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Operational Due Diligence Insights

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Welcome to Our August 2013 Edition

Welcome to the August 2013 issue of Corgentum Consulting's *Operational Due Diligence Insights*. This newsletter serves as a resource for news, opinions and insights focused on issues related to operational risk and operational due diligence on fund managers including hedge funds, private equity funds, real estate and traditional managers.

Too Little Too Late? - Taking Stock of the SEC's Presence Exam Program

Since the passage of Dodd-Frank many in the hedge fund and private equity industry have realized that regulators are increasingly ceasing the opportunity to become more hands on in their approach towards overseeing conduct in the financial markets. The U.S. Securities and Exchange Commission in particular has undertaken a number of initiatives in this regards starting with new mandatory registration requirements, Form PF and the loosening of recent restrictions surrounding fund raising and marketing efforts via its interpretation of JOBS Act rules.

As part of its initiative to become more omnipresent in October 2012 the Office of Compliance Inspections and Examinations ("OCIE") within the US SEC

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launched an initiative known as the National Exam Program ("NEP"). Through this initiative the SEC is trying to close the gap between its mandate to actively police the financial markets and the realities of their under resourced agency. Even as recently as a few years ago, the SEC was on extended onsite audit cycles with many managers. During the operational due diligence process, it would unfortunately not have been uncommon for investors to learn that a hedge fund manager may not have been visited by the SEC for a period of several years.

With the flurry of new funds registering with the SEC as a result of Dodd Frank legislation, the SEC launched the NEP to effectively make its presence known to all newly registered funds (i.e. - investment advisers registered after July 21, 2011). Hence, these exams have come to be known as so-called "Presence Exams."

These Presence Exams are not full blows SEC onsite audits. Rather, they are so-called risk-based examinations focusing on a few specific areas that the SEC deems to be "higher risk." Specifically, the areas that the [SEC has stated](#) it intends to focus on during these Presence Exams are, "one or more of the following":

- Marketing
- Portfolio management
- Conflicts of interest
- Safety of client assets
- Valuation

Are Presence Exams Missing the Point?

This approach is reminiscent of the old days of hedge fund administration where a NAV light approach was employed. Through using this approach, effectively the SEC is acknowledging that it does not have the resources to adequately review all newly registered advisers thoroughly, but rather is taking a light touch approach to the process. This new SEC light process simply places a further onus on investors to conduct their own operational due diligence.

In reviewing the list of items in the SEC light (aka: Presence Exam) reviews, it is interesting to see not only

what the SEC has included in this list as being higher risk, but what it has omitted as well. Framed in the context of recent historical frauds, this list seems to omit certain categories that many investors would deem as high risk in the current environment. Consider the basic principle of independently confirming service provider and counterparty relationships. In the case of Madoff for example, which the SEC famously did not catch, Madoff did not actually trade with any counterparties, so one would logically think the SEC would escalate the subject of counterparty confirmation to a high risk area. However, the SEC light Presence Exam list doesn't include this.

Another recent topic in the news relates to the use of material non-public information to engage in insider trading. Many investors would likely deem this as a high-risk area as well. While the SEC separately seeks to police insider trading, the Presence Exam initiative does not specifically include a review of any basic compliance controls that may be in place to perhaps monitor and curtail insider trading activities within the fund itself.

Gauging Fund Manager Response

Now that the initiative has been up and running for a while, as investors approach advisers who registered within the past two years, they should inquire if they have been contacted as part of the Presence Exam initiative and what their response has been. If they have already undergone a Presence Exam review, investors should inquire as to what questions the SEC asked and more broadly how the review went in general.

It is worth asking these questions, because investors may learn that many newly registered funds may have found themselves caught off guard by the SEC. Indeed certain fund managers may have anticipated better preparing for future SEC visits by working with third-party compliance consultants or undergoing mock audits, but simply were contacted by the SEC for a Presence Exam before they had the chance to adequately prepare.

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Conclusion

The SEC is faced with a difficult task of regulating the hedge fund and private equity industries with limited resources. It is easy to throw stones at this organization however, the point is not to criticize their work, but rather to highlight the fact that investors increasingly need to take responsibility for conducting their own operational due diligence. Even though the SEC is taking a well intentioned approach to focus on high risk areas, their reviews are casting too shallow a net to be effective for investors.

