Operational Risk Mitigation:

An Intelligent Response By Discerning Hedge Funds to Elevated Litigation Risk in a Climate of Fear, Volatility, Uncertainty and Doubt.

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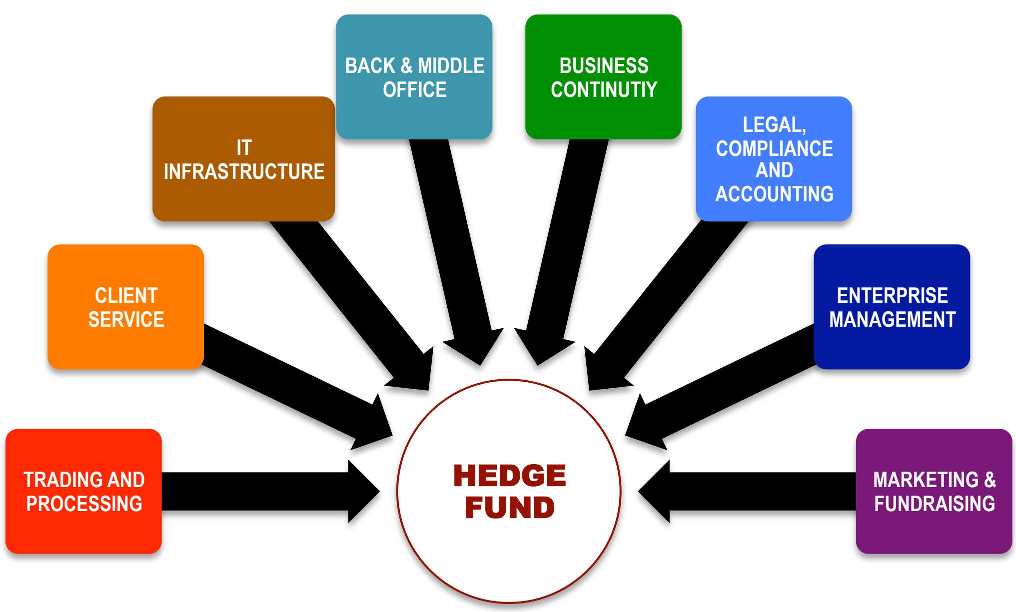
The credit crisis, high-profile fund closures, failures, unprecedented volatility, persistent economic uncertainty, demands of investors and a dynamic regulatory environment have elevated the litigation risks for hedge funds. In a world of ever changing and exponentially increasing requirements from markets, investors, service providers, regulators and other key participants, **operational risk: the risk of underperformance or loss resulting from inadequate or failed internal processes, people or systems is** HIGH. Funds and Investors embrace investment risk but process (operational risk) is unacceptable and must be avoided.

In hedge fund investing, the process of executing strategy and decisions have great impact on return realization, business performance and enterprise continuity as well as significant personal economic implications for fund principals. Research demonstrates that catastrophic events such as fraud and fund failures or less-harsh consequences in the form of "alpha slippage" or performance drag" all tend to result from operational issues. The magnitude and velocity of trading and the large sums of money invested requires a hedge fund to employ significant experienced internal resources in combination with holistically, well-resourced external service providers and vendors to insure successful operation. As such, the execution blueprint and operational infrastructure contain a myriad of operational risks arising from the various relationships.

- Risks Arising from the Relationship Among Business Partners.
- Risks Arising from the Relationship with Employees.
- Risks Arising from the Relationship with Limited Partners or Investors.
- Risks Arising from the Relationship with Portfolio Companies.
- Risks Arising from the Relationship with Third Parties.
- Risks Arising from Regulation.

THE SUPPORTING CAST

HEDGE FUNDS - THE ULTIMATE NETWORKED AND OUTSOURCED BUSINESS ENTERPRISE



ENTERPRISE-WIDE IMPLEMENTATION OF "BEST PRACTICES" & "BEST OF BREED" RESOURCES

An indicator of the rising risk level is reflected by the increase in insurance rates for operational risk events. Insurers are quoting rates that are 5 percent to 10 percent higher for coverage that protects hedge funds against government investigations and investor lawsuits. A hedge fund with $200 million in assets under management seeking $5 million of coverage could expect to pay about $75,000 annually, up from less than $70,000 not long ago. The aggressiveness of regulators is driving prices higher. Regulators have stepped up enforcement actions against asset managers, leading some carriers to project higher claims costs from professional-liability lawsuits. The conventional wisdom is that rates will continue higher as will the pace of investigations along with the degree of enforcement.

The following headline events are further tangible reflections of the elevated operational risk climate.

1) **The Galleon probe**, which leveraged the widespread use of FBI wiretaps for the first time in an insider-trading investigation, led to convictions of more than two dozen people, including the firm's co-founder Raj Rajaratnam. Former Goldman Sachs Group Inc. director Rajat Gupta was charged in October with passing nonpublic information to the hedge fund manager.

2) **MF Global**, the broker-dealer run by former Goldman Sachs Co-chairman John Corzine, filed for bankruptcy Oct. 31 after a $6.3 billion bet on the bonds of some of Europe's most indebted nations prompted regulator concerns and a credit downgrade. Government investigators have been analyzing events prior to firm's collapse, when as much as $1.6 billion in client funds went missing. MF Global and some key executives face at least two potential class actions over the collapse. Futures customers of MF Global Inc. have been competing to lead a lawsuit over the alleged theft of $1.2 billion of their assets. An investor suit led by the Virginia Retirement System alleges that executives made misleading statements that inflated the prices of MF Global securities.

