
Hedge Funds and Servicers Face Op Risk Issues

By Chris Kentouris

February 5, 2007 - The collapse last year of Amaranth Advisors, coupled with increased institutional scrutiny, has pushed operational risk higher on the management agenda for hedge funds, their service providers and regulators alike.

Even before hedge funds and their risk profiles had gained their recent prominence, operational quality and reliability were relevant issues because the type and quality of hedge fund management vary widely. Managers range from small private offices and boutiques with as few as ten employees, to others with the trappings of large institutional firms, with myriad variations in between. With only 2 percent of institutional assets--pension funds, endowments and insurance companies--globally invested in hedge funds, there is plenty of room for growth. Add to that the passage of the U.S. Pension Protection Act in 2006, and hedge funds could be in store for a groundswell of new investors.

Many hedge fund catastrophes can be attributed to outright fraud or errors in valuation--hence calls for closer regulation, or at least greater transparency. Amaranth appeared to be a simple matter of bad decisionmaking: More than \$6 billion was lost because of bad bets on natural gas.

So what should savvy institutional investors be looking for in the way of operational risk? Start with appropriate procedures for anything from basic disaster recovery to the complex process of valuing over-the-counter derivative contracts. Operational risk "typically encompasses everything that is not market-related and includes front-, middle- and back-office operations," explains Andrew Rosson, chief technology officer of alternative investment manager Reservoir Capital Group, who spoke at a recent seminar in New York on hedge funds and operational risk. The event was hosted by Eze Castle Integration (ECI) of Boston and New York-based communications solutions provider IPC Systems.

Stephen Crowe, strategic account manager at IPC, cited the following examples of critical operational elements on the applications side: trade order management systems (OMS), execution management systems and general portfolio accounting. On the infrastructure side, he said, necessities include replication technologies, storage networks, bandwidth and collocation.

Institutional investors frequently regard funds of hedge funds as a means of mitigating operational risk, since assets are allocated to more than one fund manager. But there are no guarantees--quite a few fund-of-funds managers were on the hook when Amaranth blew up. A fund-of-funds manager still has to monitor the procedures of underlying fund managers.

"Each hedge fund manager has different subscription policies--dates when monies can be invested and documentation must be completed," says Paul Pomfret, chief executive of PDP Capital, a fund-of-hedge-funds company in Palm Beach, Fla. "A missed opportunity due to the lack of operational efficiency on the part of the fund-of-funds manager means that extra cash may be remaining and another month must go by before the investment can take place." In the meantime, the fund-of-funds manager is faced with a misallocation of assets.



Grandi

Disaster-Wary

Such scenarios are only too common, say hedge fund experts, because of the paper-intensive method involved in completing subscriptions. A few custodian banks--HSBC, for one--have developed automated, proprietary platforms to handle such services while others, including PNC Financial Services Group subsidiary PFPC Worldwide, say they complete the documentation for fund-of-funds clients.

In the case of single-manager hedge funds, having appropriate business continuity planning is becoming key to winning institutional funding. While maintaining business continuity in the mainstream financial services industry has been high on the regulatory agenda at least since the Sept. 11, 2001 terrorist attacks, disaster planning in the growing hedge fund community is only just beginning. Too few firms have adequate plans in place.

"Everybody in the business has a good understanding that a lot of the hedge fund failures are related to operating or infrastructure issues, as opposed to investment strategy issues," says ECI president Chris Grandi. "Disaster recovery falls in the operating category."

If disaster-planning competency is correlated with the size of a fund, then smaller outfits, with less than \$1 billion under management, would be most at risk. "It is common for a start-up to match the degree of planning to the level of their initial operation," says IPC's Crowe. "But when you begin to obtain new funds and scale up, if you haven't thought through the direction and process of your technology, then you end up in a quandary and playing a losing game of catch-up that can lead to disaster."

Adds Grandi: "As the industry becomes more institutionalized, there will be more investor-driven demand to have better disaster recovery in place. Institutional investors and fund-of-funds investors are now demanding to see disaster recovery plans in place before they approve the allocation of funds."

During his presentation at the New York seminar, Grandi cited several cases--without naming names of hedge funds that could not operate for anywhere between several hours and several days because their business continuity plans were insufficient. Accordingly, ECI has expanded its disaster recovery services, including VoIP (voice-over-Internet protocol) telecommunications and strategic consulting.

Hedge fund administrators, which are typically responsible for funds' middle- and back-office services, also have had to make disaster recovery a priority. Fulcrum, in Hamilton, Bermuda, is only too aware of the havoc a natural disaster--namely a hurricane--can wreak on its valuations service. In an emergency, Fulcrum can within a few hours restore its customer records, trading data and general ledger through a backup facility in Toronto. It's never been put to the ultimate test, but having it in place means that the company meets "the highest operating standards" imposed by its hedge fund clients and their investors, says Andrew Annett, Fulcrum's director of IT, infrastructure and user support.