Do Hedge Funds Need A Pandemic Plan?

During the operational due diligence process some of the key areas frequently reviewed are the areas of business continuity and disaster recovery planning ("BCP/DR"). Part of this review process typically includes requesting that a fund provide investors with actual copies of their BCP/DR plans. The response to this request may in and of itself be revealing. For example, some funds may not have a separate BCP/DR plan and instead may incorporate this into other documentation such as a compliance manual. Other firm's may have a document entitled BCP/DR plan, but instead the plan may be heavily focused in one specific area such as technology planning. However, assuming that a fund does provide a BCP/DR plan that covers more than just technology, investors may find several pieces of interesting information that may not be immediately available upon reviewing a short summary of the BCP/DR plan in another document, such as a DDQ.

One point of information that may surprise investors is that certain BCP/DR plans may address how the firm

would respond to a wide range of exogenous events including terrorism and even epidemics of infectious diseases known as pandemics. At first glance investors may think such planning is overkill. Sure employees can become sick, or during the winter season there may be a spread of diseases such as the flu, but generally they do not rise to the point of a wide-spread pandemic. However, isn't that the point of BCP/DR planning - to make plans so that the fund can continue operations should an unexpected or unlikely event occur?

Pandemic Scares Do Happen: SARS and Swine Flu

An example of this which directly affected the hedge fund industry was the 2002 severe acute respiratory syndrome (SARS) outbreak in Asia. At the time many Asian hedge funds, including those in the hedge fund centers of Singapore and Hong Kong, were suddenly faced with the problem of attempting to continue their operations in the face of regional travel advisories and compulsory quarantines. Another more recent example was the 2009 global swine flu outbreak. In such situations, a fund with a detailed and tested pandemic plan would have likely fared much better than those who had never considered it.

Is the Pandemic Plan Appropriate or Just Boiler Plate?



If a fund does have such plans in place, the next question facing investors is whether the plan is appropriate for the firm. A good place to start when analyzing pandemic plans is with the language in the BCP/DR plan document. Firstly, investors should consider if the language in the plan is appropriate for the size of the firm. Investors may realize that in some cases, perhaps in their eagerness to provide what they deem to be complete BCP/DR plans, funds may include wide-ranging boiler plate descriptions of pandemic planning

that may not be appropriate for a firm of their size. Consider for example, a BCP/DR plan which contains language with less than 10 employees that has a detailed pandemic plan with nine levels of different escalations depending on the nature of the outbreak.

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This isn't to say that a small hedge fund shouldn't plan for a pandemic event however, too detailed a plan suggests that the plan may not have been designed with the firm in mind, and may not be practically implementable for the firm. Instead, such firms may benefit for smaller scale BCP/DR pandemic plans which are more appropriate for a firm of their size.

Regardless of the firm's size, investors should also consider whether they feel the language contained in the fund's BCP/DR plan is something the firm will actually follow or is just boiler plate in nature.

Consider for example, the following sample language from a BCP/DR plan related to pandemic planning: "In the event of the first human outbreak case in North America, the fund will minimize face to face contact by conducting transactions with vendors, investors/investees via email, telephone, and electronically wherever possible. Face to face interactions will only occur when every other option has been used."

Investors should not simply take this language on face value from the BCP/DR plan and instead inquire further with the firm. An investor could perhaps start such questioning by asking a fund to generally describe its BCP/DR plans. If they omit the subjects of pandemic planning all together, perhaps they don't take this subject too seriously. Furthermore, if they have a BCP/DR that does address pandemics, but they do not address it when describing the plan then how can investors be reasonably expected to believe some of the detailed descriptions contained in such plans. Consider the following, sample language from a BCP/DR plan related to pandemic planning structured in a Q&A format:

Question: In the event of an outbreak in the United States, describe how you will provide for new employee on-boarding to familiarize replacement resources with their duties as quickly as possible?

Response: The fund's business function processes have been documented in our policies and procedure manuals. The fund's teams consist of multiple

investment professionals. Weekly meetings are held for all investment professionals for status updates of active investments as well as potential investments. New employees would be familiarized with the documented procedures and policies and included within the weekly meetings.

