

Due Diligence

Legal, Operational and Risk Considerations for Institutional Investors When Performing Due Diligence on Hedge Fund Service Providers

By Jennifer Banzaca

The old paradigm of hedge fund due diligence focused on the hedge fund manager and the new paradigm focuses on hedge fund service providers. That is, the purpose of hedge fund due diligence used to be (broadly, pre-2008) to ensure that the hedge fund manager itself had, internally, sufficient people, process and plant to maintain its return and risk profile. However, the credit crisis that began in 2008, and the frauds it brought to the fore, highlighted the franchise risk posed by service providers to hedge funds and managers. Consequently, post-crisis hedge fund due diligence has focused more squarely and thoroughly on service providers. For example, in a June 2010 study, hedge fund operational due diligence consulting firm Corgentum Consulting analyzed data from over 200 hedge fund allocators and concluded that hedge fund “investors are focusing the bulk of their due diligence efforts on legal, compliance and regulatory risks.”

The primary reason for this shift in focus – from managers and performance (then), to service providers and operations (now) – relates to the estimated harm from adverse outcomes. In relative terms, most investment losses are high probability, low magnitude events, while most operational failures are low probability, high magnitude events. The chief goal of due diligence is to avoid low probability, high magnitude events; and, moreover, the credit crisis taught that the probability of some operational failures may not be so low after all. Lehman Brothers provides the most sobering example. Hedge funds that used Lehman’s U.S. or U.K.

brokerage entities as their only prime brokers and that did not perform adequate due diligence on Lehman’s custody and cash management arrangements – or that did perform such diligence but did not incorporate its lessons – wound up with significant investor assets tied up for long periods in bankruptcy, SIPA or administration proceedings.^[1] The purpose of service provider diligence is to identify operational issues that can have a material adverse effect on investment outcomes – issues such as the commingling of hedge fund customer assets by certain Lehman brokerage entities.^[2]

With the twin goals of providing guidance to investors conducting due diligence on hedge fund service providers, and to hedge fund managers and service providers anticipating such diligence, this article: identifies key hedge fund service providers; details ten specific areas on which investors should focus when conducting service provider diligence; highlights areas of diligence specific to certain service providers; discusses strategies for accessing the data necessary to perform adequate due diligence; and incorporates recommendations regarding the timing and frequency of service provider due diligence.

Key Hedge Fund Service Providers

A hedge fund is a pool of money to which a number of entities provide services by contract (with the pool or with one another).

Hedge Fund Manager

Far and away the most important service provider is the hedge fund manager itself. The manager often organizes and manages the fund and selects the other service providers.

Prime Broker

Another key service provider, often a close second to the manager in importance, is the prime broker. Services typically provided by prime brokers to hedge funds include custody, clearing, trade execution, lending and margin, securities lending and capital introduction. Many hedge funds use multiple prime brokers to mitigate counterparty risk, and some hedge funds are using so-called “synthetic” prime brokerage to obtain leverage. See “What Is Synthetic Prime Brokerage and How Can Hedge Fund Managers Use It to Obtain Leverage?,” The Hedge Fund Law Report, Vol. 3, No. 13 (Apr. 2, 2010).

Administrator

Third-party administrators provide services to hedge funds that include: calculation of net asset value, valuation of assets, investor reporting, maintenance of books and records, processing of subscriptions and redemptions and Anti-Money Laundering and Know Your Customer analysis. Historically, many hedge fund managers – especially those with more hands-on investment strategies (such as distressed debt) – performed some or all of these functions in-house, but since 2008, institutional investors have been pushing hedge fund managers to outsource these functions. The chief rationale for outsourcing is to obtain a third-party verification of the existence and value of portfolio assets. See “Hedge Fund Managers Retaining ‘Private Regulators’ to Demonstrate a Credible Commitment to Compliance,” The Hedge Fund

Law Report, Vol. 2, No. 27 (Jul. 8, 2010). Some hedge fund managers have been able to accommodate this goal while keeping administration in house, thereby retaining the value invested in building a proprietary administrative function. See “How Can Hedge Fund Managers Maintain the Efficiency Advantages of In-House Administration While Addressing the Valuation, Transparency and Conflicts Concerns of Institutional Investors?,” The Hedge Fund Law Report, Vol. 3, No. 2 (Jan. 13, 2010).

