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focused on growth,  
security and  
performance.

## **Client Briefing**

Hedge Fund Managers &  
Fund of Hedge Fund Managers

## **Infrastructure Enhancements**

Adapting to an Environment of  
Increased Investor Scrutiny

### **Summary**

- The following enhancements to internal policies, fund terms, external service providers and your internal team will strengthen your investor relationships by demonstrating rigor in fulfilling your fiduciary duty.
- Valuation, controls and exits remain top concerns. Managers must demonstrate fair treatment to all investors.
- Managers are organizing disclosures, reports and meetings in anticipation of requests.
- Investors are digging deeper and deploying more resources prior to investing.
- Evaluating and implementing, as appropriate, these recommendations will anchor your investors and place your firm in a better competitive position.

## Investors' Perspective

During recent years, experienced hedge fund investors have suffered at least one whiplash that has caused them to re-evaluate their approach. Even if they weren't invested with Samuel Israel or Bernard Madoff, they have been subject to lock-ups, gates, claw back threats or were offered a payment-in-kind, liquidating trust or side pocket. Post-trauma, non-investment risks are at the front of investors' minds. Investors are on high alert to prepare for any type of unexpected outcome in the future.

In order to meet investors' concerns in this competitive landscape the industry is following a 'safety focused' trajectory similar to that followed by the automotive sector in the last century. While early car models were a novelty, today's models must meet performance, style as well as safety standards. Successful firms must anticipate and exceed buyers' and regulators' safety requirements, reaching beyond basic components (seat belts, anti-lock brakes and air bags) to produce a premium offering that addresses the higher standards now desired.

Due diligence teams are spending at least twice as long researching a manager's firm prior to investing. The review is often performed by separate teams analyzing fundamental, operational and quantitative risks. Investors are particularly attuned to a manager's thoughtful approach to the fulfillment of their fiduciary duty while

building a relationship with the manager.

The Decagon team has identified areas for improvement that we believe will allow your firm to make it successfully through the investor review process. We've categorized the enhancements into four broad categories:

- I. Internal Policies
- II. Fund Terms
- III. External Service Providers
- IV. Internal Team

These structural enhancements will help your team focus on specific investor value-added measures to improve the product, shorten the sales cycle and support solid investor relationships.

## I. Internal Policies

### Documented Control Processes

**Provide detailed diagrams and documentation around control processes, work flow, responsibilities, exception review and reporting.** This documentation can expedite an investor's on-site due diligence review as well as assist in audit and regulatory reviews.

Multiple control points and staff redundancies are the focus of operational due diligence inquiries. This applies not just to cash movements and trading, but for dozens of control processes including: new client acceptance, releasing documents to prospective investors, fair transparency to all investors, personal trading review, regulatory compliance and other portfolio and operational risk management decisions.

*Auditor: "We meet with a firm's CFO and ask questions around our inherent interest: 'How can you make us comfortable?'"*

### Valuation Policy Depth

**Maintain a formal Valuation Policy in compliance with FASB 157.** The valuation process should involve qualified external oversight and describe the processes for escalating valuation difficulties, independent of the Portfolio Manager.

Investors are most concerned with:

- Multiple inputs to pricing
- Analysis of unrealized gains that impact the NAV and performance fees
- Independence through qualified professionals and
- Recordkeeping that reflects a consistent methodology.

*Moody's approach, when assigning their OQ (Operations Quality) to a manager recommends, "a written review process...(with) formal categorization of positions into different degrees of liquidity requiring different types of outside sources for pricing."*

*Accounting Firm Partner, Security Valuation Practice: "The PM knows the valuation best. That said, we have a documented and organized way to provide a value for illiquid assets. We will not undermine our brand by giving Negative Assurance, only Positive Assurance where we ask questions and do research."*

## II. Fund Terms

### Anticipating Clear Exits

**Prepare to discuss scenarios that provide for the orderly operation of the fund in the event of large withdrawals, severe market illiquidity, exit of a strategic investor, loss of a key person or fund liquidation.**

Investors are looking for comfort to ensure fair treatment, a thoughtful approach and ample communication during worst case scenarios where there may be a severe misalignment of interests.

Recent years have provided live stress-tested examples of manager decision-making when investors herd towards an exit queue.

Managers are adding language to compliance and offering documents that address concerns around issues such as:

- Lock-ups or suspension triggers
- Avoiding language with incentives that push investors that were not anticipating redeeming into a redemption cue
- Defining the use, operation and liquidation of special purpose vehicles (side pockets, liquidating trusts)
- Specifying when paying-in-kind satisfies the legal redemption schedule

### Tailor Fees and Risk Levels

**Tailor fee and risk levels to different investors' appetites through multiple classes.**

Additional feeders have been created in order to meet a variety of investor needs, policies and time horizons. Through these feeders managers are often offering fee discounts for longer lock-ups to truly identify and reward longer-term investors. In addition, managers are leveraging classes or series up or down in order to provide a variety of volatility levels to more closely tailor a fund's appeal to a greater number of investor groups with different risk tolerances. There have also been discussions lately of series with hurdle rates and caps on fees.

As always, it is a trade off. Increasing the menu of classes can result in operational complexity and conflicts especially between classes or managed accounts with different liquidity profiles. These potential conflicts must be made apparent to all share classes along with the possibility for liquidity to be reduced or impacted by either market events or the concurrent management of other classes.