Putting aside the fact that the response doesn't really answer the question, does such boiler plate language make an investor feel as if the fund really has a detailed plan in place to onboard new investors in the event of a pandemic? Furthermore, do investors really believe that the fund will go on a hiring spree in the event of a pandemic?

Conclusion

Analyzing not only the language of BCP/DR plan, but having frank discussions with fund managers regarding the fund's planning can provide insights into not only how seriously the fund takes BCP/DR, but can also provide valuable insights into other potential yellow flag issues that may be in place at the fund. Focusing on areas such as pandemic planning may seem to be outside of the scope of certain fund's BCP/DR planning, but as recent examples demonstrate, there are situations where such planning can insulate funds from risk should a disaster strike.

Private Equity Real Estate Fund Evaluation - Are You Tailoring Your Approach?

When investors seek to perform an operational due diligence review of a fund there are certain core elements that are universal across all fund types. For example, regardless of whether a fund is a hedge fund, private equity or long only fund most investors would agree that an operational due diligence review should

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incorporate an analysis of the fund's valuation procedures. While such an analysis may be simpler for a liquid long only fund as compared to a private equity fund, the point here is not to focus on the benefit to the investor of analyzing a topic such as valuation, but rather that it is a critical element of a fund operational risk evaluation. Other areas of a fund's operational risk profile are more strategy specific.

Some of these core review items are specific to fund structures. For example, in a pooled hedge fund versus a private equity fund, analyzing the terms and rights of an investor Advisory Committee may only apply to the private equity fund (since hedge funds don't typically have such committees). Other core review elements are specific to different investment types. Investments in real estate funds, sometimes referred to as private equity real estate, present a good example of this.

Investors seeking to perform operational due diligence on real estate funds, will quickly learn that beyond the shared core commonalities across all fund types, a review of a real estate fund presents a number of unique intricacies specific to the asset class. Of course, real estate is a broad category and there are many different types of real estate funds. That being said, there are some shared characteristics across real estate funds that investors may want to consider in designing a tailored operational due diligence approach to this asset class. Without such a tailored approach, investors run the risk of ignoring key real estate specific operational risk areas.

Consider for example a real estate fund that uses the capital raised to invest directly in property with tenants. The goal of course is that the tenants pay rent and the property generates income for the fund. While certain investors might bucket this tenant rent generation process into the scope of an investment due diligence

review, the actual functional process by which cash is collected and accounted is another matter entirely. Often times, an investment due diligence process may not cover the intricacies of tenant rent collection and it is left to the operational due diligence review to fill the gap.



Continuing our example of tenant rent collection, investors could inquire during the operational due diligence process for example if a lock box arrangement was in place. This would be one independent control that could seek to minimize the ability of an onsite property manager to misappropriate tenant rents before they make it to the bank.

Examples of the other types of items specific to real estate funds that investors might want to inquire about during the operational due diligence process include:

- The process by which property managers are vetted and approved
- The use of technical consultants (e.g. structural and mechanical engineers, surveyors etc.) for items such as environmental analysis
- The use of third-party appraisers
- Property title research process
- Analysis of appropriate property level insurance coverage
- Cash flows relating to property level budgeting and expenditures
- Controls surrounding tenant lease negotiations and the offering of beneficial tenant terms such as building signage or designated elevator access

Conclusion

Real estate can present a whole host of considerations that may not be present in other types of private equity investments such as venture capital fund analyses. Investors that tailor their the operational due diligence process to consider real estate specific risks can yield

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significant benefits by developing a more complete operational due diligence review, as compared to a general blanket approach which can leave some risks un-researched.

Controlling Fund Software Versioning

Consider the following scenario. A hedge fund utilizes a multi-function third-party software application. This system, with all its bells and whistles, is used in the front and back office and to assist with risk analysis to perform several other key functions including preparing nightly portfolio reports. The fund has used the system for over two years, has been happy with the system and the level of ongoing support provided by the third-party vendor that makes the software.

