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Operational Risk

Top Ten Operational Risks Facing Hedge Fund Managers and What to Do about Them (Part Three of Three)

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By Jamie Sklar, *Hedge Fund Law Report*

The failure by a hedge fund manager to appropriately plan for, detect and address operational risks can lead to economic and other costs (e.g., the loss of valuable business or investor information and data) and reputational harm. Yet the challenges associated with a quickly evolving hedge fund industry, the proliferation of operational risks and resource and personnel constraints make it difficult for hedge fund managers to identify and effectively address operational risks. A recent guide published by SEI, entitled "Top 10 Operational Risks: A Survival Guide for Investment Management Firms" (Guide), speaks directly to the lacuna in best practices in this area. The Guide identifies some of the recurring operational risks in the hedge fund industry and offers practicable ideas for handling such risks.

This is the third and final installment in a three part HFLR series summarizing the key takeaways from the Guide. The first installment discussed a hedge fund manager's attitude and approach towards operational risk; the need for effective oversight of firm functions; and the imperative of appropriate training and staffing to minimize operational risks. See "Top Ten Operational Risks Facing Hedge fund managers and What to Do about Them (Part One of Three)," Hedge Fund Law Report, Vol. 5, No. 40 (Oct. 18, 2012). The second installment addressed information hand-offs; pitfalls in automating processes; and workflow documentation. See "Top Ten Operational Risks Facing Hedge Fund Managers and What to Do about Them (Part Two of Three)," Hedge Fund Law Report, Vol. 5, No. 42 (Nov. 9, 2012). This installment discusses segregation of duties; reconciliation gaps; care in entering into agreements; and planning within the rapidly evolving regulatory and competitive landscape of the hedge fund industry.

Risk Area #7: Amalgamated Assignments; Improper Segregation of Duties

This section of the Guide focuses on instituting controls through deliberate segregation of employee duties. Such segregation may make sense because, among other things, it is the best method to manage potential and actual conflicts of interest and to avoid fraud. The Guide acknowledges that such segregation may be difficult in smaller, newer firms with fewer employees who must handle multiple functions. See "Benefits, Challenges and Recommendations for Persons Simultaneously Serving as General Counsel and Chief Compliance Officer of a Hedge Fund Manager," Hedge Fund Law Report, Vol. 5, No. 19 (May 10, 2012). The Guide also

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acknowledges that segregation has become more difficult for better-established firms that have reduced their headcount during the financial crisis and are simultaneously dealing with more investment products and portfolio transactions. The Guide recommends that managers consider an operational review to assess whether necessary segregation of functions has been accomplished. Where the firm is not able to effectively wall off duties due to insufficient staff levels or structures, it should consider outsourcing certain functions in the interest of reducing operational risk. See "Aite Group Report Maps Outsourcing Landscape for Hedge Fund Managers, Including Outsourced Services Offered, Trends, Goals, Drawbacks and Provider Profiles," Hedge Fund Law Report, Vol. 5, No. 43 (Nov. 15, 2012).

Segregation of duties can be achieved by instituting certain internal controls to avoid conflicts and potential fraud. Important controls include prohibiting portfolio managers or traders from pricing their own portfolios or being involved in trade settlement or reconciliation; keeping clear lines of demarcation between trade support staff and reconciliation staff; and keeping clear lines of demarcation between performance measurement teams and sales/marketing teams. Another important control mandates that counterparties send trade confirmations directly to operations personnel (copying traders if desired) instead of having them first pass through the trading desk.

Fund Assets and Firm Assets

Managers should clearly delineate responsibilities with respect to the handling of firm assets and accounts versus fund assets and accounts. This is a matter that should be considered, for example, when the question arises as who should have authority to approve a fund's outgoing wire transfers. For separate accounts, the Guide recommends that the investment manager avoid exercising any authority to initiate an outgoing wire transfer on behalf of a managed account client. The Guide notes that if the manager did exercise such authority, it would be considered to have constructive custody of client assets, which would have to be disclosed in the manager's Form ADV. In the case of a fund, the Guide suggests that the wire transfers be approved by at least two persons, including, where practicable, an employee from the internal operations team at a manager and a representative of the fund's administrator. Members of the investment team or employees involved in reconciliation should never be involved in wire transfers. The Guide further recommends that there should be limitations on the accounts to which funds can be wired (e.g., only from the custodian to the fund administrator) and that procedures be implemented to provide for a check on the amounts to be wired and the accounts to which funds are sent. See "Ten Steps That Hedge Fund Managers Can Take to Avoid Improper Transfers among Funds and Accounts," Hedge Fund Law Report, Vol. 4, No. 13 (Apr. 21, 2011).

