PART

I

Processes and Procedures

CHAPTER 1

What is a Hedge Fund?

In the investment world, "I run a hedge fund" has the same meaning as "I'm a consultant" in the rest of the business world.[1]

Whenever I have interviewed staff for roles in operational risk and due diligence for alternative investments – one of the questions I tend to ask is "what is a hedge fund?" The responses in my view provide a good indication of the way someone approaches this industry and the range of answers has been a source of much discussion amongst members of my teams. It is not an easy question to answer and formal definitions are scarce.

Alternative investments themselves appear easy enough to identify by eliminating traditional investing but even here the boundaries continue to blur with 130/30 funds, REITs and the ability to use derivatives beyond just efficient portfolio management as regulators have come to accept the use of such instruments. The Alternative Investment Funds Directive (AIFMD) in Europe makes the definition even more interesting as possibly everything that is a collective investment but not an Undertaking in Collective Investments in Transferable Securities (UCITS) is now likely to be an Alternative Investment Fund if it does not fall under one of the specified exemptions.

To quote Circuit Judge Randolph in *Phillip Goldstein, et al v Securities and Exchange Commission*: "'Hedge funds' are notoriously difficult to define. The term appears nowhere in the federal securities laws, and even industry participants do not agree upon a single definition." He also refers to an SEC Roundtable on Hedge Funds in 2003 where David Vaughan, a partner in law firm Decherts, cited 14 different definitions for hedge funds found in government and industry publications. Referring to the President's Working Group on Financial Markets, Hedge Funds, Leverage and the Lessons of Long Term Capital Management (1999) he points out that "[t]he term is commonly used as a catch-all for 'any pooled investment vehicle that is privately organised, administered by professional investment managers, and not widely available to the public.'"

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[1] http://www.dummies.com/how-to/content/what-is-a-hedge-fund.html. This material is reproduced with permission of John Wiley & Sons, Inc.

Hedge funds are hard to pin down by definition but have some common characteristics:

- The main vehicles/structures in which the investments are managed (funds) tend to be in a jurisdiction that is not the same as that of the investment manager – generally for tax, regulatory and disclosure reasons (although onshore hedge funds are getting more common in Europe and have always been common in the US, where the manager will often have an onshore and an offshore version of the funds).
- The funds generally have a lighter form of regulatory overview and the investment managers are often subject to lighter regulatory regimes (although AIFMD has changed that in Europe as has the Dodd–Frank Act in the US).
- The funds are able to use leverage which can be unlimited even though the manager may indicate the level of leverage they expect to employ in the prospectus.
- There is little prescription on the form that the offering documents for the fund need to take, the types of disclosure required in them and the nature of reporting to investors.
- There is minimal proscription on the types of investment activity and instruments that the manager can use or enter into on behalf of the fund unless restrictions are voluntarily adopted in the fund documents or rules that arise from a listing need to be complied with.
- A number of the significant operational activities such as trade settlement, administration, transfer agency and custody are outsourced to third parties who may themselves be in another jurisdiction.
- These funds are not generally available to the investing public and there are generally qualification requirements in respect of nationality and types of investors including investor sophistication and knowledge (ironically, often measured by the amount of wealth the investor has).
- There is an assumption of *caveat emptor* when investing in these funds as it is assumed that the investor has done its homework prior to investing and these investments are for institutional and very wealthy investors who generally hold non-voting preferential interests in the fund.
- The focus of the investment manager of the fund is normally to preserve capital and to try to achieve absolute returns for their investors rather than returns relative to an index.
- The manager is usually remunerated for its efforts by a fixed fee with reference to the assets being managed and a variable fee with reference to the returns it is able to generate.
- The governance of the fund is generally determined and controlled for all practical purposes by the investment manager to the fund, e.g. through the use of management shares which retain the voting rights in the fund for most things other than adverse changes to the investor's rights.

The risks of investing in these funds – apart from the investment risks themselves – are driven primarily by the structure of the fund, its service providers and the contracts with these third parties for services, the manner and extent of control over investments, the independence of governance and the nature of the instruments and the manner in which they are used. Fraud can also be an issue, but the chances of detecting fraud (as opposed to its indicators) are, in my view, low in any due diligence review. In relation to fraud the best one can expect to do is identify those environments in which fraud is possible and seek to avoid or control them. But for the investor, in the absence of fraud, the main impact hedge fund risks have on the safety of their investment can be summed up simply into:

- asset loss/investment risks – whether through leverage, trading bets, concentration, market events;
- liquidity and exit risks;
- valuation risks; and
- reporting risks.

Operational risk in a hedge fund context has been evolving as a concept and different people have different views on what it means. Even looking at the books currently available on the subject, the approaches differ, emphasising the backgrounds of the authors – whether it be a quantitative modelling approach or one that emphasises background research. For the purposes of this book, operational risk covers all those risks that are not investment risks and this defines the scope of the due diligence requirements discussed in this work. Some risks arguably are both operational and investment risks – leverage, liquidity, concentration risk and counterparty risk are some examples – but the focus of the investment professional is different to that of the operational risk professional, even in these areas of overlap, and therefore in my view merits discussion. In any event operational due diligence cannot be done in isolation of the investment due diligence. The two should be done in tandem if they are to be effective.

These characteristics make operational risk and the operational due diligence process an essential element of investing in alternative investment funds.

Although this book focuses on hedge funds, its application to other alternative investment funds is not significantly different because the principles do not differ, except perhaps in minor detail and regulatory focus.

1.1 THE ROLE OF A HEDGE FUND IN AN INVESTMENT PORTFOLIO

A lot of empirical research appears to suggest that active investment management rarely beats the market. So why bother? I am no expert in this area, but sophisticated investors consider hedge funds for the following reasons:

- Alternative investment funds tend to operate on a tax-neutral basis, which makes them attractive to investors to maximise tax planning opportunities.
- A lot of investment talent in the industry has moved to the world of alternative fund investment and this is one of the ways to tap into that talent.
- These investments provide a degree of diversification.
- Research suggests that although the main driver of returns is asset allocation strategy; investors who understand this and can identify the right alternative investment funds for their time horizons can benefit from such investments.
- Alternative investment funds focus on capital preservation and absolute returns – theoretically this means that a manager can go to cash if they are not comfortable with the investment environment.

- Although leverage can magnify the risks of loss, such investments give the opportunity to get leveraged exposure, thereby increasing the return (and of course loss) potential.
- It is argued that the manager and investor's interests are more greatly aligned through the fee structure and level of investment by the manager in the fund.

It therefore seems clear that there is a place for hedge funds and alternative investments in the market and that as these products evolve, due diligence processes need to evolve to enable investors to take sensible decisions in the light of the risks that they identify and assess. This makes understanding some of the structural and operational issues of previous due diligence exercises important.