One morning fund personnel come into the office and find that the system isn't functioning properly. After having their internal IT department investigate and run a series of tests they determine that there is no problem with their network or systems. They contact the software provider who informs them that overnight they rolled out a new software update and that might be the culprit. The fund had been using this software application for quite some time and had not experienced any problems with upgrades in the past. Why was this one different?

Well it could be a myriad of reasons. Unfortunately for our hypothetical fund, they must now work with the software provided to not only remedy the immediate problem, but ensure that this problem does not occur again. In the real world these types of fixes often take time. The fund might be able to implement a temporary solution such as reverting to a previous instance of the software application, but there is still a delay that could ultimately affect profitability. This scenario highlights some of the risks related to software version updates that might impact a fund.

Software version controls and oversight may be overlooked by some investors during an analysis of a fund's information technology function. As outlined

above however, when issues occur related to software updates, particularly for critical systems, they can cause a number of problems ranging from prolonged business disruptions to data loss and trade errors. The good news for investors however, is that such problems are avoidable for funds.

Many software updates involve software vendors pushing updates automatically to users of the software. Under this *push update model* the fund may not even know that the software has been updated the next time they log in. In many cases, updates are pushed out by vendors to repair or enhance existing behind the scene functionality, which is not immediately apparent to system users. Other types of push updates may be more visible to end-users and may add new system features or functionality.

Another type of software update may require the fund to pro-actively install the updates. One example of these so-called *pull updates* would be when a new version of a fund accounting system is released. Often times the decision to upgrade to a newer version can be an expensive and require a support team from the application vendor to work with the fund to assist in the upgrade. This is why some funds opt to sit on the sidelines through several new software releases before installing major version upgrades. Waiting for these upgrade cycles to pass before taking the leap to switch to a new version allows the fund to both save on costs and also see how other users react to the upgrades. Regardless of whether the updates are push or pull type, funds can take a number of pro-active steps to avoid disruptions.

Each hedge fund's information technology infrastructure is different. These different infrastructures and software environments interact differently with third-party technologies. For example, one fund may be using primarily a Windows 7 environment while another uses Windows XP or UNIX. In designing their new software update, the vendor may not have taken into account that the upgrade may negatively affect users who run in an older version of an operating system. Or perhaps the vendor did perform checks in this regard, but a fund has a number of

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Similarly, under a pull upgrade format, the client may not believe that the software upgrade would cause a problem, and therefore they would proceed with the upgrade only to identify problems after the fact.

During the operational due diligence process, investors should inquire if their funds are appropriately acknowledging and addressing these software upgrade risks. In order to determine if their funds are appropriately managing these risks surrounding software upgrades, some questions investors may want to ask could include:

- What is the firm's general approach to software upgrades?
- Who controls the upgrade process? (i.e. - is it vendor driven, internally at the fund or both); Has the fund pro-actively made the decision to coordinate upgrades in this manner or is this by default?
- Does the fund work with third-party vendors to remain informed of upgrades before they happen?
- Has the fund had any issues related to bugs or similar system disruptions with regards to upgrades?
- Does the fund have the ability to easily restore a previous instance of an application if an upgrade caused a disruption?
- Before an upgrade is rolled out to a fund's users does the fund's information technology function review upgrades in a test environment?
- Does the information technology function review any security or data integrity changes which may be caused by upgrades?

Before an upgrade is rolled out to a fund's users proprietary software applications that interact with the third-party application and they will not function

properly with the new upgrade. Additionally, the software vendor may not have the visibility into the client's systems to accurately predict that the upgrade may cause problems.

- does the fund's information technology function review upgrades in a test environment?
- Does the information technology function review any security or data integrity changes which may be caused by upgrades?

Investors should take measure to inquire whether or not a fund has pro-actively addressed the issue of overseeing and controlling software upgrades. Without such oversight, a fund may accidentally find itself left behind when an upgrade occurs. By actively engaging in the upgrade process funds can be better prepared to control such risks, and investors will likely have more comfort with the information technology control environment, at least from a software perspective.



