



Operational Risk: An Alternative Challenge

PricewaterhouseCoopers

We predicted that the influx of institutional money would have two effects on the marketplace – first, there would be a degree of polarisation towards the larger funds; and secondly, those funds and their managers attracting such money would come under increasing pressure to demonstrate that they operated robust systems and controls. This trend was validated to us, when we commissioned our recent EIU briefing “Transparency versus returns: The institutional investor view of alternative assets”.

What we did not predict was that the industry itself would come forward and develop its own best practice standards. In January 2008, the Hedge Fund Standards Board (HFSB) in London published its 28 Best Practice Standards (the “Standards”) and in the USA the asset managers’ and the investors’ committees of the US President’s Working Group on Financial Markets (PWG) proposed best practices for hedge fund managers and investors (the “Practices”).

The future will determine whether these industry developments are an appropriate response to the perceived issues and concerns (widely debated by politicians, regulators and the press) about the influence of hedge funds on the global capital markets. The current question is whether these proposed self-regulatory regimes can be shown to have enough teeth to meet the industry’s critics but also the fiduciary responsibilities of institutional investors for a framework of transparency and governance at the managers with whom they invest. Of course, there is the risk that if these voluntary regimes are not seen to work, then there will be increased pressure for regulatory intervention.

The New Frameworks of Standards and Practices

So the key question is whether the hedge fund industry will embrace these new Standards and Practices. Both initiatives are voluntary and adopt a market discipline approach, assuming that peer pressure and, particularly investor pressure will encourage conformity. Whilst there are some similarities between these two initiatives there are also some interesting differences.

The HFSB approach is one of “comply or explain” and existing managers who intend to register their conformity with the Standards have until 31 December 2008 to do so.

The UK “comply or explain” approach follows a similar regime in the UK for disclosure of compliance with governance standards for publicly-listed companies – the Combined Code of the London Stock Exchange. However, one important difference is that certain disclosures of compliance in a listed company’s annual report have to be independently validated by auditors. There is no such provision in the HFSB Standards; it is a self-attest regime which necessarily carries with it the risk that less scrupulous managers will claim compliance but in fact act below the benchmark of the Standards.

There is, of course, no reason why a manager (or a fund’s directors) shouldn’t commission such independent validation work (and some are already doing so) and this maybe something that over a period of time investors will come to expect.

Similarly, the HFSB required “explanatory statement” covering those Standards with which a manager does not comply is submitted privately to the HFSB and therefore not automatically available to an investor; arguably this would be an interesting document for existing or potential investors albeit there is nothing to stop a particular manager from releasing this to investors.

The proposed US PWG Practices do not have an enforcement or disclosure mechanism and will rely on voluntary conformity, which is perhaps contrary to the general perception of the US as a place of rules and regulations.

A significant difference in the remit of the US PWG is that investors were involved in developing proposed best practices for both the decision to invest in a hedge fund and the ongoing monitoring of the hedge fund investment thereafter – there is both a fiduciary’s guide (for those responsible for allocation of assets to hedge funds) and an investor’s guide (for those executing and monitoring a hedge fund investment programme). This is a welcome development and addresses one of the criticisms of the HFSB Standards where there was no investor representation.

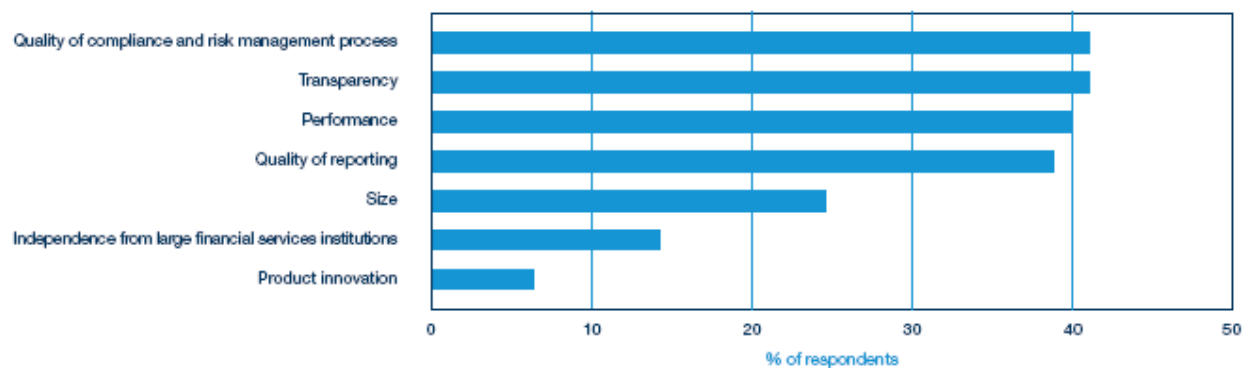


Operational Controls and Governance

What is clear is the landscape has changed. The increasing institutional money flowing into hedge fund strategies is fuelling more and more focus on operational risk.

