

IN FOCUS

Providing industry insight into market trends, best practices & service solutions.

A GUIDE TO HEDGE FUND INVESTOR DUE DILIGENCE

Helping Managers Understand the Evolving Financial Landscape

"We have seen a dramatic increase in the number of investor due diligence inquiries and site visits, especially from institutional investors."

*Christine Waldron, Senior Vice President
Alternative Investment Administration
U.S. Bancorp Fund Services, LLC*

The volatility in the market has brought investment practices into the limelight and caused increased requirements by the OCC, SEC, FDIC, and FINRA for heightened transparency, risk management, and compliance. With due diligence sharpened around investment processes and services, investors expect managers to rise above market fluctuations, adapt, and evolve their processes to ensure they are adjusting to regulatory changes and challenges. As investors, particularly institutional investors, begin conducting formal due diligence assessments of administration operations prior to placing assets with funds, management companies must augment their purely asset management focus with comprehensive compliance programs and be aware of all red flags including perceived conflict of internal administration services, valuation conflicts of interest, or affiliated prime brokerage arrangements. Any single area of perceived administration risk can create enough concern to drive investors to different managers. In an economic environment that encourages increased regulations, leaner business practices, and requires faster and more sophisticated technology, managers must take into account the entirety of their hedge fund administration and develop an infrastructure to anticipate and prepare for investor due diligence.

MANAGER PREPAREDNESS FOR INVESTOR DUE DILIGENCE

Investors contemplating significant commitments will often require an on-site due diligence tour of potential managers' operations to cover the following administration risk assessment categories:

- » Service Structure
- » Administration Firm Information
- » Talent and Staffing Resources
- » Technology Environment
- » Valuation Procedures and Controls
- » Compliance Procedures and Controls
- » Investor Servicing Procedures and Controls

It is vital for managers to treat investor due diligence processes as they would external audits, business risk assessments, or procurement processes. By taking the time to fully understand each individual investor's requirements, managers can prepare information and responses in advance of formal onsite due diligence and demonstrate full transparency of operations, procedures, and the control environment. Your proactive response highlights your commitment to the investor by taking into consideration the nature and depth of information they require and becomes an opportunity to strengthen the relationship and engender investor education and loyalty.

"The hedge fund industry is on the verge of unprecedented regulatory change. Manager and portfolio transparency, registration and increased reporting will require enhanced operational procedures to demonstrate a commitment to protect investor assets."

*George J. Mazin, Partner
Dechert, LLP*

SERVICE STRUCTURE - WHO PROVIDES WHAT SERVICE?

The initial key questions and concerns raised by investors relate to the segregation of investment and administration duties for hedge funds. Investors require detailed information regarding the firm's fund valuation, compliance, prime broker, custody, investor reporting, legal, and audit functions. Some investors have even gone as far as electing to invest only in hedge funds that utilize an independent third party administrator and non-affiliated prime broker. Although internal administration will not necessarily create a conflict of interest, investors now require more information prior to investing in order to gain comfort with a manager's affiliated administration arrangement in light of recent examples of manager fraud. Investors are not only challenging the manager's selection of hedge fund administration support, but also the choice of a qualified independent audit firm, security valuation sources, prime broker and custodian arrangements.

"An \$18 billion client selected our services based upon their institutional investor's due diligence assessment of our services – proof that the back office is critical to growing assets."

*Joe Neuberger, Executive Vice President
U.S. Bancorp Fund Services, LLC*

ADMINISTRATION FIRM INFORMATION

Investors require ownership and financial information to determine the administrator's financial soundness and stability, and to identify potential conflicts of internal or third party administrators. Administrators will be requested to provide a description of each service offered, as well as the geographic location of affiliate service offices and associated staff size. A description of the administrator's client base including client concentration, asset concentration, portfolios, and number of investors, will speak to the diversity of the business and the breadth and complexity of investment styles supported. Investors also require a complete description of the service model and how they will be supported by the manager or administrator for different types of investor inquiries. Managers are required to provide information concerning the administrator's insurance coverage, NAV service quality performance, subscription and redemption processing errors, complaint files as well as compliance and audit exceptions.

DUE DILIGENCE TOPICS:

- » Firm history, ownership
- » Organization structure
- » Company financials
- » Services offered
- » Client base
- » Service performance & Quality Reporting
- » Insurance coverage
- » Litigation

TALENT AND STAFFING RESOURCES

The administrator's talent and expertise is the most important element of due diligence responses. The investor requires comfort that the management team and senior administration talent possess the vision, authority, skills and accountability to the fund and investors in order to fulfill the role of independent compliance oversight of the manager.