10 Questions for Your Fund's Administrator

Administrators continue to be a focal point of investor's service provider reviews during the operational due diligence process. Further increasing their importance is the fact that administrators are expanding their relationships with funds and providing more services beyond the traditional shareholder services and fund accounting. Operational due diligence on service providers such as administrators can provide investors with a key source of information about fund operations. Such information may be particularly useful because it is coming from a source other than the fund manager themselves. As the frequency and scope of investor operational due diligence has increased, administrators

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have become increasingly willing to interact with investors. Investors should not pass up the opportunity to communicate with administrators as part of the operational due diligence process. Some key questions investors should consider asking in order to start off the fund review process should include:

- 1) How often do you speak to the fund? Do you ever visit the fund's offices? Does the fund ever visit you?
- 2) Has the fund accounting team that services the fund account experienced personnel turnover? If so how does this turnover compare to industry standards? How did the firm deal with that turnover?
- 3) What systems and technology are utilized by the fund's administrator? How does this compare to the software, such as fund accounting systems, utilized by the fund itself?
- 4) Has the administrator undergone an SSAE 16 or equivalent review? If so will they share a copy of the report with investors?
- 5) How does the administrator deal with fair valued positions? Are they actually performing any attempt to independently value these positions themselves? Or instead is the administrator simply collecting documentation and taking the managers word for it?
- 6) Can the administrator, independent of the fund, provide a list of brokers utilized by the fund? If so, how does this compare to any broker information provided by the fund? Furthermore, how is the administrator notified of new brokerage accounts?
- 7) What is the administrator's role in overseeing cash movements? For example, how often does the administrator reconcile cash (i.e. - daily or monthly)? Is the administrator involved in reviewing invoices to process fund expenses?
- 8) What pricing sources are utilized by the administrator? How does this compare to valuation sources utilized by the funds?

9) How does the administrator resolve pricing variances or disputes between itself and the fund manager?

10) What is the month-end NAV distribution timeline? Has this timeline changed (i.e. - become longer or shorter) over time? How does this compare to the timeline presented by the manager?

Conclusion

In addition to asking questions such as those outlined above, investors may be surprised to learn that an administrator may share a wealth of documentation with investors if they simply ask for it. For example many administrators will share with investors basic marketing materials about their firm, business continuity and disaster recovery plans and copies of engagement letters (or the actual reports) of their SSAE 16 / SOC 1 or similar reviews.

By engaging in dialogues with fund service providers such as administrators, investors may gain useful insight not only into the working of the fund's administrators, but the broader picture by which fund managers

interact with their service providers. Investors should seize this opportunity to not only evaluate administrators, but also to understand the work they perform in order to conduct a more complete operational due diligence review.

Understanding Fund Terms: *Clawback*

Operational due diligence is a multidisciplinary subject. An investor beginning the operational due diligence process for the first time may encounter subjects with which they have little to no familiarity. As the scope of operational due diligence has broadened in recent years, even seasoned operational due diligence professionals may encounter terms which they may be unfamiliar. The purpose of this section of *Operational Due Diligence Insights* is to cast a spotlight on some of the words and terms which investors may have not

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previously encountered, or tend to get overlooked in operational due diligence reviews.

This issue's word:

Clawback

Defined:

A clawback refers to a situation where an investor is compelled to return money they have already received from a fund.

What investors should know:

The term clawback has experienced a resurgence after an unfortunate surge in Ponzi schemes and frauds. In these situations what typically happens is that investors would have submitted regular capital redemptions, which were then paid out, before the fraud was revealed. After the fraud was revealed, other investors, typically via a court appointed Trustee, would then seek to reclaim or clawback, this capital. Under a Ponzi scheme scenario, the argument is effectively made that since the redemptions were paid with capital that was not representative of true profits of the fund, the redeeming investors should then share in the losses off those who did not redeem by giving back capital and contributing to the overall pot from which all defrauded investors may be paid out.

Many investors pose the question, "Is there anything they can do to protect themselves from the threat of a clawback?" In the event the fund turns out to be a Ponzi scheme or similar fraud, and a clawback is pursued litigation will likely ensue. While a detailed operational due diligence review is by no means clawback insurance, it does have several benefits from a defensive clawback litigation perspective. Those investors that can demonstrate that they took measure to effectively vet the manager both prior to investment and on an ongoing basis, will likely have surer footing to stand on in fending off a clawback lawsuit, as compared to an investor who did not perform such reviews. Of course, there are added benefits that would accrue to the investor by performing this review work, including making a more informed investment decision and mitigating their exposure towards operational risk.