Fund Records and Firm Records

Many of a hedge fund's books and records are typically maintained by custodians, auditors and fund administrators. Nonetheless, since the manager is responsible for maintaining books and records relating to client accounts, the Guide recommends that managers consider some degree of shadow accounting. See "Ernst & Young's Arthur Tully Talks in Depth with Hedge Fund Law Report About Hedge Fund Governance, Succession Planning, Valuation, Form PF and Administrator Shadowing," Hedge Fund Law Report, Vol. 5, No. 11 (Mar. 16, 2012). Shadow accounting involves the maintenance by the investment manager of its own separate set of books and records and the periodically reconciliation of these records with the records of the funds' custodians, accountants and administrators. The extent to which shadow accounting is warranted would depend partially on how data for operations functions and recordkeeping is sourced. The Guide provides that while "fund accounting calculations can leverage middle-office

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portfolio accounting data, to do so properly, care must be taken to ensure portfolio accounting information is appropriately sourced. For example, all trading information should be fed to the portfolio accounting application directly from the investment manager's order management system or paper tickets and not from broker confirmations or worse still, feeds provided from the prime broker or custodian. This is even more important when the prime broker acts as the counterparty on the trade or the custodian also functions as the fund administrator and/or middle office recordkeeper."

While the Guide acknowledges that there is a spectrum for acceptable levels of shadow accounting, it does recommend that "all investment managers match trades to counterparty confirmations 100 percent of the time, regardless of whether the manager (or its third-party middle office provider) serves as the affirming party."

Risk Area #8: Reconciliation Gaps; False Senses of Security

While managers may approach reconciliation in a very deliberate way, there are often weaknesses in reconciliation processes and systems. Managers should look at their processes and assess the following:

Comprehensive Reconciliation Procedures

There are a number of considerations that managers should remember in connection with structuring reconciliation workflows. First, where the fund administrator is involved, three sets of reconciliation should occur, including reconciliations between: the investment manager's records vs. the custodian's or prime broker's records; the custodian's or prime broker's records vs. the administrator's records; and the administrator's records vs. the investment manager's records. Second, the comparison by a performance analyst of rates of returns calculated by the manager, the custodian and/or the client's investment consultant does not alone constitute a comprehensive reconciliation. Third, reconciliation duties should be assigned to appropriate staff based on a consideration of who is best positioned to catch inadvertent errors and to guard against fraud. The manager's trade support staff, portfolio managers and traders should not be involved in reconciliation tasks.

Electronic and Consolidated Records

Custodians or prime brokers may provide certain records to the manager as a service of convenience. However, they often only agree to incur potential liability with respect to certain "official" records. With this in mind, managers should not rely upon transaction files containing back-up reports; electronic representations of an account; or consolidated reports of one prime broker showing assets across multiple prime brokers servicing an account. To be proactive, a manager should always obtain, maintain and store detailed, account-level statements and reports received directly from the applicable safekeeper and perform periodic manual reconciliation of at least a sampling of final paper reports against data provided electronically.

Scope of Reconciliations

Reconciliations should cover the quantity of securities as well as the cost basis and market value of all positions (in local currency terms). The Guide recommends "zero tolerance on position quantity, along with careful examination of fractional shares (especially for funds of hedge

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funds)." When reconciling positions, CUSIP numbers (in the case of U.S. and Canadian-issued securities) and SEDOL numbers (for securities issued outside of the U.S. and Canada) should be compared. Looking at ISIN numbers alone can hide discrepancies in market denominations, whereas SEDOL numbers will identify the market on which a security was bought or sold. Position reconciliations should also cover local currency cash balances. If cash balances do not balance, this could indicate the existence of problems in the portfolio.

Timeliness

In order to ensure that investment decisions and compliance monitoring are based on correct portfolio weights, position breaks need to be discovered through reconciliation in a timely manner. Automation minimizes delays. It is especially crucial that position reconciliation (including cash as a position) is conducted on a timely basis, and the Guide recommends that this occur daily, where possible. The time frame for transaction reconciliations depends on factors such as portfolio turnover, instruments traded and the typical amount of cash available. In addition, position breaks should be reviewed to determine whether they tended to result from errors on the part of a counterparty, a custodian/prime broker or the manager. Daily transaction reconciliation would tend to be warranted if the manager's records are found to be a predominant cause of errors. Less frequent transaction reconciliations may be acceptable if the manager's records tend to be accurate.

Margin and Collateral Statements

Reconciliation should include ensuring that the manager's records correctly reflect the identity of the agent that has possession of collateral which may have been hypothecated and rehypothecated. This can be done by reviewing statements from the agent expected to have possession of the collateral.