Accountant

Third-party accountants (as opposed to in-house fund accountants) generally audit hedge funds, create financial statements and compile the data included in K-1s that are provided to investors. Under the new custody rule, third-party accountants also will be required to provide annual surprise examinations in certain circumstances. See “How Does the Amended Custody Rule Change the Balance of Power Between Hedge Fund Managers and Accountants?,” The Hedge Fund Law Report, Vol. 3, No. 4 (Jan. 27, 2010).

Law Firm

A hedge fund manager’s outside counsel provides a wide range of services to the manager and its funds, including drafting and revision of fund and manager documents, drafting and review of service provider documents, employment agreements, compliance, tax and litigation advice, drafting of side letters and other legal services.

Placement Agent

Hedge fund managers sometimes retain placement agents to find investors for their funds. The SEC recently finalized a new rule relating to pay to play arrangements

that conspicuously did not prohibit the use by hedge fund managers of placement agents. The Hedge Fund Law Report will cover the new rule and its implications in detail in coming issues. See generally “The Four P’s of Marketing by Hedge Fund Managers to Pension Fund Managers in the Post-Placement Agent Era: Philosophy, Process, People and Performance,” The Hedge Fund Law Report, Vol. 2, No. 45 (Nov. 11, 2009).

Directors

Various sources interviewed by The Hedge Fund Law Report identified hedge fund directors as another category of service provider to hedge funds. While not typically thought of as service providers, the goals and purposes of directors are analogous to those of other service providers – their job is to provide oversight, serve as a check on the hedge fund manager and effectuate the best interests of investors. See “Directors of Cayman Islands Hedge Funds Assume a More Substantive Governance Role in Response to Institutional Investor Demands,” The Hedge Fund Law Report, Vol. 2, No. 15 (Apr. 16, 2009). Also, it should be noted that hedge funds organized in the Cayman Islands, the British Virgin Islands and certain other offshore jurisdictions have directors, while hedge funds organized onshore generally are Delaware limited partnerships and do not have directors. However, even onshore funds sometimes have analogous bodies with similar investor protection goals. See “Hedge Fund Managers Organize Ethics Boards to Advise on Close Ethical Calls, and to Credibly Demonstrate (to Regulators, Investors, Employees and Others) a Commitment to Best Practices,” The Hedge Fund Law Report, Vol. 2, No. 19 (May 13, 2009).

Specific Areas on Which Investors Should Focus When Conducting Service Provider Diligence

People, Ethics and Expertise

Like hedge fund managers, hedge fund service providers are only as good as their people. (While some service providers have sophisticated proprietary technology, that technology usually reflects the ability of the people who designed it.) Accordingly, the most important category of due diligence an investor can perform on a hedge fund’s service providers is to obtain a thorough understanding of the qualifications, expertise and ethical caliber of the personnel at those service providers.

Robert Weiner, a Director at BDO Consulting, noted that “You really want to have full knowledge of who you are doing business with, how they are conducting that business and their track record, and the only way to really get your arms around that is to thoroughly understand who the people are, where they came from, how they got to be where they are and how successful they have been in what they are doing.” Similarly, Adrian Sales, Global Head of Operational Due Diligence at Albourne Partners Ltd., observed that “Generally, the first thing you look at is the service provider’s expertise and qualifications. The experience, systems and familiarity the service provider has with the fund and strategy will help determine if they are a suitable service provider.”

Also, Cary Klivan, COO of boutique wealth management firm BBR Partners LLC, noted the importance of background checks and, in appropriate circumstances, licensure. “You want to look at people’s backgrounds, and if there are licenses

required, query whether relevant personnel have the proper licensing,” Klivan said. See “In Conducting Background Checks of Hedge Fund Managers, What Specific Categories of Information Should Investors Check, and How Frequently Should Checks be Performed?,” *The Hedge Fund Law Report*, Vol. 2, No. 36 (Sep. 9, 2009).

