

Hedge Fund Service Provider Due Diligence: A Window Into Operational Risk

During the course of the hedge fund due diligence process investors run the very real risk of falling prey to the notion that the scope of their due diligence need only be contained to the hedge fund itself. Such an approach understates the nature of hedge fund operational risk. Operational risk is both internal and external to a hedge fund. While the crux of any operational due diligence review should indeed be a focused on the hedge fund organization itself, much can be garnered from performing a review of a hedge fund's service providers including the administrator, auditor, custodian, prime broker and legal counsel. Particularly in light of the lessons of Madoff and Galleon, considerations related to a hedge fund's exogenous risk environment, and in particular any risks which lie with its service providers, can be just as important as those risks which lie within the hedge fund organization itself.

When an investor allocates to a hedge fund manager they are necessarily going long the fund's service providers. Without performing due diligence on these service providers investors are effectively making an uninformed decision. Furthermore, it is ill advised to simply rely on the quality of a certain service provider because of their size or market reputation. In many instances, particularly with regards to hedge fund administration, the actual individuals which service the hedge fund's account on a daily basis may be the determinative factor in the quality of such work being provided regardless of any institutional fortitude supporting them. Additionally, the financial stability of a service provider may also directly impact a hedge funds ability to obtain financing or access its assets as the failure of institutions such as Lehman Brothers have demonstrated.

When performing due diligence on a hedge fund manager it could be argued to a certain extent the manager has the ability to manipulate, or at least put a positive spin, on certain operational weaknesses. Such rose colored glasses are often discarded however, when an investor speaks directly with a hedge fund's service providers. In many such cases, the hedge fund manager is completely removed from any such communication between the investor and the service providers. As such, investors are essentially provided with unfettered access to a microcosm (limited of course to the service provider's respective area of interaction) of raw operational data on a hedge fund manager.

A hedge fund's service providers are often essential to the successful and continued function of the hedge fund organization. As a result, investors should incorporate a review of these service providers as part of the operational due diligence process. The roles of service providers should not be viewed in isolation. Rather, much more can often be learned from service provider due diligence reviews when not only the individual functionality in place at each service provider is evaluated, but the ways in which service providers interact with the hedge fund. Reviewing such relationships from both the service provider's and hedge fund's perspective can often result in a more complete operational picture of a hedge fund.

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**Investing In a Hedge
Fund Is An Investment
In Its Service Providers**

**An Opportunity For Raw
Operational Data
Collection**

Conclusion

For More Information