comforts enjoyed by mutual fund investors?

THE CONTINUING EVOLUTION OF FUND GOVERNANCE

Fund governance has been an evolving element of the global alternative investment management industry. The importance of fund governance increased dramatically after Madoff and other investment management scandals.

In the UK, corporate governance is engrained into the business culture including alternative investment funds. Investors are demanding of engaged and experienced governance professionals adding value and representing the best interests of investors. In the U.S. it is our observation that, the acceptance of enhanced governance is increasing dramatically as institutional investors now make up the majority of capital. These necessarily demanding investors see independent governance as a priority. Independent fund governance, whether in a partnership or corporate structure, is now best practice in the eyes of these large allocators.

In the US mutual fund industry there has been a clearer evolution. Today mutual fund boards and trustees have clear mandates from which regulators and investors take great value. Not long ago mutual fund boards were composed of largely non-independent members. Between 1996 and 2012, the number of complexes reporting that independent directors hold 75 percent or more of board seats rose from 46 percent to 85 percent. Today the vast majority of these governance bodies are independent and with an independent chairman. Investors and regulators take great interest in board compositions.

If mutual fund audit committees are seen to add comfort to investors, why is the concept not relevant to alternative investment fund investors?

Mutual Fund Audit Committees

In the mutual fund and public company worlds, audit committees represent an important and valued function for investors and other stakeholders. Expectations of these audit committees and their importance is increasing. Audit committees are under increasing scrutiny and the quality of financial reports is seen to be at stake. Uniquely in investment funds, the fund determines the price at which investors buy and sell their mutual fund shares, the net asset value or NAV. Mistakes, deliberate or inadvertent, cause some investors to lose money and opens the gates to expensive lawsuits and substantial damages.

We ask, "If audit committees are seen to add comfort to investors as to the above concerns, why is the concept not relevant to alternative investment fund investors?" More specifically, "Why doesn't that concept resonate with institutional investors who insist on effective independent oversight and governance in their stock and mutual fund holdings?"

Numerous mutual fund regulatory and professional bodies are vitally interested in mutual fund audit committee structure and procedures. The SEC, the Investment Companies Institute, the New York, American and NASD Stock Exchanges all constantly emphasize the responsibility of audit committees and have numerous requirements which continue to evolve. "Best practices" have been established for audit committees which include having a written charter to spell out its duties and powers and a recommendation that the committee be made up of individuals who are "financially literate".

The SEC has a very strong preference that at least one member of the audit committee should be a "financial expert". A "financial expert" is defined as a person who has the following attributes: (i) an understanding of generally accepted accounting principles and financial statements; (ii) the ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (iii) experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities; (iv) an understanding of internal controls and procedures for financial reporting; and (v) an understanding of audit committee functions.

The responsibilities of audit committees to mutual funds range from overseeing the integrity of the financial statements to assessing the quality of the audits performed. In perhaps typical fashion, there are ongoing attempts underway in the U.S. to develop detailed guidance and checklists to provide audit committees with a fail-safe roadmap upon which to fulfil their responsibilities and form their conclusions. Some fear that professional judgement, the most valued skills these individuals have to offer, is getting lost in the process.

AUDIT COMMITTEES FOR ALTERNATIVE INVESTMENT FUNDS

Any application of the audit committee to the alternative investment space must not, in the opinion of the authors, become checklist driven. A mandate should be established by the board in consultation with the investment manager to ensure the audit committee function will meet investor needs and expectations.

Key responsibilities of an alternative investment fund audit committee would be driven by the mandate developed. If drafted effectively, the audit committee mandate will aid CFO's and auditors and provide value to regulators. There is considerable flexibility as the detail of the audit committee mandate but we would expect to see the responsibilities include:

- Overseeing the audit – the committee would review the audit planning process and key deadlines to ensure completion meets investor and regulatory deadlines.
- Overseeing financial reporting and monitoring controls around financial reporting – the committee would work with auditors to ensure proper controls are in place and working effectively.
- Maintaining integrity of a fund's financial statements – this a broad responsibility but would be a key conclusion of the audit committee to the board as a whole and to investors.
- Provide compliance and risk management oversight which would include ensuring that auditors have fulfilled their obligations under applicable laws and regulations.
- Managing the interaction of the investment manager and independent auditor – the committee would ensure the audits are running efficiently and that agreed-upon timelines and commitments are being met by both auditors and the management. This could save the CFO and/or COO precious time around year end, save the fund audit fees for extra charges and, for audit firms, eliminate large cost overruns which are rarely passed onto their client in full.
- Understanding overall valuation work and oversee valuation of Level 3 assets.
- Oversee accounting for, and disclosure of, side letter agreements.
- Assess correspondence from the auditors including the audit engagement Communications to Those Charges with Governance. Any concerns or issues communicated by the auditors would be addressed.
- Where applicable, ensure the Cayman auditor signoff process is well planned with agreed-upon deadlines being met.
- Assessing auditor independence – this would include a review of other services provided to the fund and the investment manager by the audit firm to ensure independence is not tainted. This

is not currently being done in the alternative space and would provide considerable value to investors as it does in the mutual fund space.

