



Hedge Fund Due Diligence Bulletin

Conducting proper due diligence on third party service providers

In a typical hedge fund structure, the board of directors will delegate the different functions necessary to the day to day activities of the fund to a selection of third-party service providers. In practice, the directors, too often, are selected at the very end of the fund's creation process and therefore usually have little to say in the final choice of the service providers. The hedge fund managers, especially the start up ones, could gain by reversing the selection process on his head and bringing in the independent directors early on. By doing so, the manager will be able to benefit from the experience of the directors, demonstrate his commitment to strong corporate governance and bring some independence in the pre-launch phase.

The delegation of the day to day activities of the fund to service providers should not be confused with a delegation of responsibilities. Delegation without proper oversight of the delegated functions is ineffective and a breach of the directors' fiduciary duties which can lead to unpredictable consequences. Directors should feel comfortable with the investment manager's initial choices and have in place the proper monitoring process to ensure that the service providers continue to deliver on their promises. In most cases, the oversight of the outsourced functions is performed by the investment manager who has the day to day working relationships with the different service providers. In that case, the directors should require regular reporting.

The role of the directors, as well as of the investors, is not to second guess the investment manager's choices but to ensure that each choice was made, free of any conflict of interest, to ensure the right balance between operational efficiency, operational quality, costs, transparency and shareholders protection. The investor ultimately need to be as comfortable with the service provider's selection process as he is with the manager's investment process. The investment manager is supposedly the best person to select the service providers for the fund, since he knows the operational specificities of the investment strategy he tries to implement and he will be the one working directly with them. This close relationship between the fund manager and the service providers has its caveat as some service providers tend to forget that their client is the fund and not the investment manager.

In order to demonstrate the rigorousness of his selection process, the manager needs to substantiate his choices. If the manager used a formal request for proposal (RFP) process, he will be able to explain and demonstrate to the investors (and directors) the reasons for the selection of a specific service provider versus the other ones which have been considered. The manager will need to demonstrate the due diligence process used to compare the offers and to verify and validate the proposals. The investors will have to assess the adequacy and completeness of the selection process and decide if a further investigation is required.

After launch, the investment manager needs to regularly monitor and reassess the quality of the services provided. Controls have to be in place to monitor the delegated functions. For example, it is recommended for the investment manager to have a shadow accounting of the fund in order to be able to perform a verification of the NAV calculated by the fund's administrator in order to resolve any discrepancies before the NAV is finalized. The investment manager should also regularly visit the different service providers. If the quality of the services' declines, or the service provider is no longer the best choice for the fund (for example, if the fund grows quickly), the investment manager should consider his options. The change of a service provider is not trivial and should be performed with due care. Usually, when changing the administrator, a transitional period will be defined when both the previous and new administrator will perform the NAV calculation to ensure the smoothest transition. In any case, the change of a service provider needs to be disclosed to the fund's shareholders as soon as practicable and reasons for the changes have to be explained.

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After verifying the selection process and reviewing the services provided based upon the respective service agreements, the investor needs next to collect evidence on the services performed. A call, the use of a due diligence questionnaire or an onsite visit are the different tools used. Usually, the depth of the investor's due diligence on a service provider will depend upon the level of comfort he got from the manager's selection process, the level of operational complexity of the investment strategy employed and the service provider's reputation. The due diligence on the service providers should also include an assessment of their financial strength just in case something goes wrong!

One of the challenges for investors, in conducting due diligence on the service providers, is to get access to the necessary information. The auditors, and in particular, the big 4, are usually the least cooperative with investors. They are hiding behind the so called "privity" to avoid replying to due diligence queries. Investors have sometimes to use "tricks" in order to get just a simple confirmation that an auditor has performed an audit on a specific fund. Brokers come second in difficulty to investors. Most of them have developed standard letters which provide a confirmation of their role and a summary of the basic terms of their standard service agreement with funds. Additional information, like the level of assets under their custody may usually (but not always) be obtained with the support of the investment manager. Administrators are usually the most supportive of investors' due diligence. Some administrators have developed various solutions to provide better transparency into their activities. Sometimes, it may be useful to remind the service providers that the one who are paying the bill are the investors.

The changing landscape of the financial industry post-crisis will certainly have an important implication for the investment manager as well as for the hedge funds' service providers. The forthcoming European initiative will, for example, put more responsibilities on the local custodians' duty of asset protection. The initiatives on both sides of the Atlantic are focusing primarily on the regulation of the investment managers and the custodians but surprisingly the regulators do not address the lack of regulation of the fund's administrators. The administrators are playing a very central and increasing role in hedge funds' structure but their activities are not regulated by any law. In that context, the administrators are pushing to reduce their liabilities by for example becoming the verification agent rather than the pricing agent of the funds and therefore switching their responsibilities for pricing the portfolio to a mere oversight role. Investors should monitor this trend carefully.

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