Low Employee Turnover and Systems to Address Turnover

Investors should also look into the rate of turnover at a hedge fund’s service providers. Generally, investors want to see a low rate of turnover. However, some turnover is inevitable. Therefore, in addition to a relatively low turnover rate, investors also want to see robust training, on-boarding and knowledge management systems in place at service providers. As Klivan said, “When we do our due diligence on a service provider, we definitely want to understand the turnover within the organization and within the specific team that is servicing that hedge fund. You want to understand what the service provider is doing to combat the turnover and then ask the manager how they are reacting to it.”

Ron Tannenbaum, Managing Director at GlobeOp Financial Services, a hedge fund administrator, made a similar point on turnover, and also emphasized the importance of creating specific teams focused on particular hedge fund clients. “We do get questions on our turnover and how we train new people coming in. We’re very open about that process. We build a specific coverage group around each specific customer for all their day-to-day needs. We also have a group for client relationship management. This is something that is becoming more and more important to investors.”

Focus on the Process of Selection of Service Providers

Samuel Weiser, Managing Member at consulting firm Foxdale Management LLC, emphasized the importance of investigating the process by which a hedge fund manager selected service providers for its managed funds. Generally, a more rigorous process requires less additional due diligence by the investor, and thus less time and lower cost. Put another way, the cost expended on a rigorous (and rigorously documented) service provider selection process can be saved in the form of a shorter service provider due diligence cycle. Where cost-effective and otherwise practicable, hedge fund managers may consider a formal request for proposal (RFP) process for selecting service providers.

As Weiser explained, “If the manager goes through a formal RFP process and the manager validates – not just verifies – the responses and then selects a vendor based upon its ability to comport with the desired objectives, why would an investor second guess that process? Investors really need to look into the reasons why various vendors were chosen. You have to go down a critical path and if the answers are inadequate or incomplete, you need to extend your procedures. If the answers are acceptable, you probably don’t.”

On-Site Visits

While on-site visits to a hedge fund manager historically have been an essential element of hedge fund due diligence, on-site visits to service providers have been less frequent. However, that is changing, and on-site visits to service providers are becoming the standard of care in hedge fund due diligence. Eric Lazear, Head of Operational Due Diligence at FQS Capital Partners (U.S.) LP, explained this shift in the context

of due diligence on hedge fund administrators: “When possible, particularly with administrators, you should conduct on-site visits with the service providers the fund is utilizing and/or has relationships with. For instance, with the administrator, you want to review their NAV process, position and cash reconciliation procedures, assess the team working on fund, AML, etc. You want to know what they are doing, how they are doing it and who is performing these functions. You want to speak with the pricing team and the AML team, the cash management and the customer relations teams to review and assess the procedures being conducted at the administrator. With a manager’s permission, you also want to go through the whole process of reviewing the NAV, expenses and cash packets (i.e., the folder containing pricing support, support for NAV calculations, positions and cash reconciliations, etc.) of the specific fund to see exactly what and how the process works within the administrator.”

Compare Actual and Contractual Services and Service Levels

Lazear also suggested comparing the actual services and service levels provided by a service provider to the services and service levels provided in the contract with the fund or the manager. In other words, reviewing service provider contracts is not sufficient – an investor should also collect evidence on how a particular contract is being performed. According to Lazear, “When you conduct operational due diligence on a manager, you should always speak with the various service providers to confirm the level of services that are actually provided to the fund. For example, even if a fund has an independent administrator, you should still speak with the administrator to discuss the services they are actually providing such as the exact valuation process and cash movement.”

In the Case of Redundant Policies, Determine Which Will Govern

Foxdale’s Weiser noted that in certain circumstances, hedge fund managers and other service providers will have policies and procedures that purport to govern the same substantive areas. For example, a hedge fund manager and its administrator both may have business continuity or disaster recovery policies. (Both types of policies are discussed more fully below.) In the event that a disaster materializes and the policies conflict, which policy governs? This is not a question that must be answered in the abstract, but it is a point that should be confirmed in the course of due diligence. As Weiser put it, “to me, you first have to identify the operational risks and you can’t identify these risks until you understand the business process. For example, everyone now has a disaster recovery/continuity plan. If the fund maintains a complete mirror image of the records at the fund administrator, the question becomes whose disaster recovery plan is more important and relevant?”

