

# The Trustee's Guide to Alternative Investment Operational Due Diligence



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## Introduction:

In advance of the upcoming Opal Investment Education Symposium in New Orleans, LA on February 15-17, 2012, Corgentum Consulting has prepared this exclusive guide for Trustee's to introduce the subject of operational due diligence on alternative investments including hedge funds, private equity, and real estate funds. This introductory primer will especially be of use for trustee's attending the *Investing in Alternatives* panel session on Wednesday February 16, 2012 at 12pm.

During this session, Corgentum Consulting's Managing Partner and panel moderator, Jason Scharfman, will focus the discussion on:

- Upcoming trends in operational risk in alternative investments including hedge funds and private equity funds
- The role of operational due diligence consultants, such as Corgentum, in designing a comprehensive operational due diligence solution
- Operational due diligence challenges trustees can expect in 2012

## What exactly is operational due diligence?

Trustees who oversee allocations to alternative investments such as hedge funds and private equity may have heard the term operational due diligence mentioned more frequently over the past few years. One of the biggest reasons for this recent increase in interest in this subject are the failures of alternative investment funds for operational reasons and the outright fraud present in other funds- including those overseen by Bernard Madoff. With all of this increased interest, many trustees are seeking to dive head first into implementing an operational due diligence solution - but what exactly do we mean by the term operational due diligence?

Operational due diligence is a due diligence review of a fund that focuses on operational risks. These operational risks can be defined most broadly as a fund's non-investment related risks. Common operational risks can include:

- Back office and trade operations
- Fund service providers such as custodians and auditors
- Cash management
- Valuation policies and processes
- Legal and regulatory compliance
- Information technology and business continuity
- Counterparty management



Corgentum's approach analyzes a hedge fund's operational risks across a comprehensive spectrum of over 20 distinct risk categories.

## Why do Trustees need to care about operational due diligence?

Alternative investments such as hedge funds often utilize complex investment strategies. With these complex investments come equally complex operations.

Without having a third-party firm conduct detailed operational reviews of a hedge funds' operations, a trustee may be taking on unnecessary and often hidden operational risks which may cause substantial losses.

## Aren't operational risks always covered during the due diligence process?

Not necessarily. Alternative investment fund manager due diligence can be broken down into two parts. The first is the traditional investment due diligence which focuses primarily on the ability of a fund manager to generate attractive returns. While investment due diligence may cover certain operational areas (i.e. - who is the fund's auditor?), a dedicated operational due diligence review will cover items not covered by investment due diligence.

This detailed operational review is often a distinct review process which focuses on uncovering operations risk within alternative investments such as hedge funds.

## If I work with an investment consultant or a fund of hedge funds aren't they doing these types of reviews?

Investment consultants primarily focus on investment due diligence. The same is true for fund of hedge funds. Due to the recent attention focused on operational due diligence, many traditional investment consultants and fund of hedge funds may have begun to conduct operational due diligence reviews. Often times, these reviews are complicated by a lack of independence in the review process as well as a lack of dedicated resources and experience in evaluating operations risk.



## Why should I consider working with an operational due diligence specialist like Corgentum Consulting?

Third-party operational due diligence consultants such as Corgentum- do not have any conflicts of interest like investment consultants do. Additionally, operational due diligence consultants employ dedicated operational specialists with the experience and knowledge to detect operational risks which may result in losses at funds.

Trustees can also benefit from the knowledge that Corgentum's approach towards evaluating operational risk at alternative investment funds is not focused on any single area of operational risk (i.e. - valuation), but instead, focuses on a wide variety of operational risks. This ensures that trustees will receive well-rounded operational evaluations of alternative investment fund managers.

## What are some key areas of operational risk Trustees should seek to review in designing an operational due diligence program?

In order to avoid investing in alternative funds that have poor operations, Trustees should work with a third-party operational risk consultant to design an operational review program which focuses on evaluating a number of different alternative investment fund manager risks including:

- Trade flow analysis
- Fund legal document and financial statement review
- Compliance and legal functions
- Fund cash management and control procedures
- Business continuity and disaster recovery
- Valuation analysis

## In light of recent regulatory changes, are there any particular concerns I should have for 2012?

2012 brings with it a number of new operational requirements for alternative investment fund managers. Perhaps the most notable of which is a new SEC requirement that requires hedge fund and private equity managers to register with the SEC by February 14, 2012. After registration, there are a number of on-going filing and compliance requirements. Trustees should be aware of these new changes to the law and the effect this will have on fund manager



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operations. Additionally, Trustees should conduct detailed operational due diligence reviews which include an evaluation of a fund's compliance infrastructure, to ensure that their alternative investment managers are not only in compliance, but that they will remain in compliance going forward.

## About Corgentum Consulting

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Corgentum provides investors with the industry's most comprehensive operational due diligence reviews of hedge funds, private equity funds, real estate funds and traditional funds. Corgentum partners with investors to improve upon the efficiency and effectiveness of the operational due diligence process. Our proprietary due diligence methodologies and innovative original research allows our clients to continually manage and mitigate their operational risk exposures. Corgentum's unbiased and time-tested approach creates a substantial competitive advantage that enhances the risk management functionality of our clients. More information is available at [www.Corgentum.com](http://www.Corgentum.com).

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