

FOCUS ON

OPERATIONAL RISK

The aftermath of the financial crisis has put increased emphasis on compliance for alternative investment managers. Outlining a robust and comprehensive operational risk management policy is no longer a luxury, but a necessity. *HFMWeek* spoke to Corgentum and Kinetic Partners about shifting investor concerns, and how they have prompted a move towards enhanced risk identification and mitigation

Q HFMWEEK (HFM): WHY HAS OPERATIONAL RISK BECOME AN INCREASINGLY IMPORTANT CONCERN FOR MANAGERS POST-2008?

A JASON SCHARFMAN (JS): Firstly, Corgentum's research demonstrates an increasing trend that managers with weaker operational infrastructures demonstrate lower performance as opposed to those with stronger operations, and that difference is becoming more apparent. Also, operational risk has become more of a moving target, an example of which can be found in the recent government focus on the uses of material non-public information and insider trading (such as the Galleon case). Examples can also be found in the violent weather we have experienced such as the floods in Australia and the recent disaster in Japan, which have brought increased attention to business continuity and disaster recovery infrastructures. Also, regulatory reforms such as the Dodd-Frank Act have increased the focus on compliance. Hedge funds as well as investors have been forced to monitor and track all these issues, and have also been looking to consultants like Corgentum, which focuses purely on operational risk, for their input.

A NEIL MORRIS (NM): The primary reason is investor demand. The need for managers to clearly address and mitigate operational risks is very much driven by their investor base and the overall expectation that managers institutionalise their business.

Q HFM: HOW CAN YOUR SERVICE HELP MANAGERS IMPROVE OPERATIONAL STANDARDS?

A JS: Corgentum performs independent, third-party reviews of hedge funds solely for investors, as we believe that there is a conflict involved in selling services to both hedge funds and investors. We do work with hedge funds when requested to by investors, however; in cases where investors hire us to perform an operational risk review of a hedge fund, we can share the information we gather with the fund upon the investor's request. Frequently it transpires that the hedge fund has never before been subject to an independent, third-party operational risk assessment, and they find the information we provide to be of great value. Often, hedge funds are unaware of how their service providers view them, or how they compare to their competitors from an operational perspective.



Jason Scharfman

is managing partner of Corgentum Consulting. He is recognised as one of the leading experts in the field of hedge fund operational due diligence, and is the author of *Hedge Fund Operational Due Diligence: Understanding the Risks* (John Wiley & Sons 2008).



Neil Morris

is based in Kinetic Partners' New York office and is a CPA with over 20 years of experience. Previously, he was a founding member of the New York-based consultancy group Breakwater Compliance Partners, and the CFO and COO of a large international asset management firm. His current focus is advising on regulatory compliance and operational risk.

A NM: We provide services bespoke to our clients' needs. We have a breadth of experience across the firm, including operational, accounting and compliance experts, and can provide detailed gap-analyses between a manager's existing procedures and best-practice standards. An unbiased review can often pick up on things that managers cannot always spot in their own operations. We take a critical look at daily processes and procedures, that is to say the real guts of the organisation, and point out and implement enhancements that can mitigate risks, and offer increased efficiency, greater control and enhanced transparency.

Q HFM: HOW WILL IMPENDING INTERNATIONAL REGULATION SUCH AS THE AIFMD AND DODD-FRANK ADD EXTRA PRESSURES?

A JS: I think that the regulatory reforms are a positive thing, but they will increase both the initial and on-going costs of compliance. They will add extra pressure for investors, who might have the illusion that the measures will make due diligence redundant, when in fact the opposite is true. We are advising our clients to conduct more due diligence, as there are now many more rules and regulations with which their hedge funds must comply, and investors should not simply be content with the minimum level of compliance.

A NM: There can be no doubt that they are adding extra pressure and are another pillar that managers must build in their infrastructure. Whereas in the past managers could pick and choose where they wanted to invest resources, there is now a new paradigm which includes the need to meet or exceed new regulatory standards. Managers are experiencing the added burden of responding to the omnipresent regulators, which increases the amount of resources

that must be spent on non-trading and non-portfolio management tasks. Regulatory change has certainly raised the bar.

Q HFM: WHAT STANDARDS OF OPERATIONAL RISK DO INVESTORS NOW EXPECT?

A JS: Investors are increasingly relying upon specialty consultants like Corgentum to assist in conducting comprehensive operational reviews, really kicking the tyres of a firm, and ensuring that hedge fund managers are complying to best practice. They also expect detailed and clear documentation from managers as to the strengths and weaknesses of the operation, as well as evidence of managers' own internal due diligence process.

A NM: Investors now expect the highest standards. If you examine operational due diligence standards over several decades you see that they ebb and flow congruent with the economic cycles: in times of good returns and high performance, standards seem to slip, and vice versa. However, in my opinion, the bar has now been permanently raised. After the extreme market shock during 2008/09, and the well-publicised exposure of massive frauds, investors are absolutely demanding the highest standards from investment managers. They are looking for signs of any weaknesses which will prevent them from investing in a particular manager.

Q HFM: HOW CAN SMALL FIRMS ADAPT TO THIS CHANGE? DO THEY HAVE THE MANPOWER AND MONEY TO MAKE SURE INTERNAL CONTROLS ARE AS GOOD AS POSSIBLE?

A JS: Small firms do have the manpower and money to do so, but the biggest concern is not the money spent; a small firm's operation can be just as good as those of their larger counterparts. The essential factors are oversight, involvement of both investment professionals and senior management with operations, and proper resource allocation.

A NM: They must take a critical look at their operations and consider the kinds of things that an institutional investor would ask for. While they may not be able to afford the most expensive systems or additional manpower, they can at least offer other risk-mitigating solutions; they just have to be creative when it comes to designing internal controls. It is certainly more difficult for smaller firms: there are fewer economies of scale and they must spend a greater proportion of their margins on non-portfolio management type tasks and controls. While it is not impossible by any means, and small managers can put in what is reasonable for the size, complexity and nuances of their firm, it is certainly more difficult for them.

Q HFM: HOW CAN HEDGE FUNDS MAKE SURE THAT PERSONNEL ARE UP TO SCRATCH, WHEN IT COMES TO MAINTAINING HIGH STANDARDS OF OPERATIONAL RISK?

A JS: It is vital that they get a third-party, independent evaluation of their operations. It is also important to ask for feedback from investors



“

I THINK THAT THE REGULATORY REFORMS ARE POSITIVE, BUT THEY WILL ADD EXTRA PRESSURE FOR INVESTORS, WHO MIGHT HAVE THE ILLUSION THAT THE MEASURES WILL MAKE DUE DILIGENCE REDUNDANT, WHEN IN FACT THE OPPOSITE IS TRUE

”

JASON SCHARFMAN, CORGENTUM CONSULTING

who are performing operational due diligence, and to monitor operational risk trends and see what other hedge funds are doing. Regardless of the quality of the operational professionals, they must be vested in the organisation, and have the authority and resources to run the organisation well.

A NM: It all starts with recruitment of course, and is related to the institutionalisation of the industry. Whereas previously it might have been possible to hire someone with good basic skills and then train them in the specifics of their job responsibilities, those days are now over, and it is important to recruit staff with the existing skills and expertise in their particular role. A standard review process must also be carried out on a regular basis, as well as standard internal evaluation. It is then important to bring in firms like Kinetic Partners or other outside providers to provide an unbiased view of the organisation and its staff. ■