"We base our disaster recovery priorities on a hierarchical system," says Annett. "In any disaster, we would first retrieve information on the valuation of underlying securities, then our general ledger data that allows us to cut net asset values, and then our file servers, which involve non-customer-related business."

A survey released Jan. 17 by CarbonBased Consulting of New York on the use of risk management systems by 96 hedge fund managers--most in the U.S.--showed that 88 percent bought a primary risk management system, and 32 percent bought a secondary one. CarbonBased defined a primary system as a platform offering intraday portfolio analytics; a secondary, less frequently used system provides more detailed value-at-risk analysis.

"Firms with under \$4 billion in assets under management were more likely to use either a proprietary platform or Excel spreadsheets," says Brian Shapiro, president and CEO of CarbonBased. In all, 29 percent relied on Excel. "Current modeling tends to be plug-and-play to facilitate the required speed in time to market for new strategies," says Shapiro. "These models are often built on the fly."

As hedge fund administrators diversify their trading strategies and increase the number of prime brokers with which they do business, dependence on spreadsheets becomes more problematic. "There is a good chance there will be reconciliation breaks between the records of the hedge funds and their service providers," says Sameer Shalaby, chief executive of New York-based hedge fund software and services vendor Paladyne Systems.

The CarbonBased Consulting survey projected a rise in total spending by hedge fund managers on third-party risk and portfolio management systems to over \$5 billion this year and nearly \$9.7 billion by 2011. The buy-side research firm cited SunGard, Calypso, Murex and Sophis as key suppliers in enterprise-risk monitoring.

Data Backup

Most of the largest hedge funds engage in a practice called "shadow accounting." They do the same work as their administrators and prime brokerages and compare results. Says Reservoir Capital's Rosson, "Getting away from using spreadsheets is a great idea, and it's important to have efficient trade capture systems that can distribute the data to multiple places."

According to Rosson, many OMS are not equipped to handle complex derivative transactions. He cites an 80-20 rule: 20 percent of the volumes account for 80 percent of the operational problems. Last summer, Capital Reservoir licensed SunGard's Front Arena system to replace an otherwise manual process for trade capture.

Getting the details of the trade right is just the start. At the core of the risk management process remains valuation. Because hedge fund managers earn performance and management fees on the net asset value of their portfolios, there is an incentive to overstate valuations, a particular hazard in illiquid over-the-counter instruments.

"If a hedge fund manager trades only a handful of credit default swaps per day, the risk of errors won't be that huge, but if there are hundreds of deals completed, the right people and technology will be necessary," says Rosson. "Hedge funds that do a large number of trades are typically prepared," but many others can run into problems.

The biggest hedge funds typically rely on a combination of internal modeling, information vendors, prime brokerages and administrators to ensure they have come up with the most accurate prices for complex or exotic transactions. "We have been receiving an increasing number of calls from hedge fund clients asking questions about what methodology was used to come up with a valuation," says Stephen Wynne, president of PFPC, which administers \$90 billion in alternative fund investments.

Last year PFPC added connectivity from its middle-office system to two undisclosed market data vendors to expand the range of OTC derivative products it priced. The bank is now migrating its U.S. business to the same platform as its European operations to ensure consolidated reporting. According to Wynne, PFPC spends between \$150 million and \$175 million a year on upgrading its hedge fund technology.

Concerns about valuations were a driving force behind the Securities and Exchange Commission's decision to require the registration of many U.S. hedge fund advisers. The rule, which took effect in February 2006, was later overturned by a federal appeals court, but

industry observers expect the SEC to have a strong hand in setting hedge fund valuation standards that could be released as early as April by a subcommittee of the International Organization of Securities Commissions (Iosco).

To prevent portfolio managers from influencing valuations on assets they trade in, the U.K.'s Financial Services Authority (FSA) recently recommended to an Iosco subcommittee that it chairs procedures already endorsed by the U.S. Managed Funds Association and its London counterpart, the Alternative Investment Management Association. Many of the biggest U.S. multistrategy funds have a dedicated pricing committee and rely on a data repository.

The FSA said that hedge fund managers should separate investment management from back-office functions, have a formal policy on how valuations are determined, and have procedures in place if the firm segregates parts of a portfolio in so-called side pockets for illiquid investments. Fund managers should also regularly reconcile valuations of their positions with those recorded by their prime brokerages and administrators, the FSA said.

Iosco, a Madrid-based body whose members supervise more than 90 percent of the world's securities markets, has no enforcement powers, but standards that it adopts are adopted as regulations by its members.