### III. External Service Providers

#### Service Provider Selection

**Ensure that service providers, especially your administrator and auditor, can meet your investors' needs.** This will help smooth out any final hurdles during the sales process. In addition, managers must maintain records on the selection and monitoring of all service providers: legal, audit, administrative, consultants, technology, custodians and brokers, especially if the fund is charged for the service.

When service providers are paid by the fund, they continue to be selected by the manager. Should an investor find, often at the fourth meeting or later, a lack of accountability for fund expenses, insufficient administrator communication or an audit report with a very late issue date, it can hamper an investor's ability to proceed. Investors that need to produce audited financials, are now facing tougher scrutiny from their auditors who must look through and find comfort with your audit.

*Auditor to a Fund of Hedge Funds: "We can get comfort when at least 80% of the funds are able to provide their audited financial statements within a reasonable amount of time while we do our work. We also ask for the administrators to confirm the NAVs and hope that managers will direct their administrator to comply with our confirmation request."*

#### Interactions with Auditors Mid-Year

**Consult your Auditor mid-year to ensure a smooth audit season, discuss changes to accounting regulations and ensure any expense allocation is applied consistently throughout the year.** This will help avoid monthly return adjustments.

There are often different NAV calculations resulting from the following:

- (i) GAAP accounting,
- (ii) Terms in the offering documents and
- (iii) Either of the first two adjusted for minor restatements to taxes or valuations, often immaterial to auditors but potentially material to investors.

FIN 48 has been a source of recent concern. Sophisticated investors are aware of these issues and expect a thoughtful approach to the accounting and audit process.

*Operational Due Diligence Analyst: "We want to know a firms' FIN 48 exposure. The change in accounting rules may create costs that are attributed to investors that have already redeemed. We ask: How are they handling new accounting treatments?"*

### Administrator Independence

**Engage a full service administrator.** They are the new “must have” protection. They improve the control environment with independent oversight of fund flows, investor acceptance, valuation and financial statement production.

Investors rarely give a second look to funds that self-administer. Even industry veterans like Renaissance and Millennium, previously running established self-administered funds, were forced to make the switch.

*Operational Due Diligence Analyst: “You must look at a fund’s contract with their administrator. Do not assume that they are doing all of the typical things. NAV light is still prevalent.”*

### Choosing the Best Custodians

**Create the optimal and safest custodial platform for your investors’ assets.** An infrastructure that can manage multiple prime brokers and custodial relationships is optimal. In addition, investors prefer to see certain strategies secure term financing from their brokers or banks. Where possible, managers are arranging custodial accounts to hold unencumbered assets.

Investors are increasingly reviewing a manager’s brokerage agreements to understand under what conditions a manager will lose control of assets through changed lending conditions or margin calculations.

Longer financing terms with prime brokers is an advantageous fund feature. Investors recall front page news of brokers controlling the collateral and methods of sale of securities rather than the manager.

While prime brokers showed the door to many mid-size and small clients in 2009, the trend is now reversing. Mini-primes are also willing to compete. This has placed some advantage back into the manager’s hands to negotiate a more flexible prime broker relationship.

*Investor Quote: “Multi-prime is also becoming multi-custodian. We are seeing funds move assets away from one prime broker where possible.”*

## IV. Internal Team

### Formal Treasury Function

**Designate formal treasury responsibilities that anticipate investors' concerns around liquidity, withdrawal of financing and other events where there is a lessening of portfolio management control.**

Risk management at the treasury level now includes:

- Jurisdictional exposure
- Equity-asset liquidity management
- Prime brokerage financing terms
- Counterparty monitors

Post-Lehman, investors are aware that funds with assets or counterparties in multiple jurisdictions are assuming additional risk. Investors are asking: What are the terms and how are you monitoring your arrangements? Analysis, clear language and a risk management plan that anticipates troublesome situations is expected.

*Investor: "We want to know their process. Are they knowledgeable and ahead of the issues? How do they think about their exposures, limits, credit risk and controls?"*

### Coordinated Investor Presentations

**Prepare all of your senior management for investor meetings.**

Investor Relations professionals are now joined by PMs, CFOs, CROs and CCOs in addressing investors concerns. After a portfolio management process is deemed attractive by an investor, final meetings often focus on operational risks. Only a coordinated team marketing effort that is 'in front and upfront' can demonstrate the cooperative and dynamic culture of compliance.

To shorten the sales cycle, managers are organizing disclosures, meetings and reports efficiently in anticipation of requests.

Throughout the review, investors are wondering whether controls are sufficient to protect their capital. Questions include:

- Are specific people accountable for the compliance and risk management processes and do these individuals have a seat at the table in decision-making?
- Have risks been identified by qualified individuals and controls thoughtfully structured around them?
- If you cut back staff, where were the cuts made?

## Conclusion

While fund managers have been required to share more information, it is not a surprise that Investor Relations professionals are spending more time pre-screening potential investors in order to anticipate requests and assess the fit ahead of the process.

While the attributes of a successful manager will always include attractive returns and a rigorous portfolio management process, in today's marketplace sufficient transparency, appropriate liquidity and a strong control environment must be consistently demonstrated to present a competitive offering.

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Our goal is to support innovation, firm creation and job growth within the alternative investment management industry based on a foundation of best practices.

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