

## Industry Trends in Operational Due Diligence

The economic downturn alone is cause enough for the greater focus on operational due diligence of hedge funds – Add the recent frauds that have been reported and the subsequent call for more regulation of the industry - There is no doubt that the dynamics of the relationship between investors and hedge fund managers have changed drastically. Investors of all kinds were severely impacted by the turmoil of 2008 and hedge fund managers are facing tremendous fall out as investors re-assess their approach to due diligence. We've brought together multiple players in this dynamic industry and have asked them to share their perspectives on the last twelve months. Read on and benefit from the impressions shared in our interviews with investors, fund managers, and consultants.-

### Meet our panelists:

#### **Tim Barefield, Chief Operating Officer, PERSHING SQUARE CAPITAL MANAGEMENT**

Tim joined Pershing Square Capital Management in September of 2006. His focus at Pershing is all aspects of operations and compliance for this nearly four year old Hedge Fund. Prior to joining Pershing Square Tim was the CEO of GiftCertificates.com Inc, a leading online consumer gift card and corporate incentive program management company. Tim was also the Vice President of Human Resources for Swissotel and Accor North America, both international hotel chains. Tim received his A.M. in Psychology from Harvard University in 1997, his MBA from Rockhurst University in 1987, and his BS in Mechanical Engineering from the University of Missouri-Rolla in 1983.

#### **Howard Coleman, Managing Director, GENESEE INVESTMENTS, LLC**

Howard Coleman, a University of Washington School of Law graduate, serves as General Counsel / Managing Director for Genesee. Mr. Coleman assists in the portfolio construction, manager selection and due diligence processes, including reviewing the legal and regulatory issues involved in a prospective investment manager's strategy. Before joining Genesee in 1997, Mr. Coleman was a partner in the law firm of Riddell Williams where his practice emphasized securities litigation and other securities related issues. He is a member of Genesee's Investment Committee. Mr. Coleman also is a member of the Board of Trustees and chairs the Investment Committee of Antioch University, his alma mater.

#### **Eric Lazear, Director – Operational Risk Due Diligence, DUFF & PHELPS, LLC**

Eric S. Lazear is a Director of Operational Risk Due Diligence for Duff and Phelps, a leading global independent provider of financial advisory and investment banking services where he provides independent third party assessments of hedge fund manager's operating policies and procedures to Pension Plans, Endowments, Family Offices and Fund of Hedge Funds,

as well as any investor allocating to alternatives. In his role, he assesses the operational risks associated with their alternative investments and provides solutions to mitigate those risks. He is responsible for assessing the operational and business risk of hedge fund managers globally and overseeing all operational risk reviews for an array of hedge fund strategies worldwide.

#### **Jamie McLaughlin, CEO, GELLER FAMILY OFFICE SERVICES**

James. H. "Jamie" McLaughlin recently assumed the role of CEO for Geller Family Office Services, a multi-family office with assets under advisement of more than \$4b serving ultra high net worth clients, the majority of whom are successful entrepreneurs and business owners. Previously, McLaughlin served for nearly five years as a Managing Director and head of a new office in the New York market for Convergent Wealth Advisors. He spent the previous ten years at Mellon where he was the regional president of Mellon Private Wealth Management's New York region.

### The Interview:

#### ***1. How has your perspective of Operational Due Diligence changed since autumn of 2008?***

I quote Jamie McLaughlin: "The world has changed. Period." Jamie is referring specifically to the pre-Madoff world, in which very, very large and successful multi-strategy hedge funds had partners so coveted, so big, that "they literally didn't have to verify anything for anybody." For Jamie, those days are gone forever. Howard Coleman agrees that the Madoff scandal certainly raised far more red flags where fraud is concerned, but also points out that the "things Madoff didn't do were already deal killers in our portfolios and I think it's the same case with other funds of funds as well."

But how has the world changed for the hedge fund manager? Tim Barefield likens operational due diligence by investors a year ago to a "hammer that can be applied to every nail, no matter the size." Now, investors who were content with a simple "check-the-box" approach prior to Lehman or Madoff are suddenly much, much more thorough. How thorough? Eric Lazear says that investors are "taking a closer look at all of the details surrounding all aspects of their operations," and Tim offered some examples for me: "The onus is on us to do really good due diligence on all of the partners, every operational process, every system that you implement... your decision about who helps you with your technology, your research service ... people want to know – 'how did you decide?' People are really interested in your decision making process when selecting the additional prime broker. They want to know that your processes are thorough."

## **2. What are your thoughts on more investors pursuing managed accounts?**

Overall, the panelists are not impressed by the gaining popularity of managed accounts. “It’s not the end-all, be-all,” Eric says. “You may avoid worries about gates and suspensions, but you still need to conduct due diligence that explores the possibility of cross-pollination.” Tim agrees, and points out that managed accounts can’t be the one-size-fits-all solution for all strategies. “Does it make sense for some funds? Absolutely. But if we had a managed account, it would violate one of our core principles from day one: Any information we make available to one investor, is available to all of our investors. Period.” For Jamie and Howard, from the investor side of the question, it really boils down to optics. What you see is what you get with a managed account, which can be a pretty attractive thing to some investors. But robust due diligence on a fund can accomplish nearly the same thing. And on the fund side, Tim maintains that if a fund “does a good job of looking at business structure, matching investor liquidity with portfolio liquidity, ensuring investors are treated the same across the board, and communicating effectively,” there is no need to offer a managed account at all.

