

## Six questions Hedge Fund Directors should know the answer to

Everyone is more focused on risk. A financial crisis built on a catastrophic failure of risk assessment will have that effect on an industry. With their reach being extended by the Alternative Investments Directive, the FSA is turning up the heat on the Director's of regulated entities, expecting high levels of knowledge and experience to be combined with more time considering risk management. The days of perfunctory risk assessments are gone. Welcome to a world where Director's need to know, with more certainty than ever, the answers to the really tough risk questions.

These questions, which we look at below, are a stiff challenge for any Director to address with confidence in the answer. For a partner or director of a hedge fund, where operating models are built upon the outsourcing of significant parts of the business, the challenge is exponentially larger. Consider:

1. Does the organisation have the capital strength to survive a severe downturn or

shock? For hedge funds that question needs to be read in plural – all organisations that are key parts of the supply chain need to be assessed and evaluated as financially viable at far greater frequency than has been the case historically.

2. Do we know all the key vulnerabilities in our supply chain? Most hedge fund boards have spent some time thinking about the possibility of a supplier suffering a major operational incident. What is often not understood is the risk that a supplier to their supplier fails. That scenario is at least as likely and potentially just as damaging.
3. What is the backup plan if a key supplier goes down, and is that plan viable? Prudent organisations have crisis management protocols and plans, tested to ensure they work. Consider a major incident where a prime broker cannot trade, or an administrator fails, it is critical that you know not only

what they would do in these circumstance but who would do it and how this would impact your fund and its investors.

4. What is the risk posed by change initiatives? Some of these are about service improvement; many are really about cost reduction. Suppliers will sell hedge fund boards on the positives, the Directors needs to focus on the negatives and how they are being managed to protect the service they receive.
5. Do we understand the risks we thought we understood? The reliability of investment risk reported by external suppliers is dependent upon data quality, model assumptions and parameters and even the graphical choices used to present the information. Disraeli coined the phrase "lies, damn lies and statistics". Hedge fund managers need to know the investment risk information they receive is presenting the truth.

6. How safe is the data of the fund and its investors and what is your exposure to financial crime? In the current environment all financial services organisations will be more susceptible to fraud and technology intrusion because more people will be trying to commit fraud. Considered alongside cost savings at suppliers which often fall heavily on 'peripheral' control activities, this concern increases.

Answering these questions and understanding the fund's exposure to risk is a challenge when so much of it is experienced vicariously through third party administrators, custodians, brokers, technology firms and professional advisors.

The traditional model employed by hedge fund boards has been to delegate much of their assurance over risk to the same suppliers who provide them with their core services. So SAS 70s, when available from administrator and custodians, have content and coverage specified by your supplier rather than the fund. It is hard to see how this approach can answer the demands of reasonable due diligence, not while there exists such a clear conflict of interest between the needs of the fund and the self-interest of its suppliers.

Kingston Smith Consulting LLP, the business protection consultancy, is ideally placed to help hedge funds review the activities of their key suppliers, reporting back on the quality of risk management and controls assurance relating to the fund. This may be through a risk management health check, or by deep dive reviews of the service or of particular areas of concern.

Kingston Smith Consulting combines expertise in the investment industry and demonstrated independence to give hedge fund boards the risk insights they need to run their organisations effectively.

We **deliver solutions**, defining and agreeing the outcome you require and charging the price which achieves that end, so that you will always understand the cost and benefit of our services.

We focus on achieving **return on investment**, we measure our success on the value you realise, this means solutions delivered to your specific needs and not someone else's template.

We **bring expertise** and experience to every engagement; every consultant in our team has a record of successful delivery in their field of expertise.

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