

# Hedge Fund Operational Due Diligence - An Absolute or Floating Standard?

Hedge fund investing is a global exercise. This is true more today than ever. Even a U.S. based hedge fund manager with no offices overseas still likely has exposure to non-U.S. borne operational risks via market exposures and marketing activities to international investors. The more common example is a hedge fund manager which has offices in both the U.S. and overseas. These offices may be simply for client service and business development or a hedge fund may actually have traders and operations professionals based in these offices. When performing operational due diligence on managers with a global presence, as well as with managers who are more regionally focused, investors will quickly surmise that certain operational processes and standards are more common in some parts of the world than others. These differences may, in part, be attributed to the peculiarities of certain regulatory frameworks however, by in large they are fueled more by local customs rather than requirements. How then is an investor supposed to compare these, sometimes nuanced, differences in the operational practices of hedge funds? Should an absolute best practice standard be applied regardless of where in the world a hedge fund operates? Perhaps a floating standard where regional considerations are factored into the operational risk analysis of a hedge fund manager? If a floating standard is applied, how can an investor facilitate consistency in comparisons among different regional practices? In making these determinations investors may consider leveraging Corgentum's global expertise to facilitate both an understanding and analysis of worldwide hedge fund operational risk trends.

## Absolute Best Practice Standard

At first glance comparing the operational risks of hedge fund managers against an absolute best practice standard may inherently seem to be the best option. This standard however, can lead to an overly rigid framework where certain hedge funds or regions become non-investable by default. Consider for example the issue of audited financial statements. It can be argued that U.S. GAAP is a more transparent accounting standard than IFRS. Therefore, continuing our example, an investor following an absolute best practice standard may argue that it would be best practice for all hedge funds which are required to report under IFRS to also produce U.S. GAAP compliant financials for investor review. According to this standard virtually all European and Asian hedge funds would be deemed uninvestable. This clearly does not facilitate most portfolio construction schemes as well as needlessly excludes a host of quality managers with sound operational risk infrastructures.

## Floating Standard

In much the same way the application of an absolute best practice standard may suffer from being overly rigid, so too may a floating standard suffer from being overly flexible. Consider for example a floating standard which requires a hedge fund manager to be in compliance with and prepared for financial regulatory audits. Now consider a Hong Kong based hedge fund manager who does not have any mock regulatory audit performed. The manager may argue that the Hong Kong Securities and Financial Commission does not require such mock audits, they have never been audited within the last five years and they are confident they would pass such an audit with flying colors. Compare this with a U.K. based hedge fund manager who, believing that the U.K. Financial Services Authority will be increasing audit frequency and scrutiny, utilizes a compliance consultant to perform bi-annual mock audits. For the sake of argument, let's assume that each manager may be correct about the enforcement vigor of their respective regulatory regimes. In both cases, the floating standard of compliance and preparedness for regulatory audits is satisfied and may equate these funds to have equal amount of operational risk in this regard. Ultimately however, the argument could be made that, assuming that the mock audits are conducted competently and the hedge fund repairs any deficiencies notes, that the U.K. based manager has a lower amount of operational risk with regards to a regulatory audit.

## For More Information

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