## **3. What have the last 12 months meant to the level of transparency required by investors, and how are managers reacting to these new requirements?**

Of course the demand for transparency has gone up. Investors are hungry for more information. Jamie points out that, when you consider the high payroll costs of the average hedge fund – what it takes to keep the talent on board so that the fund continues to perform well for the investors, the cost to implement a structure allowing for more transparency and peace of mind for investors is nearly insignificant in comparison. And yet, investors are demanding that these funds add to their cost structures at a time when these players are hurting. “The fact is, the shift has gone to meeting the public demands and the general partner is no longer driving the bus.” “It’s definitely a buyers’ market,” Howard agrees. “Some managers will still keep some information confidential, but you’re still getting a lot more than ever before.” “There are limitations,” Tim admits. “We’re a very big fund, and we only have 10 positions. Maintaining a lock-down approach on confidentiality during certain time periods is crucial. But given the regulatory filing requirements, most of the time people have a very broad and deep picture of our holdings.”

## **4. How are managers responding to the possibility of regulation?**

“Different camps have different thought processes,” Eric says. “Some expect to register very soon and so are starting to implement the necessary

changes now. Others are incorporating new processes to prepare for registration, but are also waiting to see what the final requirements will be. And of course, some are not moving on this at all because they don’t want to spend the time or money until it is absolutely necessary and until the managers know exactly what they will be required to do.” Jamie maintains that the public is pushing for funds to register because its desire is to understand who these people really are, without trying to leaf through a 60 page, opaque document that is impossible to read. “But the devil is in the details,” Howard cautions. To register as an RIA isn’t a big deal, “but the crazier things coming out of the House – it will fundamentally change the business.” To that end, Tim notes that many funds are getting more meaningfully involved, trying to “influence possible regulatory initiatives” in a positive way, so that “things that add no value, but only make it more complicated, can be avoided.”

## **5. What are you hearing from other investors regarding operational due diligence?**

Basically, investors want to know why they won’t experience a Madoff with your fund. Howard says that their processes haven’t really changed, but the way in which they communicate these processes with the investors definitely has. There is a great deal more hand-holding as the investors move beyond the check-the-box approach of the past.

Tim Barefield: “The one interesting thing ... people really appreciate, more than before, that your operations, your business, has to be as solid as your portfolio investment strategy. For smaller firms, that was really an after thought ... outsource the technology, the trading ... Three people in a room with a broker line and a telephone could run a fund... those days are over. The moment you get your asset base to a point where you can afford to run the business in a robust and redundant manner, you better be running it that way. You can’t have a single point of failure; where fraud, mistakes, errors, can’t bring you down. You must have a business that is scalable and has the proper controls in place. Whether you’re ten people managing a billion or forty people managing a trillion dollars, the investors want the same level of certainty that you have what you say you have, and that it isn’t disappearing because of some silly mistake. You can’t say, ‘We’re small, so we don’t need that stuff.’”

Eric Lazear says that more and more investors are going to outside consultants to be sure they know what needs to be done, what questions need to be asked. And for those investors who, like Jamie, do their own due diligence, the information required before committing to invest is both more broad and deep: “Prior to fall of 2008, there is no way a general partner would ever disclose the composition of their limited partners. This is perhaps the most propriety information a hedge fund has. That is a big, big shift in favor of the limited partner. Now when we ask for a composition of

other investors, to evaluate the likelihood of a gate getting thrown up, we're given a pie chart. This notion of transparency is at such a level now that a hedge fund we consider investing in must and will provide use with answers to every question we should ask. We simply will never give them our money otherwise."

## **6. How has your view on counterparty risk changed, post-Lehman?**

Tim's fund has "always had an aggressive view toward mitigating our counter party risk. We collatorize everything we can. The only thing that has changed now; if we're going to hold a security for a long time, we like to move it to a more trust-like structure, rather than letting it sit at a prime broker." But he is perhaps the exception. Eric Lazear says "Most funds are looking much more closely at this than they ever have historically. Hedge funds have to completely understand their relationships with their prime brokers." "Like evaluating on an account-by-account basis, to see if the funds have been rehypothecated," Howard points out. "It is constant vigilance: Confirming counter parties, evaluating whether or not those counter parties are in danger of going under, the concentration of funds with that counter party. We analyze the credit worthiness of the counter parties constantly."

## **7. Have you changed your operational due diligence process?**

On the investor side, Jamie and Howard have both made adjustments, though of different degrees. Jamie feels that internal processes have stayed the same, but "more qualitative questions" are asked before recommending a fund. For Howard, the change is more pronounced: "We definitely have more focus on counterparty risk. We've created additional documentation and have a matrix now, instead of a basic template or report. It's another layer of documentation to truly ensure that you've followed through all of the steps of due diligence." When wearing his "other hat", and working with his own investors, Howard says that they spend much more time focusing on the operational component in presentations than ever before. "We want them to know that they are protected." Tim's fund has implemented an even more structured process in their communications with potential and existing investors on due diligence topics. "We make sure we can answer the questions that nobody ever asked before, but are asking now. People are following the money that they would invest with you from beginning to end and want to know your processes are tight, so there is no risk of losing it."