Overreliance and Substitution

While it generally is a good thing for a hedge fund or manager to be a significant client of a service provider, it can be a bad thing if a manager is the service provider’s only client or constitutes the vast majority of service provider’s revenue or profit. Specifically, it can be bad because the service provider may not have the financial wherewithal to maintain the level of independence sufficient to serve the best interests of the hedge fund’s investors. Timothy Mohr, a Partner at BDO Consulting, explained that in cases where a hedge fund is the sole client of a service provider (or “vendor”), “the success of that vendor’s entire business depends on the success of that fund. That can be a serious problem as the vendor might be willing to compromise certain practices or

regulations in order to keep that fund's business." Likewise, Lazear counseled that "you want to look at how independent the service provider is to the fund/manager. Does the fund/manager account for a large portion of the provider's business and revenues? If so, is the manager receiving any special treatment or privileges?"

Klivan also emphasized that overreliance by the manager on a single service provider can be dangerous for the manager. The use of multiple prime brokers by a growing number of hedge funds is a good example of the growing recognition of this potential problem. See "Migrating Toward Multi-Prime: Did Your Manager Decrease or Increase Operational Risk?," *The Hedge Fund Law Report*, Vol. 2, No. 23 (Jun. 10, 2009). As Klivan said, "looking at the relationships and how much a fund manager depends on any one particular service provider is critical. There is a different level of reliance and risk attached to each service provider depending on the type of service that is being provided. You have to look at whether there are other service providers that the manager could substitute for them."

Length of Service and Changes in Service Providers

The relative length of service of a particular service provider to a hedge fund is an important factor for investors to consider. The flipside of this is that inadequately explained changes in service providers are often a red flag. "Any time a manager changes service providers, it's going to raise questions," Klivan said. "The investor is always going to have to try to understand why the change was made and the manager should make that reason clear. If the reason is that the firm simply outgrew a particular service provider, well, that may be a perfectly valid reason. When a manager gives you its reason for the change, you have to decide whether that

reason makes sense. Also, if you get conflicting information from the manager and the service provider on the reason for the change, that's a red flag. It could be an indicator that something odd is going on."

Weiser added that in cases of changes to service providers, "you want to find out, and verify with the old service provider, the reason for the change. You want to know whether there was a formal RFP process to select the replacement service provider and if it was a quick change or if it was simply that the service provider no longer met the manager's needs and the manager went through a long due diligence process to find a new service provider that was a better fit. If it was a quick change, that's probably an indication there was a problem. You want to know what kind of due diligence the manager did on the service provider, how many other vendors it looked at in the process and what kind of evaluation process it performed in choosing a service provider."

Has the Hedge Fund Outgrown Its Current Service Providers?

However, not all changes to service providers are red flags. As suggested by Klivan and Weiser in the quotes above, there may be circumstances in which a hedge fund outgrows a particular service provider, based on size, strategy or other factors. Klivan explained this process in greater detail, as follows: "I've seen a lot of managers that have historical relationships with certain service providers, which can be a great sign of stability, but sometimes can be detrimental. As the manager grows, it may add new funds with more complex strategies that maybe the administrator or other service providers do not have the proper level of sophistication to handle. You have to check that the fund is getting the level of service that it needs from its service providers. For example,

a certain administrator may have the capabilities to handle a plain vanilla long/short equity fund. However, if the manager launches a complex credit fund, that same administrator may be over its head in valuing the more complex assets or in handling the accounting issues associated with such assets.”

Disaster Recovery and Business Continuity Plans

As indicated above, conflicts between the disaster recovery and business continuity plans of hedge fund managers and their service providers need to be resolved in the course of due diligence. However, the absence of disaster recovery and business continuity plans at a service provider can be a red flag. See “What Are the Key Elements of a Comprehensive Hedge Fund Adviser Disaster Recovery Plan, and Why Are Such Plans a Business Imperative?,” *The Hedge Fund Law Report*, Vol. 3, No. 8 (Feb. 25, 2010); “Key Elements of a Hedge Fund Adviser Business Continuity Plan,” *The Hedge Fund Law Report*, Vol. 3, No. 7 (Feb. 17, 2010).