Fraud Spotlight: A Post Box Used to Fool Auditors and Regulators

Hedge fund fraud takes many different forms. From Ponzi schemes to inflated NAV's, the options for hedge fund fraud are wide and varied. Ultimately, the end result is the same in all frauds – investors lose money. The methods however, are where the variations occur. In perhaps a new twist, a North Carolina hedge fund manager is accused of using a post-office box to facilitate a fraud.

James Shepherd , ran a commodity fund that has been accused of Fraud. The CFTC, recently [sued Shepherd](#) for fraud and misuse of customer funds, alleged that Shepherd via his [Shepherd Major Play Option Fund LP](#) misappropriated approximately \$4.45 million from approximately 176 individuals.

Specifically, according to the CFTC's Complaint, Shepherd fraudulently told investors and prospects that their funds would be invested in on-exchange options on commodity futures and that the fund's assets would not be commingled with the assets of any other entity. Instead, the CFTC alleged that beginning in 2006, Shepherd allegedly transferred a large portion of the money to his own bank account and to a bank account in the name of a separate hedge fund operated by Shepherd, which he used to pay redemptions to those hedge fund investors. It was also alleged that to further the fraud, he distributed fraudulent financial statements and forged bank statements. Several articles have drawn analogies between this case and the [Peregrine Financial Group](#) scandal perpetrated by [Russell Wasendorf](#).

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The CFTC complaints alleged that Shepherd used a personal post-office box that he told his auditor and regulator was the property of his bank. Shepherd spent some of the misappropriated money to build a \$2 million home in Vass, North Carolina, U.S. prosecutors said. Shepherd's attempts to fool auditors didn't stop there. Interestingly, it was also alleged that the defendants used these false bank statements to fool auditors and the NFA during their regulatory audits. Shepherd eventually decided to [plead guilty](#).

This highlights a very important point. It is critical that investors understand the limits of auditor and regulatory oversight. In this case, it seems Shepherd presented the auditors and regulators with fraudulent statements and they did no further follow up to check with the bank to confirm the accuracy of the financial statements. While it may be considered most advantageous from the perspective of an investor to have the auditors perform such checks, these verifications might have simply not been within the scope of the audit engagement for the financial statement auditors. Similarly, the regulators might have felt, as is their discretion unfortunately, that contacting the bank to confirm the fund's balances was not called for.

This real-world example demonstrates quite clearly why investors may benefit from not blankly relying on auditors or regulators. This is exactly the kind of situation where operational due diligence could have served to fill in the gap for investors between the role of the auditors and regulators. In this case, investors could have asked a number of different questions including contacting the fund bank directly and attempting to perform an asset verification exercise and contacting. This is not to criticize the work of the regulators, rather instead it is to highlight to investors that they must take responsibility for performing their own due diligence before they allocate to a manager. By analyzing a fund through detailed pre-investment operational due diligence investors will take further measures to potentially mitigate their exposures to fraud rather than having the regulators mail it in on their behalf.

This article was originally posted on the Corgentum Consulting blog. For more details please visit www.Corgentum.com/blog

Focus On Related Party Transactions

When reviewing audited financial statements during the operational due diligence process, investors should not only consider the actual numbers contained in the different sections of the financial statements, but the financial statement notes as well. One key part of the notes is the *Related-Party Transactions* section. It may be easy for investors simply to look at this section and dismiss it as a boiler plate language however, often times meaningful details may be buried within this section.

Related Party Fees

The financial statement disclosures pertaining to related party transactions often starts off with a general summary of the fees the investment manager receives and how often it receives them. This section then typically proceeds to include general disclaimer language, which unfortunately for investors, effectively gives the fund manager a great degree of fee flexibility. This language generally mimics similar language in the fund's offering memorandum, and reads something to the effect of, "The Investment Manager, in its sole discretion, may reduce or waive the management fee with regards to certain limited partners." The fee section then typically concludes with the actual amount (i.e. - not a percentage) of what the fee actually was.