## **8. Are you performing additional due diligence on service providers?**

If cash is king, then the reputation and quality of your service provider is queen. Across the board, the service providers hedge funds choose to administer their fund, perform their audits, or to be their prime brokers are under far more scrutiny than ever before. Howard's due diligence team no longer simply confirms an account's existence, but looks into the structure and nature of the account. Also, a smaller firm is almost a deal-killer... "not entirely, though. If we really like the manager, and we find it's a regional provider, we'll do a little bit more homework. If it turns out that the firm is truly small with only a few clients, we won't move forward." In fact, name recognition and reputation in the service providers a hedge fund chooses is so important, Howard points out that of the fifty-five hedge funds they are invested in, not ONE of them isn't with a top-tiered auditor. For Eric, the ability to talk directly with the service provider is key. "It's the calls with the administrator that really add value. If a manager says they don't allow this, then we'll pass on investing with them." Tim's fund puts a great deal more into stress testing potential providers: "When we choose a provider for anything, we always look at no less than three from which to make our selection."

## **9. Can hedge funds still viably self-administer, or is it a thing of the past?**

"Consider how ludicrous this is," Jamie says. "You're giving someone data and no one but you has verified its veracity. 'If you want to defraud me, Mr. Madoff, I've just made it incredibly easy for you to do it.'" Howard and Eric qualify this a bit. "If Renaissance Medallion ever opened up, people would still invest with them, regardless. But anything short of that, definitely not," says Howard. "There are also a couple of large funds that are self administered that have very basic strategies, but they make it a point to go above and beyond for their investors – maybe they have three different auditors come in to do their books though out the year, one for the 12/31 and another for the 6/30 year end, as well as a separate auditor for the SAS 70 ... They might as well hire an administrator," Eric adds. Here's another idea: "I think you should self-administer and have an outsourced administrator simultaneously," Tim says. "If you're any good at this business, your management company should be very profitable. You can afford to have a small team and pay an outsourced administrator. At the end of the day, people give you money, and the only thing you can give them is return on the money ... in the meantime, all they get are these reports, telling them as accurately and as timely as possible: This is how much money they have now. Those are the two fundamental things we do in this business."

## **10. What is an operational due diligence characteristic that would stop you from investing with a manager?**

“Self administration, self custody and pricing are the three biggest issues,” says Howard. “If a fund has their own bank account instead of a third party custodian, it’s done.” Eric agrees: “A big flag is a manager trading in esoteric securities and getting no independent valuation. If the administrator isn’t independently verifying/valuing the marks, or if they’re using a small-tiered administrator, the combination would be a deal-breaker.” Tim notes two things that would be of concern for him as an investor: “One would be lack of alignment of the infrastructure design with the investment strategy, and the other would be style drift. If I came in at one point, and then six months later there was a different strategy in place – any time there is a significant change in their approach to what they do and how they do it - I would be very, very concerned.” For Jamie, the market’s “shift has marginalized the thinly staffed firms.” He maintains that, especially for a fund of funds, “your obligation is to do due diligence and it’s a contradiction if you’re understaffed to do this.” When choosing underlying managers, it comes down to your judgment, not only the objective considerations the other panelists note above, but also a more subjective, visceral judgment, to truly separate the wheat from the chaff. It requires more than reviewing public information, faxed data and a telephone call. “You MUST go the extra mile and pass a qualitative judgment on every hedge fund principal and strategy. You visit them. You have a relationship with them. You look them in the eye and you decide if they are a safe bet for your investment.”

## **11. What kind of ongoing operational monitoring is now conducted on underlying managers?**

Tim notes that now, those performing ongoing operational due diligence on his fund are much more likely to ask the follow up questions. “Any open item gets tracked down, all the way to conclusion.” Tim says that, now more than ever, the pressure is on the fund of funds. “A fund of fund invested in the next Madoff ... they’re done. Obviously this shouldn’t have happened in the first place, but now there’s REALLY no excuse – there will be a big price to pay for making that kind of mistake again.” Howard definitely feels the pressure: “We look at weekly returns and what we know about the manager’s space. If it deviates, it will raise yellow flags. We may call them spontaneously to see what is going on. We schedule monthly or semi-annual visits, and we focus on operational due diligence more now than ever before, particularly cash management. How does money go in and out of the fund, and who controls it?” Eric takes similar action: “We verify a manager’s assets quarterly and/or semi-annually. We also contact them every six months to get a high level overview of any changes in their operations. Then we conduct ad hoc reviews, and closely examine anything happening during the time frame in between scheduled check ups and visits.” Jamie, too, asks for more info and asks for it much more often: “Now we can demand estimates on their monthly performance within two to three days of month end. A year ago, we could have never demanded that.”