The speed of demise of some large funds is causing institutional investors to reappraise the strength of the systems and controls at their underlying hedge fund investments, whether the exposure to the strategies is via fund of hedge funds vehicles or made directly. Institutions, as investors, unlike high net worth individuals, are subject to fiduciary risk and therefore acutely conscious of the need to demonstrate that they have done all that is reasonably possible in due diligence and ongoing monitoring to guard against investment failure; failure brings litigation risk. Indeed our briefing "Transparency versus returns: The institutional investor view of alternative assets" produced in cooperation with the Economist Intelligence Unit (EIU), reported that concerns around operational risk areas was a greater risk for manager de-selection by institutional investors than actual investment performance.

Q: What do you consider to be the main criteria for de-selecting a provider?



Please note that totals do not always add up to 100 because of rounding, or because respondents could choose more than one answer.

Source: PricewaterhouseCoopers/Economist Intelligence Unit survey, January 2008

The current market conditions and resulting volatility are causing particular scrutiny of certain aspects of controls and governance in any hedge fund manager's processes. Although the extent of adoption and implementation of the voluntary standards and practices discussed above remains to be seen, their publication is, by definition, raising the awareness of the types of controls that should be in place and ways in which monitoring of their ongoing effectiveness can be achieved. Three areas are noted below:

- There is increased focus on the investment process and whether the risk management systems in place are fit for purpose – fit to meet the risk and volatility profile portrayed to the end investor.
- Similarly, there is much discussion about the robustness of the procedures around the valuation of a fund's net assets. Indeed the implementation of FSA 157 under US GAAP (and a similar standard being developed under IFRS) is set to make valuation processes and disclosure even more complicated. A properly documented valuation process with appropriate escalation procedures to the fund's board which is made transparent to investors is the right answer. Hedge funds are private investment vehicles and transparency of process between investor, the fund's board and the advising hedge fund manager is surely a prerequisite of a successful partnership.
- Less highlighted are the issues around taxation and the need to incorporate appropriate procedures to ensure that tax rules and regulations are met both at the fund investment level and at the level of the fund's interaction with its hedge fund manager. If the relevant tax rules and regulations are not followed, there is a risk that the tax neutral status of the hedge fund will be jeopardised. The implementation of Fin 48 for US GAAP funds and the need to provide for tax where it "is more likely than not" that a tax liability will arise is only serving to highlight the importance of the proper operational management of tax within a hedge fund's infrastructure.



Culture, Controls and Reward

The effective operation of a process of systems and controls requires that individuals adhere to the control framework. This in turn requires the overall culture of the firm or “the tone from the top” to be supportive and, in particular, that the reward and compensation strategies give sufficient weight to adherence to the control framework in each individual’s annual performance assessment.

Businesses that grow rapidly, where there is a high emphasis on revenue/profit generation such as the hedge fund industry, often find that the operational infrastructure (often referred to as the mid and back office) to be in a state of permanent “catch up”. There have been well publicised instances of where a firm’s culture has developed so that it becomes accepted that controls can be overridden or are not taken seriously. Balancing reward strategies and talent management so that they are not biased towards risk and short-term thinking is becoming increasingly recognised as a key ingredient of a strong control framework. This issue has not escaped the attention of the regulators and is line with their focus on governance and the competence of a firm’s management.

Regulation

Since our last whitepaper, the EU’s MiFID legislation has come into effect. Hedge fund managers have had to embrace more prescriptive rules in relation to best execution and conflicts of interest. Whilst this has mainly involved enhancement of existing procedures, there have been repeated warnings from the regulators, notably the UK FSA, that they are concerned about market abuse; their interest is hardly surprising given the involvement of hedge funds in the world capital markets.

In June 2008 the UK FSA quickly introduced a rule concerning the disclosure from entities with short positions in stocks undergoing a rights issue; this was unusual in that there was no prior consultation and certainly caused ripples of discontent in the industry. It appears that the regulators were concerned about the then market conditions and potential impact on a number of financial sector rights issues.

Although two to three years ago there was much talk about the retailisation of hedge funds, there has been slow progress in the last year. The EU is still considering whether there should be a regime for private investment funds to be marketed under a pan-European set of rules. In the meantime, the UCITS III legislation is allowing the development of short extension funds, typically 130/30 funds, following the lead established in the US; investments in such funds is to date mainly funded by institutional money.

Potential future EU developments include the emergence of a group led by Poul Rasmussen calling for an EU framework for transparency, registration and authorisation for managers of hedge and private equity of funds. His report has been ratified by the European Parliament but it is too early to determine precisely where the legislative effect will fall.

Conclusion

The immediate challenge for the hedge fund industry is to prove that it can embrace the principle of transparency around operational controls (and prove on an ongoing basis that they are working effectively) as more institutional money is allocated to hedge fund strategies. At present, it seems that this institutional money is tending to find its way to the larger and longer standing hedge fund managers who should have the resources and infrastructure to demonstrate (or develop) a system of strong controls and processes.

For any hedge fund manager, embracing the publicised Standards and Practices will not be without cost. In all likelihood, such associated costs will be absorbed by the hedge fund manager. But if this is a cost that must be paid to demonstrate to investors that well run hedge fund operations have appropriate governance and controls and to satisfy the regulators concern for investor protection and avoidance of systemic risk, then it is a cost of doing future business in this sector and a cost that must be met.

This is an excerpt from the annual global hedge fund whitepaper “Operational Risk: An Alternative Challenge” published in September 2008.