Investors will complete a thorough assessment of the administrator's investment securities talent, including industry and specific product service tenure, certifications, and biographies. Responses should focus on the specific product requirements related to the investor's fund selection with respect to staff sourcing, efficiency, and the administrator's capacity. Investors require information concerning the training and development of administration staff, especially concerning the accounting for complex investment instruments such as fixed income derivatives.

"The complexities of due diligence require hedge fund investors to work closely with well capitalized third parties who can provide detailed analysis regarding custodial risk, performance attribution, risk analysis and market exposure."

*Steve Vermut, Managing Partner
Merlin Securities*

DUE DILIGENCE TOPICS:

- » Management team
- » Turnover
- » Training programs
- » Education
- » Expertise regarding specific strategies
- » Staff levels – accounting, compliance, tax, legal
- » Internal audit staff

TECHNOLOGY ENVIRONMENT

DUE DILIGENCE TOPICS:

- › Data security
- › Portfolio accounting
- › Investor accounting
- › Tax reporting software
- › Customer service software
- › Reconciliation software
- › Data feeds – pricing, rate and corporate action data
- › Disaster recovery

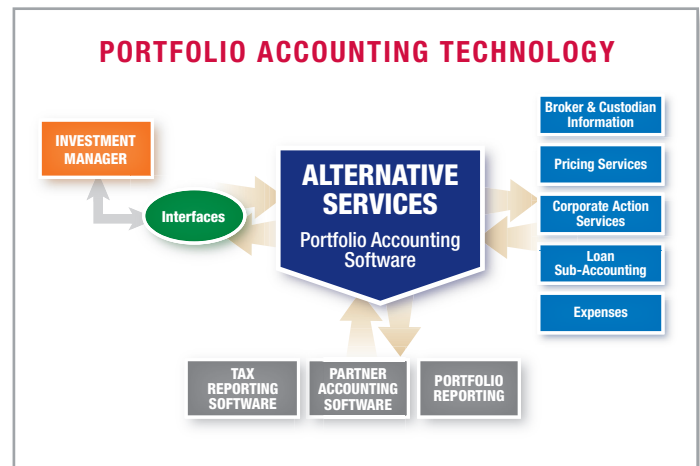
Managers are required to demonstrate the efficiency and stability of their technology environment, allowing the investor to assess the business risks associated with accuracy, timeliness, change management, or technology failure. Investors' interest in the manager's administration technology considers the software application features to automatically perform processing such as incentive fee calculations and tax allocations. Managers' responses should focus on the breadth of the fund accounting and investor accounting systems in addition to the administrator's formal contingency plan preparedness.

"Pending hedge fund industry reform may require managers to enhance their policies and procedures, including documentation, testing and audit support with respect to the entire investment and administration control environment."

*Chris Bellamy, CPA, Partner
Cohen Fund Audit Services, Ltd.*

Investors require a description of both physical and system data security access controls to satisfy confidentiality and control procedures regarding access to investor and portfolio cash. If managers deliver investor statements electronically or provide investors access to documents through a Web portal, they will want to also include a detailed description of the application's security access, password administration, and confidentiality measures.

Managers should expect due diligence to focus on technology automation and the efficiency of the administrator including data integration between the portfolio accounting system, partner accounting software, tax reporting, investor reporting tools, security pricing, corporate actions, rate, and sub-accounting systems. (See included charts). Investors will request the administrator to identify any functions performed "off-line" or manually, in order to understand accuracy and operational risks. By also describing all internal and external technical support staff and resources available, managers will give their investors confidence in the support and enhancement of their various technology applications.



VALUATION PROCEDURES AND CONTROLS

DUE DILIGENCE TOPICS:

- › Data security
- › Security pricing sources
- › Independent verification
- › Valuation procedures
- › Valuation deadlines

Investors require significant detail concerning NAV calculation procedures including the source of valuation data, verification process, controls, and deadlines. Due to recent scandals, investors are extremely sensitive to the involvement of managers in the calculation and dissemination of the fund and investor asset valuations. Investors will gain comfort in the valuation process to the extent the manager can demonstrate independence in the calculation of the fund's NAV.