- As in the mutual fund world, the audit committee could make objective decisions, or assist with decisions, on auditor selection, retention and compensation. If done correctly and with the right committee members, management would benefit from the experience of the committee. Investors would gain assurance that the auditor selection process has been done objectively and with oversight by an independent party and that the selection is based on more than the cheapest fee quote as that is not always in the best interest of investors.

The audit committee mandates can be very flexible but the overall objective is to protect investor interests without introducing unnecessary bureaucracy. An effective mandate will ensure that the very critical audit process is independent and that a quality audit is conducted. For investment managers with audit committees they can stress the value to investors this provides when meeting with potential investors and operational due diligence teams –a differentiating factor from competitors.

If drafted effectively, the audit committee mandate will aid CFO's and auditors and provide value to regulators.

AUDIT COMMITTEE COMPOSITION AND LEADERSHIP

For larger boards and/or boards that govern a large group of many smaller entities, we believe the creation of an audit committee would a relatively easy addition. Larger boards typically have individuals with diverse skill sets and the creation of an audit committee of two or three independent individuals with knowledge of financial reporting would be most likely possible. For this committee to be effective in the eyes of investors it must be comprised of only independent directors. Clearly best practice is to have at least one "financial expert" on the committee, which we discuss further below.

The most obvious option is to simply add one board member to an existing board who has the required "financial expert" experience. Assuming investors and the investment advisor are satisfied with the existing board members, adding an individual with the right audit committee leadership skills achieves an effective audit oversight function for the fund with little disruption.

The concept of the audit committee or audit oversight is not however only applicable to large funds and complex groups. The concept can be applied to smaller boards and for standalone funds who typically have a board of two independent directors and one representative from the investment manager. These growing smaller funds are trying to appeal to institutional investors who will find the audit committee/oversight concept appealing. These smaller boards do not need a radical overhaul to reap the benefits of audit oversight. They could simply add one new board member who has "financial expert" skills. That individual would take on the audit oversight function and report back to the board.

CHALLENGES

As previously discussed, there is a concern among stakeholders in the mutual fund world that the audit committee is moving towards a checklist mentality and a lack of professional judgement. If you have the right professionals on the audit committee you need to benefit from their insights and judgement. Given the flexibility of the alternative investment world, the risk is low that the function degenerates into a painful exercise for CFO's and the auditors and, worst of all, adds no value to investors. The committee must to be allowed to have the flexibility to use their accumulated experience to maximise audit committee effectiveness.

As this concept gains acceptance in the alternative investment industry there may be a challenge finding enough individuals to fulfil the critical "financial expert" role. That person must chair the committee, or take on the function solely, and report to the main board. There are few professionals in the existing database of offshore directors that would possess these skills although there are new entrants entering the marketplace constantly. Without the proper leadership the audit committee concept will lose credibility.

Investment managers will achieve a level of governance that exceeds current best practices and that will appeal to potential large allocators.

Finally, there is an additional cost to be incurred to gain the benefits of audit oversight. The responsibilities of the audit committee are significant and investor expectations are rightly high. If working correctly, this committee is a winner for all stakeholders. An effective audit committee will, among other benefits, give investors addition comfort that is currently absent, satisfy regulators, aid CFO's during the audit process and in evaluating auditor performance. It will also potentially save audit overrun charges. Investment managers will achieve a level of governance that exceeds current best practices which will appeal to potential large allocators. If the committee is effective the benefits will far outweigh the costs.

If organized properly and working correctly, the audit committee is a winner for all stakeholders.

CONCLUSION

Audit committees are a prominent and important component of corporate governance in both the public company and the mutual fund world. The benefits are recognized and valued by all parties including investors, auditors, regulators and management. Shouldn't alternative investment fund investors and other stakeholders gain the same benefits and comfort?

In the alternative investment fund industry, effective fund governance is an increasingly important topic. Its importance has become very prominent with institutional investors whom now makeup the majority of invested capital in the industry. Best practices for fund governance now includes:

- Independent professionals comprising the majority of the board
- Diverse and complimentary skills sets among directors
- Experienced and active professionals filling governance positions
- Split boards with professionals from different governance services companies
- Recognition that the cheapest director is not necessarily the best choice for investors and the fund.

In a publication from the operational due diligence firm Castle Hall Alternative's titled *Redefining Corporate Governance; Towards a New Framework for Hedge Fund Directors*, they comment – "Finally, once a "best practice" board has been created, the bigger question is what happens next — what should the directors actually do? There is clearly little point adding more experience and capability to a board, if all key decisions impacting the structure and operation of the fund remain wholly vested with the manager." The material goes on to examine some of the areas where boards could and should become more active, including negotiating the PPM and mandating that administrators and other service providers perform more robust procedures.

Recognising that the audit process is a cornerstone of fund governance, we propose that a logical extension of board responsibility and one which will undoubtedly provide more effective governance; the creation of an audit committee.

To compete for institutional investor allocations, investment managers need, at the very least, to meet governance best practices. Meeting these best practices is mandatory just to be considered by these necessarily demanding investors. By exceeding these best practices through the early adoption of the audit committee could an investment manager create a competitive advantage? It would certainly provide potential investors with additional comfort and put a manager ahead of the curve in satisfying tough questions from these highly valued investors.

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