Management Review

The reconciliations performed by back office staff must be reviewed by management of the manager. Regulators will want to see evidence of management's review in connection with an audit. Management reviews should be conducted and documented pursuant to established review procedures. If middle office functions are outsourced, the service provider should perform the management-level reconciliation review, but managers should continue to conduct regular position break report reviews.

Soft Dollar Reviews

While not normally part of an accounting based reconciliation process, soft dollar payments should be reviewed to make sure that they are properly made and recorded.

Risk Area #9: Reading the Fine Print; Know Thy Legal Entities

This section of the Guide discusses entering into agreements without understanding or appreciating their implications. Given the focus by investors and regulators on operational controls and counterparty risks, managers must take responsibility to make sure that they do
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not unintentionally expose fund assets to unnecessary risk due to a failure to properly review their contracts.

Business Side Attention to Agreements

The Guide cautions that contracts such as ISDA, prime brokerage, custodial and administrative agreements must be read by personnel responsible for the applicable functions, not just by the manager's lawyers. These documents require input and understanding from personnel on the business side who are familiar with investment operations, technology and client behavior. See "Katten Partner Raymond Mouhadeb Discusses the Purpose, Applicability and Implications of the August 2012 ISDA Dodd-Frank Protocol for Hedge Fund Managers, Focusing on Whether Hedge Funds Should Adhere to the Protocol," Hedge Fund Law Report, Vol. 6, No. 4 (Jan. 24, 2013). The Guide provides an example of a provision that was included in Bear Stearns' standard Limited Liability Authority Certificate and Trading Authorization agreement for brokerage accounts that gave each authorized signatory at a manager individual authority to trade, to receive confirmations, to enter into agreements, to wire money and to delegate these powers to others. This provision would of course, be inconsistent with the principles of segregation of duties for the purposes of mitigating fraud risk and would likely be contrary to the policies of many managers who signed these agreements.

Careful Reading

Senior executives of managers who sign documents must ensure that they understand what they are signing. The Guide suggests that depending on lawyers and subordinates to have scrutinized documents is not sufficient. The failure to carefully read and understand documents can lead to the waiver of certain protections and an increased risk of fraud. The lack of care in reviewing documents from both a business and legal perspective contributed to much of the havoc that occurred in connection with the failures of Lehman Brothers and Bear Stearns. In some cases, managers did not realize that the entities they were contracting with gave rise to more counterparty risk than they had anticipated. For example, many managers either contracted with a U.K. subsidiary of Lehman Brothers, Inc. or signed agreements allowing assets to be transferred to such U.K. subsidiary, in each case placing assets outside the jurisdiction of U.S. bankruptcy courts and/or circumventing U.S. rehypothecation limits. In other cases, managers signed agreements allowing Bear Stearns Securities Corp. to move cash into accounts that made their funds general creditors of Bear Stearns & Co., eliminating the intended insulation of prime brokerage assets from a default by Bear Stearns & Co. Some managers permit operations staff to select sweep vehicles without legal or investment review, effectively giving them authority to make investment decisions.

To be proactive, the Guide recommends that: (1) a firm develop procedures that require agreements to be read by both legal and operational departments; (2) documents with key service providers should be scanned and made available to staff throughout the organization; and (3) workflows should be established to help ensure that documents are reviewed by appropriate personnel of the manager. The Guide further notes that in monitoring counterparty risk, attention should be given to the regulators to which the counterparties are subject and that firms should monitor net exposure to, as well as the creditworthiness of, their counterparties.

Risk Area #10: Poor Planning and Slow Response Times; Changes in the Firm, the Marketplace and the Regulatory

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Environment

Planning in the Face of Industry Changes

Hedge fund managers have been operating in an industry that is undergoing significant and rapid changes. The changes are being driven by a combination of market and regulatory demands. Clients want new investment products producing better returns; more information delivered more quickly; adoption of key industry standards; reduced risk; and lower fees. Regulators are imposing layers of additional requirements driven by legislative efforts to overhaul the financial services industry. In this context, operational risk management requires deliberate long-term strategic and operational planning. Managers should anticipate industry changes and address necessary changes for the firm with a focus on the strengths of their own balance sheet and long term profitability.

As many managers have relied on leaner staffs after the financial crisis, they are inundated with daily challenges, and it may be tempting to delay the type of long-term planning required to adapt to industry changes. Procrastinating on long term business planning can, however, severely diminish a firm's survival prognosis in the face of this complex and evolving business environment.

To stay on top of industry changes and focus on long term business planning, managers must stay informed about the changes affecting the industry by reading the news and industry publications, attending conferences and networking. In addition, managers can, with consultant help if necessary, "call upon well-established techniques for surveying, evaluating and addressing business risks, including brainstorming, mind-mapping and forecast calibration."