Investors also focus on the source of NAV data including security prices, corporate actions, and rate information used in fund valuations. The pricing of illiquid or complex derivative instruments generates heightened investor scrutiny to assess whether managers determined these values or obtained independent counterparty issuer/dealer valuations. Investors will also request valuation policies and procedures approved by the fund's independent auditor and assess whether the annual audit includes an independent testing and verification of fund valuations. Valuation deadlines are important for investors to understand NAV process efficiency, service standards, and historic ability to meet those deadlines. Managers' experience in consistently delivering accurate NAVs within 1-3 days of a period-end provides investors with insight into the talent and efficiency of their administration.

COMPLIANCE PROCEDURES AND CONTROLS

DUE DILIGENCE TOPICS:

- › SAS 70 or similar external report of controls
- › Regulatory audits, results
- › Procedure manuals
- › Reconciliation process
- › Disaster recovery test results
- › Audit exceptions

Never before have fund compliance procedures and controls been so important to the hedge fund industry. Investors require written compliance procedures, adherence to procedures, and details on whether compliance testing is automated or manual. Investors are looking for formal compliance programs that include an identified AML officer, chief compliance officer, and risk officer. Managers will be requested to provide a SAS70 or similar document demonstrating independent review of the control environment. Additional compliance testing inquiries will focus on investment restrictions, offering document compliance checks, leverage restrictions, frequency of testing investment restrictions, issuer concentration, diversification tests, and the reporting and review of compliance testing by management of the administrator.

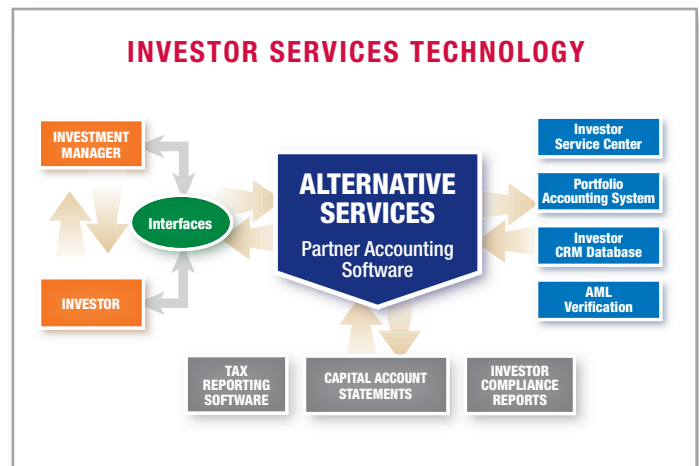
INVESTOR SERVICING PROCEDURES AND CONTROLS

DUE DILIGENCE TOPICS:

- › AML process
- › Investor reporting
- › Cash processing
- › Payment processing

Investor due diligence involves a review of all policies and procedures related to investor accounting and reporting including AML compliance, subscriptions, redemptions,

payment processing, and investor capital account reporting. Investors will carefully assess the handling of all investor cash, procedures for review and approval of all subscriptions and disbursements, and internal and external secondary authorizations. Investors will require information concerning managers' ability to accurately perform the accounting and processing of investor allocations, management and incentive fee calculations, hot issues and side pocket allocations, tax estimates, and investor statements. As in any experienced audit, the investor is looking for segregation of duties for these functions as well as a review and approval process. Descriptions of accurate and timely investor reporting is paramount in the due diligence process in order to gain investors' confidence in the transparency of information concerning their investment.



CONCLUSION

The hedge fund industry is driving investors to perform risk assessments of hedge fund administration support. By looking at investor due diligence as an opportunity to showcase operations, and by being prepared for detailed questions, hedge fund managers can demonstrate transparency, create investor confidence in their investment practices and administration, and secure assets.



ABOUT THE AUTHOR

Bob Kern - As an Executive Vice President for U.S. Bancorp Fund Services, LLC, Mr. Kern serves as Director of Business Development. With over 28 years of industry experience, Mr. Kern works with investment management firms to customize mutual fund and alternative product service solutions.

Headquartered in Milwaukee since 1969, U.S. Bancorp Fund Services, LLC currently provides services to more than 270 fund families, with over 1,600 portfolios and over 1,800 fund classes and administers 3.5 million shareholder accounts with \$583 billion in client assets. U.S. Bancorp Fund Services' clients include mutual funds, investment partnerships, hedge funds, separately managed accounts, fund-of-funds, and offshore funds. It is a subsidiary of U.S. Bancorp, the sixth largest bank in the United States with assets of \$281 billion, NOTED IN THE 2009 FOURTH QUARTER CORPORATE PROFILE.

© 2009 U.S. Bancorp Fund Services, LLC. All rights reserved.