Focus on due diligence raises new challenges

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Created *10/12/2009 - 14:22*

Due diligence has been thrust to the forefront of the alternative investment industry in the wake of the Madoff scandal and the Lehman Brothers collapse. All participants in the investment arena now perform greater due diligence on their partners, counterparties, suppliers and clients, and this has significant implications for independent non-executive directors.
One of their key roles is to help funds meet rising investor standards and withstand greater scrutiny. At the same time, all independent directors should be performing their own due diligence on the funds on whose boards they are invited to sit.

Andrew Edgington, of ICG Management Limited, which provides independent non-executive directors to funds, says: “We have to be as comfortable with the structure as the investors.” Potential concerns may centre on the exposures run by the manager, compliance and risk controls, the experience of the investment team, the capabilities of the service providers – including onshore and offshore counsel and the administrator.

As far as raising standards for funds to withstand third-party scrutiny, one of the key roles of the independent director is to monitor service providers to the fund and provide constructive input and challenge to issues and proposals. Says Edgington: “Our model is to encourage regular board meetings, push for regular reports from the investment manager and to receive ongoing feedback from the administrator. We also seek to ensure that there is an agreed valuation framework in place so that issues with valuation and pricing policies, for instance, can be clearly identified and resolved in an expedient manner or avoided altogether.

Many experienced independent directors have shown their mettle over the past year, working with managers and lawyers to help resolve the myriad problems that have arisen. “An individual client can get the benefit of the collective experience of our team of directors and how we have resolved the issues of other funds in similar circumstances,” Edgington says.
And the ability and experience of independent directors is now regarded as a crucial factor as the industry starts to grow again and new funds are launched. The independent director who has overseen the creation of a number of different funds over a long timeframe can instinctively recognise potential pitfalls in the fund documents and can act as an interface with lawyers. “We work with counsel so the new offering document is as robust as possible,” Edgington says. “Lawyers will tell you a lot of problems can be avoided if the documents are well constructed in the first place. The documents of many existing funds can be five to ten years old and the language often does not have the flexibility that is standard in new funds today.”

With the greater level of investor due diligence being performed, independent directors are being questioned on the number of directorships held and their other activities. “In order to ensure the delivery of robust service levels, we need to be able to respond promptly, personally and in detail to issues that may arise,” Edgington says. “Even though the position is non-executive and does not require daily attendance to the affairs of the fund, when I’m on a board I need to be available at all times, even while on holiday.”

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