3) **Knight Capital Group** suffered massive trading losses caused by bad software, which triggered a cascade of mistaken trades that wiped out $440 million of its capital. While details remain unclear, it's thought that the errant code may have come from a third-party vendor.

Soundness of the operational environment is more critical than ever before for both fund principals, investors and the entire global financial system. Candidly, many funds regardless of size don't have a properly-documented and staffed operational risk management function. In the instance of litigation, opposing counsel will invariably review documented process and procedures as well as the backgrounds of those involved. Determining the existence of documented procedures and the depth of experience and character of those involved is a natural activity in the discovery process. In addition, evaluating the consistent adherence to procedures as well as "best practices" and use of "best-of-breed" resources is an adjacent. Any deviation from "standard operating procedures" or insufficient/subpar resources will wave a red-flag for further analysis. No fund should provide potetntial litigants i.e. investors or regulators with a roadmap to successful judgment. Therefore, "thorough, periodic and continual" internal operational risk assessment is a prudent exercise, which serves as a business and personal protection strategy in a highly litigious, volatile and dynamic regulatory environment.

What is a "thorough" internal operational risk assessment process?

A "thorough" internal operational risk assessment rigorously analyzes enterprise-wide processes. However, there are limits. Furthermore, in a climate of unprecedented volatility, tail risk events are more likely and history doesn't necessarily repeat itself the same. Some risks cannot be eliminated - only managed and mitigated. But if there are no provisions for the management and mitigation of operational risk, lax internal fund management and broad investment mandates in combination with inadequate, inappropriate or inexperienced operational assessment only serves to increase the possibilities for unfavorable outcomes. The 'devil is **ALWAYS** in the details'. Among the numerous issues to consider:

➢ **Behavior, Integrity and Commitment**. The actions of employees should support the greater good of all stakeholders. Whether someone's behavior is illegal, unethical, self-serving, or contrary to a fund's policy and whether the internal climate exists to prevent such activity is crucial. Background checks that identify educational and behavioral characteristics that correlate with success as defined by the fund prospectus is essential. This means a separate risk management function; a budget commensurate with the fund's risks; documented policies, procedures, and controls; appropriate fund governance; and consequences for improvisational or inappropriate behavior. The walk and the talk must be in sync. Senior managers must respect controls and all employees must feel empowered to support operational risk management.

➢**Standards and Empowerment**. The standards for managing and controlling the fund must be explicit, easy to understand, and transparent. Employees know the risks and, in some cases, create them. Involving them directly in risk management is more efficient and employees should be encouraged to identify, address, and comment on the fund's operational risks.

➢**Metrics and Benchmarks**. Should be timely, actionable, accurate, and transparent to all. In the right environment, having information available to all employees can reduce losses. Procedures should reflect best practices. These must include written policies and guidelines, valuation policies, compliance monitoring, regulatory reporting, review of external and internal risks, control self-assessment, process controls, internal and external audits, identification of process versus policy gaps, and exception reporting.

➢**Process flows, Gaps and Exceptions**.. There must be a step-by-step definition of how the operating environment works from the point of view of both the client and the fund. This becomes the basis of an audit. Process flows also can help identify individual or serially untoward events and identify policy gaps. They should start with existing conditions, not ideal ones, and identify risks as well as opportunities. Gaps should be prioritized, and a plan should be developed to address them. The key is to balance risks with rewards and to select important events and controls. Every risk doesn't have the same weight. As such, not every policy variance has the same importance or can be addressed instantly. There should be a clear, practical procedure for granting exceptions.

➢**Controls and Documentation**. Operational risk drivers change over time. Therefore, a defined, dynamic process should be in place that keeps policies relevant as well as documented and supported by a philosophy and strong governance process.

Summary

Comprehensive rigorous, periodic and continual internal operational risk enterprise-wide self-assessment by a hedge fund in tandem with continual monitoring can be a sound mitigation strategy in response to elevated litigation risk.

While funds are in the pursuit of consistent, exceptional uncorrelated returns as well as enable investors to meet fiduciary and governance responsibilities, they must also strive to self-protect through a combination of legal structuring, clear documentation and sound business practices.

The preceding has been a brief discussion and by no means exhaustive. A full explanation of operational risks and the necessary steps to mitigation are beyond the scope of this paper. As the facts and circumstances will vary by fund and managers should consult with appropriate specific expertise to ensure that selection of the best mitigation strategies matches the given risks.

About Johnson & Company and The Author: Johnson & Company is an Austin,Tx-based consultancy, which provides marketing and fundraising advisory services to alternative asset managers and alternative investment consulting services to investors (institutional and private wealth) as well as consultants, advisors and other key intermediaries.

While our service focus and solutions are for asset managers and investors, we deeply understand that investment bankers, prime brokers, attorneys, accountants, independent administrators, commercial real estate advisors and technology vendors, are all integral components of the eco-system of a successful alternative investment operation. Therefore, we often collaborate and work in partnership with such professionals to assist small funds. Consequently, we welcome inquires from firms and individuals that operate within this sphere to broaden our relationships, augment our knowledge base and bring the highest level of service to our clients.

Bryan K. Johnson is Founder and managing partner and has 20+ years experience within alternative investments. Previous to launching Johnson & Company, he served as Global Head of Marketing and Business Development for the Alternative Investment Group at Moody's Investors Service (MIS), responsible for the deployment of Operational Quality (OQ) Ratings For Hedge Funds. Prior to his tenure with Moody's, he served as chief expert witness for The Attorney General of Texas and The State of Texas in the evaluation of hedge funds and private equity firms as acquirors of the assets of Texas Genco in the multi-billion dollar true-up of Centerpoint Energy (CNP:NYSE)

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