



Mastering Operational Due Diligence to Meet the Expectations of Institutional Investors

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What do you see as the main sources of operational risk for your organization over the next two years?

- ▶ ***People***
- ▶ ***Valuation***
- ▶ ***Complexity of new products/strategies***
- ▶ ***Compliance with Regulatory changes***
- ▶ ***Technology***
- ▶ ***Trading Volume***
- ▶ ***Infrastructure***
- ▶ ***Human error***

What steps will your organization be taking to improve the management of it's operational risks in anticipation of investor, rating agency and regulatory queries?

- ▶ *People*
- ▶ *Technology*
- ▶ *Policies & Procedures*
- ▶ *Expertise*
- ▶ *Controls*

Some key industry perspectives from our Panel: Due Diligence Questionnaires

- ▶ A thorough and thoughtfully answered [standardized] due diligence questionnaire provided early on can provide a potential investor with a solid understanding of the manager, cutting down on time spent on the due diligence process and setting the tone for future conversations.
 - ▶ Value of outsourced due diligence (i.e. Rating Agency, Amber Partners), SAS70 on-going communications and monitoring - what to expect?

Some key industry perspectives from our Panel: Rapid Growth:

Planning for growth by putting systems & procedures in place that are scaleable will help address investor concerns about the manager's ability to handle rapid growth, as well as inspire confidence in the manager's business savvy/plan.

- ▶ Role of administrator and service providers in organizational lifecycle Introduction of new instruments

Some key industry perspectives from our Panel: Acknowledgement of Risk

- ▶ Every firm should know exactly where their greatest risk(s) lie, be open about them, and demonstrate that they have been thoughtful in taking steps to make sure that risk is monitored/managed.
 - ▶ Pricing risks (privates, illiquids)
 - ▶ Risks of and associated with staff turnover
 - ▶ Technological risks (largely stemming from introduction of new products, as highlighted in "Rapid Growth" section above).
 - ▶ Why is valuation especially challenging in 2008? FAS 157 and lower liquidity?

Core Functions

- ▶ Portfolio management
- ▶ Trading
- ▶ Middle office
- ▶ Back office (
 - ▶ Trades are not identified and/or recorded timely
 - ▶ Corporate actions are not identified
 - ▶ Cash and securities balances do not agree to custodian (“no-fail market” issues)
 - ▶ Securities requiring fair valuation are not identified
- ▶ Technology
- ▶ Accounting (Management Co & Fund Administration)
- ▶ Tax
- ▶ Legal & Compliance
- ▶ Risk Management
- ▶ Investor servicing Compliance
- ▶ Service provider relationships

Define Roles and Responsibilities

- ▶ Identify the Person/Group Responsible for Each Functional Area
 - ▶ Centralized or decentralized
 - ▶ In-house or outsourced
 - ▶ Segregation of duties
- ▶ Identify a Person/Group Responsible for Each Risk
 - ▶ Is there oversight?
 - ▶ In-house or outsourced
 - ▶ Segregation of duties

Define Procedures and Controls

- ▶ Match Procedures to Each Identified Risk
- ▶ Minimize Non-Essential Controls
- ▶ Focus on Key Controls

Document the Process

- ▶ Policies and Procedures Manual
- ▶ Responsibilities Matrix
- ▶ Update Regularly

Measure the Effectiveness

- ▶ Use of Checklists
- ▶ Evaluate Cause of Errors
- ▶ Enhance Controls Based on Experience

Define the Oversight Process

- ▶ Periodic “Internal” Audits
- ▶ Integrate with Compliance Function
- ▶ Outsource Considerations

In closing: Investors & Regulators Expectations

- ▶ It is clear that both the investors' and regulators' appetite for increasing levels of financial and operational disclosure from alternative investment vehicles is not abating. Better preparation and packaging of disclosure documentation will increase response time and minimize strain on the organization.

In closing: Due Diligence checklist: What do

- ▶ Typical data requested by investors and regulatory bodies include:
- ▶ Corporate records and company structure
- ▶ Securities Financial documents
- ▶ Asset valuation policies and procedures
- ▶ Credit arrangements
- ▶ Material contracts
- ▶ Intellectual property
- ▶ Management and employees
- ▶ Property and equipment
- ▶ Systems
- ▶ Litigation and other contingent liabilities
- ▶ Risk management and compliance procedures
- ▶ Regulation
- ▶ Taxes
- ▶ Sales, marketing and distribution
- ▶ Business and strategy

In closing: A summary of the key points:

1. The level of disclosure for hedge funds, private equity firms and other alternative investment vehicles is rapidly increasing due to increased interest by investors, and calls for enhanced regulatory oversight.
2. Disclosure requests are comprehensive in nature and will be disruptive to organizations that are not prepared. Clients should proactively prepare for these requests to minimize the effect on the organization, and overall response time. This will reflect positively on the organization when compared to less organized peers.
3. Organizational roles and responsibilities should be defined, and a document repository tool developed.



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