While many regulations arising out of the Dodd-Frank Act in the U.S. and the Alternative Investment Fund Managers Directive in Europe have not yet been finalized, managers should be attempting to assess the potential impact of these laws. To be proactive, the Guide recommends that managers educate themselves by turning to industry group analysis of these laws. Relevant industry groups include the CFA Institute and the Council of Institutional Investors in the U.S. as well as the Alternative Investment Management Association in Europe. Some of the findings provided by these groups include:

- The requirement to register with the SEC will cover more managers including those domiciled outside of the U.S.
- Additional reporting requirements will be mandated, and staying on top of these requirements will require managers to "harness their data to satisfy new demands for transparency" making "[r]obust data aggregation, normalization and governance . . . even more important than ever before."
- Growing regulatory compliance requirements will continue to increase the cost of doing business. As a result, better established managers will likely be looking to improve margins by growing their assets under management (AUM) without a proportionate increase in staffing which could result in increased merger and acquisition activity in the industry. Smaller managers that are not acquired may move to outsource more of their middle office functions.
- Managers will continue to face increasing pressure from institutional investors for higher returns and lower fees.

Focusing on Costs

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As discussed in part one of this series, there is a tendency for managers to focus on revenue drivers (i.e., assets under management) with less attention paid to the number of accounts or portfolios managed and how the complexity of funds drives costs through higher staffing and systems needs and accompanying operational risks. The Guide recommends that managers make use of benchmarking in analyzing their cost structures and quantifying the bottom-line impact of key cost drivers. See "Citi Prime Finance Report Dissects the Expenses of Running a Hedge Fund Management Business, Identifying Components, Levels, Trends and Benchmarks," Hedge Fund Law Report, Vol. 6, No. 1 (Jan. 3, 2013).

Organizational Expansion

When managers hold off on adding staff or infrastructure in connection with expansion, the service level they provide to their clients (e.g., providing periodic reports in a timely fashion) tends to suffer. SEI suggests that this often leads to "band-aid solutions" and "workarounds" becoming a regular part of operations, which results in overstretched staff and increased operational risk. The Guide recommends that managers "[u]tilize metrics and factor operational staffing and systems needs into planning for new product and sales initiatives." To avoid surprises, budgets should take into account resources required to match expected increases in AUM and new product offerings.

Involving Middle- and Back-Office Personnel in New Product Launches

Including operations and IT staff in discussions concerning new product offerings should not be an afterthought. It is important for such personnel to be informed of, and involved in, such matters so that they can put in place the required workflows, procedures and systems to incorporate the new offerings into their functions smoothly while minimizing operational risks. A new initiative to invest in new markets or new instruments may require a number of operational changes including additional arrangements with custodians, prime brokers and fund administrators; additional valuation policies and pricing sources; and additional reporting. According to the Guide, best practices include inviting compliance, operations and IT staff to be active participants in discussions about new product launches and creating new product committees to meet regularly to discuss and approve new product launches which include such personnel.

Operational Performance and Diligence Standards

As M&A activity increases, the lines between alternative investment managers and traditional managers will become blurred. See "How Can Hedge Fund Managers Organize and Operate Alternative Mutual Funds to Access Retail Capital (Part One of Two)," above, in this issue of the Hedge Fund Law Report. Institutional investors are likely to begin to demand that managers comply with the Global Investment Performance Standards (GIPS) that are required for traditional investment firms. To be proactive, the Guide recommends that investment managers consider implementing GIPS before they are widely required. See "A Step-By-Step Guide to GIPS Compliance for Hedge Fund Managers," Hedge Fund Law Report, Vol. 4, No. 44 (Dec. 8, 2012).

Conclusion

In the investment management business, it is no secret that taking care of middle- and back-office operations is secondary to achieving the goals of realizing investment returns and

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attracting investor money. The Guide notes that personnel in these functions "may feel, justifiably, that they are noticed only when things go wrong." Many managers are managing more product offerings and portfolio transactions with smaller staffs. Nevertheless, the importance of robust risk management practices at the operational level is becoming increasingly apparent as: (1) risks at these levels have been known to put managers out of business in recent years; (2) regulators are demanding significantly more in terms of attention to operational risk matters and compliance with specific procedures in connection therewith; and (3) investors are becoming more and more focused on operational risk in connection with their due diligence of managers. Senior executives and principals at managers should think seriously about the ten risk areas discussed in the Guide and in this three-part series, and consider how to address these and other operational risks in light of the characteristics and structures of their businesses.

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