Service Provider-Specific Due Diligence

Prime Broker Due Diligence

Understanding the relationship between a hedge fund and its prime broker(s) is a key part of the service provider due diligence process.

According to Weiser, “Instead of looking solely at the balance sheet and capital adequacy of a prime broker, it would be better to talk to the account rep and ask about the working relationship with the fund and how trades, transfers and new investors get processed. Don’t ask the prime broker if it performs certain functions (based on responses from the fund manager). Instead, ask questions that let the prime broker tell you what it does.”

Administrator Due Diligence

As indicated above, while not all hedge funds have third-party administrators, more and more do, largely in response to demands from institutional investors. See, “Implications of Demands by Institutional Investors for Independent Hedge Fund Administrators,” *The Hedge Fund Law Report*, Vol. 2, No. 3 (Jan. 21, 2009). Tannenbaum, of GlobeOp, the administrator, has first-hand insight into the administrator diligence process. “In the past we might get questionnaires or phone calls asking what we did,” he said. “That was all they needed to know and they moved on. Now investors want proof. They want to come in and meet with key people. They want transparency reports showing the job was done correctly.”

Klivan added that “The administrator is the primary service provider you want to focus your attention on. There is no reason why any investor should not be granted access to the administrator to at least be able to have a conversation with them about the processes they go through to perform the services they perform for the fund.”

Auditor Due Diligence

Klivan cautioned that “There’s little information you’re going to get out of an auditor about what they actually do during a given audit. They’re not going to meet with you to discuss the audit. The comfort is that they should be independent and following accepted auditing standards. So, the risk is that you don’t have a quality audit firm that is knowledgeable about the hedge fund industry. In this case, you really need to know who the auditors are and that there is, in fact, a relationship with the fund.”

Outside Counsel Due Diligence

Klivan suggested that outside counsel may be similarly tight-lipped (and for valid reasons, including attorney-client privilege, work product protection and protection of client confidentiality). “Lawyers aren’t typically going to talk to you about the types of issues they are dealing with on behalf of a fund or manager, so you gather most of your information through conversations with the manager,” Klivan said. “You want to check that it is a law firm that is well-known within the hedge fund community and that at least part of its practice specializes in financial services, specifically on hedge funds. You want to try to find out if there are any current cases against the fund, the manager, or the principals of the manager. There is a limit to the amount of information you’re going to get directly, so you’re really just relying on who the manager and fund are using and what experience the firm has with dealing with hedge funds.”

Director Due Diligence

While some investors may not traditionally think of the board of directors as service providers, Albourne’s Sales said he feels that hedge fund directors are service providers and should be included in the due diligence process. Sales said investors need to make sure directors have the experience and knowledge to understand the fund’s strategy so as to provide effective and independent oversight over that fund.

Lazar agreed that the board of directors is an important service provider on whom diligence should be performed. “I do not think historically that people spoke with the board of directors or paid much attention to them. Given the turmoil in 2008/2009, where managers imposed gates, created side pockets and suspended redemptions, investors are now

reaching out to the board of directors to find out who they are, what they do for the fund and what experience they have with the relevant strategy.”

However, proper due diligence invariably starts with the fund manager, Sales noted. “Technically, the investment manager is a service provider to the fund and the obvious starting point is to look at the controls in place at the investment manager to make sure it has proper systems, staff and duty separation.”

How to Obtain Critical Data on Service Providers

Generally, investors can obtain data on hedge fund service providers through three channels: (1) themselves, with the consent of the manager and service provider and usually under the terms of confidentiality agreement; (2) via professional operational due diligence providers; and (3) through publicly available documents and data (including SAS 70 reports, Internet searches of public records, industry reports and news articles).

On the first point, Sales noted that fund manager consent is necessary before a potential investor can speak with a fund’s service providers. Because some of the information about the relationship with the fund manager may contain proprietary information – such as trading systems specs or portfolio positions or assets – some service providers or managers will ask investors to sign confidentiality agreements so that information is not redistributed or used in a manner adverse to the interests of the fund or manager.

