

The Role of Operational Due Diligence for Managed Accounts

Joshua Kestler is the Chief Operating Officer of HedgeMark.

Since the Global Financial Crisis in 2008, institutional investors have become increasingly focused on operational due diligence as a key component of the manager selection process. HedgeMark, as a managed account and infrastructure platform provider with a deep commitment to position-level risk analytics, has a unique perspective on the role of operational due diligence in hedge fund investing. Specifically, we believe a core benefit of the managed account structure is the heightened fiduciary framework established by the separation of duties between the hedge fund manager, in its role as investment manager, and the managed account platform provider who oversees all operational functions. The hedge fund manager retains trading authority while the managed account platform provider is responsible for most day-to-day operational functions (including those which inherently introduce conflicts of interest when performed by the manager). These functions include, but are not limited to, oversight of fund accounting and administration, negotiating prime brokerage and ISDA agreements, counterparty monitoring, control of all cash and collateral movements, monitoring

of compliance with written investment guidelines, and independent performance and risk reporting. We believe that the segregation of investment and operational functions, which is the norm with traditional investments and a core component of HedgeMark's managed account structure, eliminates many of the operational risks associated with hedge fund investing.

Despite the protections afforded to institutional investors through a segregated managed account structure, we believe that operational due diligence will continue to play an important role in the investment process. In this respect HedgeMark does perform operational due diligence on all managers before such managers are approved for the HedgeMark platform, thereby minimising the work required of investors utilising our systems. HedgeMark, among other things, evaluates the managers' capabilities with respect to trade processing, trade allocations, reconciliations, IT systems and business continuity to confirm that the manager has the ability to effectively run a managed account alongside other funds and accounts. We also conduct background checks on hedge fund management companies and their principals

to look for any red flags. HedgeMark believes that while operational due diligence remains an important tool, the use of a managed account structure can mitigate, if not largely eliminate many of the operational risks associated with hedge fund investing.




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Neil Brown is Senior Partner at Earth Capital Partners LLP, a company which specialises in sustainable projects, energy efficiency and renewable energy.

"Earth Capital Partners aims to deliver attractive returns to our investors through projects, companies and financial instruments, which address Sustainable Development challenges, such as climate change, energy efficiency and socio-economic development," Brown explains of the firm.

With a career in asset and risk management spanning thirty years, Brown started work as a broker and trader of derivative instruments, moving on to several years self-employed as a derivatives and risk management consultant, and eleven years as Global Head of Risk Management for HSBC Asset Management and Credit Suisse Asset Management, prior to his current role. It is this breadth of experience which Brown believes gives Earth Capital the edge over competitors.

During a long career in the industry, Brown has come across various challenges when conducting risk assessment in complex alternative investments.

Alternative asset managers face a major conflict of interest in the tension between the incentives available and the manager's fiduciary responsibility; a sound risk assessment must address the scale of and the systems in place to manage this conflict.

"The complexity of the products available and the variety of asset classes are a minefield for a generalist. Knowing how and why misconduct might arise requires detailed knowledge and experience, coupled to a thorough investigation of processes and procedures. This requires detailed knowledge of industry best practice and the ability to investigate how and why these might be avoided."

Finally, Brown explains how due diligence could be the key to success. "Sound operational procedures are the key to the smooth operation of an alternative asset manager. They do not, of themselves drive return, but they do help to reduce the risks to investors of a manager that is unlikely to deliver the mandated product or where there are insufficient levels of segregation, oversight and control."




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Patric Wisard is founding partner of aicons AG, a Swiss-based due diligence firm.

Switzerland-based aicons AG was founded in 2002 and is today one of the leading due diligence firms for alternative investments.

"For almost 11 years, aicons AG has served institutional investors with in-depth investment, operational and legal due diligence and monitoring on over 800 hedge funds, private equity funds and other non-traditional as well as traditional investments," explains Wisard. "Well over \$150bn has been invested based on aicons AG's research and advice. Pursuing a low-profile approach with highest confidentiality, aicons AG supports institutional investors with a custom-made service, i.e. we often act as an "in-sourced" specialist team."

On the subject of standing out from the crowd, Wisard explains what sets aicons AG aside. "It is the people that make the difference," he affirms. "aicons AG's staff has a natural devotion to forensic-style

due diligence. Our team is truly multidisciplinary and each professional is capable of performing investment, operational and legal due diligence on virtually all strategies and structures. aicons AG is not a due diligence factory but a place to go for those who want to go at least one step further than others."

The use of an operational due diligence specialist has proved crucial on many occasions for aicons AG's clients.

"Over the last 11 years the firm has saved its clients from investing with managers which were later found to be fraudulent," Wisard explains. "And further saved its clients various times from investing with managers which subsequently suffered heavy losses due to operational short-falls (for example, insufficient escalation process in risk management)."

Looking to the future, Wisard states that he believes operational due diligence in the private equity fund

industry to be more than 10 years behind the hedge fund industry. "Based on unanimous feedback from private equity fund managers, only very few investors actually perform operational due diligence on private equity funds," he comments. "It could well be that the next "Madoff" will occur in the private equity industry!"




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