

## Safeguarding Investor Interests

The landscape for private capital investment management has changed dramatically over the last two years. Faith in established relationships and structures has declined significantly and investors are now questioning how much reliance to place on institutional asset managers and managers in the alternative space.

High profile scandals in the asset management sector have led many family offices, private capital investors and professional trustees to reassess their whole approach to the financial markets and their investment activities.

Those investors who have had material exposure to hedge funds have also endured a painful time as a result of the financial downturn. It has brought home to many of them that they did not fully appreciate certain of the liquidity management features embedded in many third party managed funds. The imposition of redemption gates, dealing suspensions and redemption deferrals had the effect of locking investors in and leaving them little control over these investment positions once the market started to seize up and decline. Hard to value and illiquid assets were also hived off to side pocket vehicles leaving investors with disjointed investment holdings whose values and liquidity profiles were opaque and uncertain.

It is little wonder that investors have started to question whether the funds they have invested in and their managers were sufficiently aligned with investor interests. The result has been a movement towards bespoke asset management solutions and a much more hands on approach by private capital investors to the investment process.

Three key areas can be identified where family offices, private capital investors and professional trustees are now focusing greater effort and using professional advisers and consultants to vet and structure investment terms to safeguard investor interests.

- **Parameters and Controls on Managers**

The key governance issue is focused on seeking to align the interests of investors with investment managers and identify in advance the conflict of interest areas that may arise from the investment manager's other activities and relationships. A much greater amount of time is now being devoted to analysis of performance fee structures and carried interest arrangements to ensure fee structures strike the right balance between investors and the investment manager. The operation of high watermark provisions are now picked over carefully as are hurdle arrangements and manager catch-up provisions. The terms on which manager commitment is made alongside investors provides important assurance. Careful reviews of proposed investment structures and investment funds are now followed to understand the valuation methodology that will be applied, whether manager override discretions will exist to adjust portfolio valuations, how liquidity requirements for open-ended funds will be managed, what key man provisions should apply in relation to the investment manager and what termination rights will exist over the investment manager's appointment.

- **Transparency and Accountability**

Investors are also focused more on the adequacy of the information flow to them from underlying funds and managers in terms of audited data and other periodic statements. A key aspect of accountability is to ensure that approvals to all material changes to an investment mandate or fund structure are reserved to investors and that investors **do** have voting rights attached to their interest in fund investments and are not disenfranchised by the issue to them of non-voting securities as has often been the case with fund structures domiciled in the Caribbean.

- **Investor Representation and Intervention Rights**

Linked to accountability is the need to ensure effective investor representation and relations with the investment manager which is often achieved through participation in investor committees. Greater coordination between investors participating in the same investment fund or project is necessary to ensure their membership rights on investor committees are exercised to full effect. Investors committees are intended to enable investors to hold the manager to account. It is vital for investors to chair and manage investor committee proceedings and not allow the manager to control the dialogue. More focus on negotiating step-in rights for investors is essential if performance deteriorates below agreed levels or other trigger events occur. In these circumstances investors need to reserve the right to become more actively involved either by appointing investor representatives directly to a fund board or by suspending all or part of the investment manager's mandate or ultimately having the right to direct termination of the investment manager engagement.

The upshot is a much greater degree of active involvement by family offices, private capital investors and professional trustees using professional advisers and consultants to negotiate investor requirements with a proposed investment manager. Greater coordination and planning of investment participation gives private capital investors a better appreciation of the issues and risk associated with the project and ensures they are better placed with intervention and step-in rights to protect their financial interests in the event that key performance indicators disclose that managers are not meeting their targets.

For further information or advice please use the contact details below.