That said, Sales observed that in recent years, the transparency into the fund and service provider relationships has improved. “Managers now want to go out of their way

to show investors that the controls they claim are being carried out actually exist. As such, they are more willing to allow service providers to respond to inquiries. Additionally, the service providers want to show that they are providing the level of services that they claim to be providing because ultimately the investor is paying for these services since the costs are directly charged to the fund.”

Weiser agreed that the transparency into the service provider relationships is improving. “I would say hedge fund managers are becoming more transparent. Managers should not have anything to hide about any of their service providers. Any information that an investor would ask for that’s withheld is a red flag. Looking at it from an operations standpoint, if a manager won’t tell you what the terms are of their relationship with a particular vendor and they won’t show you the contracts if you ask to see them, it’s certainly a red flag.”

However, Klivan noted that there are limits to how much information a hedge fund manager is willing to allow its service providers to disclose. That level will vary from fund to fund but also from investor to investor. “How much access you get to information about a hedge fund’s relationships with its service providers from the hedge fund manager may depend on how large an investor you are. Obviously, the larger you are and the more you are looking to invest with a manager, the more influence you’ll have in getting the information you are looking for.”

With respect to public records and private diligence providers, BDO’s Weiner noted that “In the past, some fund managers were unwilling to share some information about their service providers. Investors who asked questions were

often shut out. Now if that happens, investors are likely to walk away. Also, if some data is not available from the fund manager or in the public domain, then you have to look to outside providers of due diligence services that have experience in that industry and have relationships with a lot of these players or reliably sourced information.”

Ongoing Due Diligence

Service provider due diligence is not a one-time undertaking. Just as investors are constantly monitoring the fund manager, they should also be monitoring the fund’s service providers for any changes in personnel, services offered or relationships with the fund manager. As Lazear noted, follow-on due diligence is just as important as initial due diligence.

Tannenbaum agreed that it is important to conduct ongoing due diligence, and noted that some investors are demanding periodic reports on services or personnel changes at service provider companies. “Things change and can change quickly with any service provider,” Klivan concluded. “I would want there to be, at minimum, an annual review performed almost to the level of due diligence performed during the initial assessment. Any changes in service providers throughout the year, managers should disclose that to investors immediately.”

[1] On Lehman, see “Will the Proposed Out-of-Court Plan Help or Hinder Efforts of Hedge Fund Creditors to Recover Assets from Lehman Brothers International Europe?,” *The Hedge Fund Law Report*, Vol. 2, No. 41 (Oct. 19, 2009); “How Can Hedge Funds Get Their Money Out of Lehman Brothers International Europe?,” *The Hedge Fund Law Report*, Vol. 2, No. 31 (Aug. 5, 2009); “Should Hedge Funds Purchase Unsecured Debt of Lehman Brothers Holdings

Inc.? Key Legal Issues Impacting Returns,” The Hedge Fund Law Report, Vol. 2, No. 26 (Jul. 2, 2009); “Lehman Brothers Holdings and Certain of its Subsidiaries File for Bankruptcy Protection,” The Hedge Fund Law Report, Vol. 1, No. 21 (Sep. 22, 2008); see also “Hedge Funds Turning to Prime Brokerage Trust Affiliates For Added Protection Against Prime Broker Insolvencies,” The Hedge Fund Law Report, Vol. 2, No. 25 (Jun. 24, 2009).

^[2] To the extent such commingling was the default procedure at a Lehman entity, it should have been identified by pre-investment operational due diligence conducted by investors in hedge funds that used the relevant Lehman entity as a prime broker. To the extent such commingling constituted a departure from Lehman’s contractual obligations, it

should have been identified by ongoing operational due diligence conducted by such investors. But of course, such prescriptions relate to an ideal world. On the ground and at the time, it was difficult based on the industry structure (many hedge funds, few major prime brokers) for many hedge funds to negotiate terms with Lehman or other prime brokers. Also, segregating customer assets may have resulted in fee increases, diminished access to leverage and other adverse changes in terms. See “Aite Group Report Examines the ‘Mini-Prime’ Broker Landscape and Projects Slow and Steady Long-Term Growth Outlook for the Hedge Fund Industry,” The Hedge Fund Law Report, Vol. 3, No. 8 (Feb. 25, 2010).