This last piece of information, the actual amount of the fee, can be used by investors to further analyze the various sections of the financial statements contained earlier in the audits. For example, the actual amount of the management fee provided in the Related Part Transaction section can be compared to the management fee figures in other parts of the financial statements such as in the Statement of Income. Similar comparisons can be made for other related party fees such as the incentive allocation. Additionally, it may also

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be useful to compare the fee information disclosed in this section to fee details that may have been disclosed in previous year's audit.

Related Limited Partner Capital Balances:

Returning to the related party transactions disclosures in the financial statement notes, generally this section also includes details of related limited partner capital balances. This figure can then be compared to *skin in the game* type asset information provided by the fund manager outside of the audited financials. Similarly, these figures may provide clarity with regards to the balances of actual funds that are invested in other funds. This information can then be used to facilitate a comparison to provide insights into any discrepancies on a vehicle level basis between the fund's reported figures and those contained in the financial statements.



More About Fee Waivers:

In addition to the information listed above, related party transaction disclosures may also contain other pieces of information including any specific fee waivers among related parties and transactions made among the firm's different funds. Items such as fee waiver disclosures should be considered by investors not only in the context of a review of the audited financial statements themselves, but in the broader operational due diligence review as well.

For example, during an on-site interview a fund's representative they may have made a statement to the effect of "all employees invest with the same terms as everyone else." If a fee waiver is then disclosed in the audits, does this mean that the fund employee was lying? Not necessarily, the argument could perhaps be made that the fund employee was referring to liquidity terms and not necessarily fee waivers. As this example, certain disclosures made by the funds in this instance may be open to interpretation. As such, it is better to not blindly take the funds word for it and instead

perform your own double checking with regards to related party transaction terms that may benefit the fund such as fee waivers. Such analysis can serve as a useful tool during the operational due diligence process.

Inter-Fund Transactions:

Turning to the concept of transactions among the firm's funds, this is another area that investors should inquire about during the broader operational due diligence process as well. For example, one reason for this is that in a master-feeder complex, investors may run the risk of having one vehicle (i.e- the offshore fund) disadvantaging another vehicle (i.e. - the onshore fund). As an example of the potential risks related to an inter-fund complex transaction, one could look to the SEC

allegations in the [Martin Currie China fund case](#).

Once again, general information learned during the operational due diligence process regarding the potential for funds to participate in transactions with each other, can be supported by disclosures in the audited financials related party transaction section. In certain cases, specific detailed related to the transactions may be

disclosed in the audits. Often times such disclosures can give investors another perspective on the magnitude, nature and frequency of such transactions.

Conclusion:

There is nothing inherently wrong about related party transactions. In some cases they come up during the normal course of business of a fund complex. The goal during the operational due diligence process should be for investors to understand the nature of such transactions, controls in place surrounding any such transactions and their economics to both the fund and investors. By reviewing related party transaction disclosures in the audited financial statement, in conjunction with a focus on any such transactions during the broader operational due diligence process, investors may gain useful insights into the risks surrounding such arrangements.

On the Calendar

Please see below for a list of upcoming operational risk items of note and events:

- [Canadian Family Office & Private Wealth Management Forum West](#) (Vancouver, BC Canada)
September 26-27, 2013.
Corgentum to speak at *Global Hedge Fund Trends for 2014 panel*
Presented by Opal Financial Group
- [GAIMOps International](#) (Paris, France)
November 12-14 2013.
Corgentum to moderate *Roadmap for Analyzing Audited Financials Statement panel*; and
The Swiss Collective Investment Schemes Act panel
Presented by IIR USA

About Corgentum Consulting

Corgentum Consulting is a specialist consulting firm which performs operational due diligence reviews and background investigations of fund managers.

We work with investors including fund of funds, pensions, endowments, banks and family offices to conduct the industry's most comprehensive operational due diligence reviews. Our work covers all fund managers and strategies globally including hedge funds, private equity, real estate funds and traditional funds. Our sole focus on operational due diligence, veteran experience, innovative original research and fundamental bottom up approach to due diligence allows us to ensure that our clients avoid unnecessary operational risks. More information is available at www.Corgentum.com or follow us on Twitter [@Corgentum](https://twitter.com/Corgentum).

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