



A take on internal controls - Part II

In [part I](#) of this article, we described two accounting guidance used by financial institutions to report on their internal controls. The second part will cover the standards that have been developed by various organizations involved in the alternative investments industry and more broadly in the finance industry.

The main difference between the existing standards and SAS 70 or AAF 01/06 guidance is that no external party is involved in the verification of institutions to see if they comply with those standards. Except for the Hedge Fund Standards Board (see below), the standards are to be viewed as guidelines for investment managers to implement sound operational practices.

The AIMA has developed, in 2008, a website at www.hedgefundmatrix.com, which allows one to view, side by side, the practices recommended by various standards, under five headings: (1) Creating and managing a hedge fund business, (2) Investment process and portfolio risk management, (3) portfolio administration and operational controls, (4) raising capital and investor relations and (5) hedge fund structure and organization.

The "Matrix" is based on the following documents:

- AIMA
 - Guide to Business Continuity Management for Hedge Fund Managers
 - Guide to Sound Practices for European Hedge Fund Managers
 - Guide to Sound Practices for Hedge Fund Valuation
 - Offshore Alternative Fund Directors' Guide
- Hedge Fund Standards Board (HFSB)
 - Hedge Fund Standards: Final Report
- International Organization of Securities Commissions (IOSCO)
 - Principles for the Valuation of Hedge Fund Portfolios
- Managed Fund Association (MFA)
 - Sound Practices for Hedge Fund Managers
- President's Working Group on Financial Markets
 - Asset Managers Committee Report

The "Matrix" is geographically very well balanced as it covers standards developed by two UK associations, two US associations/groups and an international organization. In terms of representativeness, the matrix is somehow biased toward investment managers. The AIMA in the UK and the MFA in the US are the representatives of the alternative investment industry and their members are hedge fund managers, fund of funds managers as well as industry service providers. The HFSB and the Asset Managers' Committee established by the President's Working Group on Financial Markets are both composed exclusively of hedge fund managers. Finally, the IOSCO is representative of the financial markets regulatory bodies around the world.

The Hedge Fund Standards were drawn up by the Hedge Fund Working Group (HFWG). The HFWG, comprising of 14 hedge funds based mainly in London, was set up in 2007 in response to concerns about the industry, including financial stability and systemic risk. The HFWG completed its work in January 2008 and then published its report outlining

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the Hedge Fund Standards. As of today, 54 managers became signatories of the standards. The HFSB is based on the "comply or explain" principle. Each member needs to annually prepare a "conformity statement", which is sent to the HFSB. In this statement, the member must first state that he will make available to all investors and prospective investors, in hedge funds managed or advised by him, a statement (a "Disclosure Statement") which indicates whether or not he complies to the standards, and if not, the reason for which he does not comply, i.e. by reason of choice or by reason of inability to comply. In the "conformity statement", the investment manager must also confirm that he is using agreed upon disclosure language so as keep the HFSB harmless (not liable) and to reinforce the HFSB's sole role as the custodian of the standards. In our experience, it is sometimes difficult to obtain the "disclosure document" since the investor relations department is usually not aware of the HFSB's requirements. Keeping in mind the non-binding aspect of the HFSB and the fact that the document is not reviewed by an external body, the investors should ask for this document as it may provide an interesting basis for an operational due diligence.

All the above mentioned documents describe the standards/practices and related guidance and examples which are intended to assist and illustrate how compliance might be achieved. The standards are usually described in broad principles so as not to be too restrictive and to allow even small managers to comply. Therefore, the imprecise language used in the standards leaves them to interpretation by the managers based on their own understanding and in their own context.

The standards provide a good framework, for managers and investors alike, to analyze the compliance of operations to the industry "agreed upon" practices (not to be always understood as best practices). The use of the standards as benchmarks will require each user to translate the standards into "practical standards" in order to define their own thresholds for compliance.

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