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HEDGE FUND DUE DILIGENCE

What are today's investors demanding of their hedge funds? Aside from exceptional financial returns, there is an increasing tendency to hold fund management accountable for expenses, sound compliance policies, and overall adequate disclosures. If investors detect a problem in any of these areas, they stand ready to walk away from the deal. In response to such savvy investors, hedge-fund managers are making serious efforts to improve fund transparency.

Fund "Freedom of Expression"

Last year's changes in the way hedge funds may be offered and sold—a result of the federal Jumpstart Our Business Startups (JOBS) Act—has unleashed a flood of advertising and other promotions to the general public that were previously subject to the 80-year-old ban on general solicitation. Private issuers may now publicly ply their investment opportunities—including boasts of past performance—throughout all media venues, but along with such freedom of expression comes greater disclosure obligations to the consumer.

"Red Flag" Awareness

Issuers may only sell securities to "accredited investors," i.e. people whose net worth is in excess of $1 million and/or who have an annual income in excess of $200,000. Hedge funds are designed for sophisticated investors, yet not all investors have in fact displayed such sophistication when it comes to conducting due diligence—until now. An "Operational Due Diligence Survey" of global hedge fund investors conducted by Deutsche Bank found that the five most common red flags for investors were a lack of willingness on the part of fund promoters to provide transparency, inadequate compliance controls, poor segregation of duties, inexperience in critical roles, and inappropriate valuation policies.

Priority of Concerns

Of the 70 global investor entities polled (both institutional and individual), 64% said that investigation of "miscellaneous expenses" was important to them, 38% cited valuation policies as being of major concern, and 73% placed the focus on compliance and regulatory framework and in particular mitigation of risk in a cross-border regulatory environment. Satisfaction with the level of experience—or lack thereof—of the fund's manager is another factor that can prompt an investor veto. Interestingly, failure to provide adequate transparency trumped all other concerns.

Hedge Funds Respond

Scott Carter, an executive with Deutsche Bank's Markets Prime Finance, America in New York noted,

> Investors increasingly access hedge funds as part of a broader set of portfolio solutions which deliver superior risk adjusted returns. With this comes an expectation for robust operational controls, and we are seeing hedge funds successfully respond to these demands.

Hedge funds increasingly view transparency and compliance as not merely regulatory obligations but rather a key marketplace differentiator for the diligent investor

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