
Governance & Risk Management Practices

Enterprise Risk Management & Investment Risks

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Presented by:

Keith J. Keller
Managing Director
Duff & Phelps
keith.keller@duffandphelps.com
678-642-4356

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Section 1

Risk Management Practices

The Opportunity for Governance & Risk Management Practices

Many industries are continuing to evolve and adapt to a new, more demanding, operating environment. Some of the key trends that are presenting challenges for industry participants include:

- Growing investor sophistication – Increased scrutiny of operating and investment performance and transparency over reporting across the organizations are increasing complexities of businesses and increasing client reporting requirements and complexities of governance and compliance.
- Improving operations scalability and control – Achieving scale in operations remains an important operational imperative while maintaining process efficiencies and the necessary control environment.
- Product innovation – Pressure for higher margins, new products and the use of alternative investments led by growth in hedge fund and fund of hedge fund strategies are presenting both business opportunity and operating challenges related to staff skills, technology, control environments and business operations.
- Regulatory and compliance requirements – Expanding regulations, overlapping mandates and tighter enforcement continue to raise the cost of compliance and increase the consequences of non-compliance. Regulatory and compliance initiatives remain a high priority and are evolving in all industries.
- Complex trading and investment approaches – With continued growth in derivatives and alternative investments, investment managers are challenged with managing increasing valuation and settlements complexity while maintaining a robust risk management and internal control environment.

Definition & Purpose in Investment Operations

“Enterprise risk management is a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.”

*...Committee of Sponsoring Organizations of the Treadway Commission
September 2004*

“All activities of an organization involve risk. Organizations manage risk by identifying it, analyzing it and then evaluating whether the risk should be modified by risk treatment in order to satisfy their risk criteria. Throughout this process, they communicate and consult with stakeholders and monitor and review the risk and the controls that are modifying the risk in order to ensure that no further risk treatment is required.”

*...the International Organization for Standardization (ISO)
2009*

Current Guidance Related to Risk Management Practices

The most prominent frameworks, guidance and disclosure/regulations include but are not limited to the following:

Frameworks

- COSO ERM
- ISO 31000

Guidance

- S&P
- NACD Whitepaper
- AICPA Audit Committee Effectiveness Center

Disclosure/Regulation

- SEC Proxy Disclosure
- NYSE Requirements
- Dodd-Frank Wall Street Reform & Consumer Protection Act
- Basel III

The charts on the following two slides summarizes the highlights and application of each of these resources.

Risk Management Frameworks

	COMMITTEE OF SPONSORING ORGANIZATIONS (COSO)	INTERNATIONAL ORGANIZATION FOR STANDARDIZATION (ISO)
PRINCIPLES	<ul style="list-style-type: none"> Value creation or preservation Process ongoing and flowing through organization Applied in strategy setting Objectives identified, roles and responsibilities, lines of reporting Developed in consideration of entity size and nature of activities Open communication between Management and Board of Director React dynamically to changing conditions Effectiveness of risk management continually evaluated 	<ul style="list-style-type: none"> Creates value Integral part of organization process Part of decision making Systematic, structured and timely Tailored and aligned with risk profile Transparent and inclusive Dynamic and responsive to change Facilitates continual improvement
COMPONENTS	<ul style="list-style-type: none"> Internal Environment Objective setting Event Identification Risk Assessment Risk Response Control Activities Information and Communication Monitoring 	<ul style="list-style-type: none"> Mandate and Commitment Design of Framework; Establish the context – internal and external Risk Identification Risk Analysis Risk Evaluation Risk Treatment Communication Consultation Monitoring and Review
APPLICATION	All companies (public & private)– September 2004	All companies (public & private)– November 2009
VALUE PROPOSITION	<ul style="list-style-type: none"> Reducing operational surprises /losses Enhancing risk response decisions Aligning risk appetite and strategy Common language to discuss risk Manage cross enterprise risks and realize opportunities 	<ul style="list-style-type: none"> Continual Improvement Full accountability for risks Application of risk management in all decision making Continual communication Full integration into governance structure

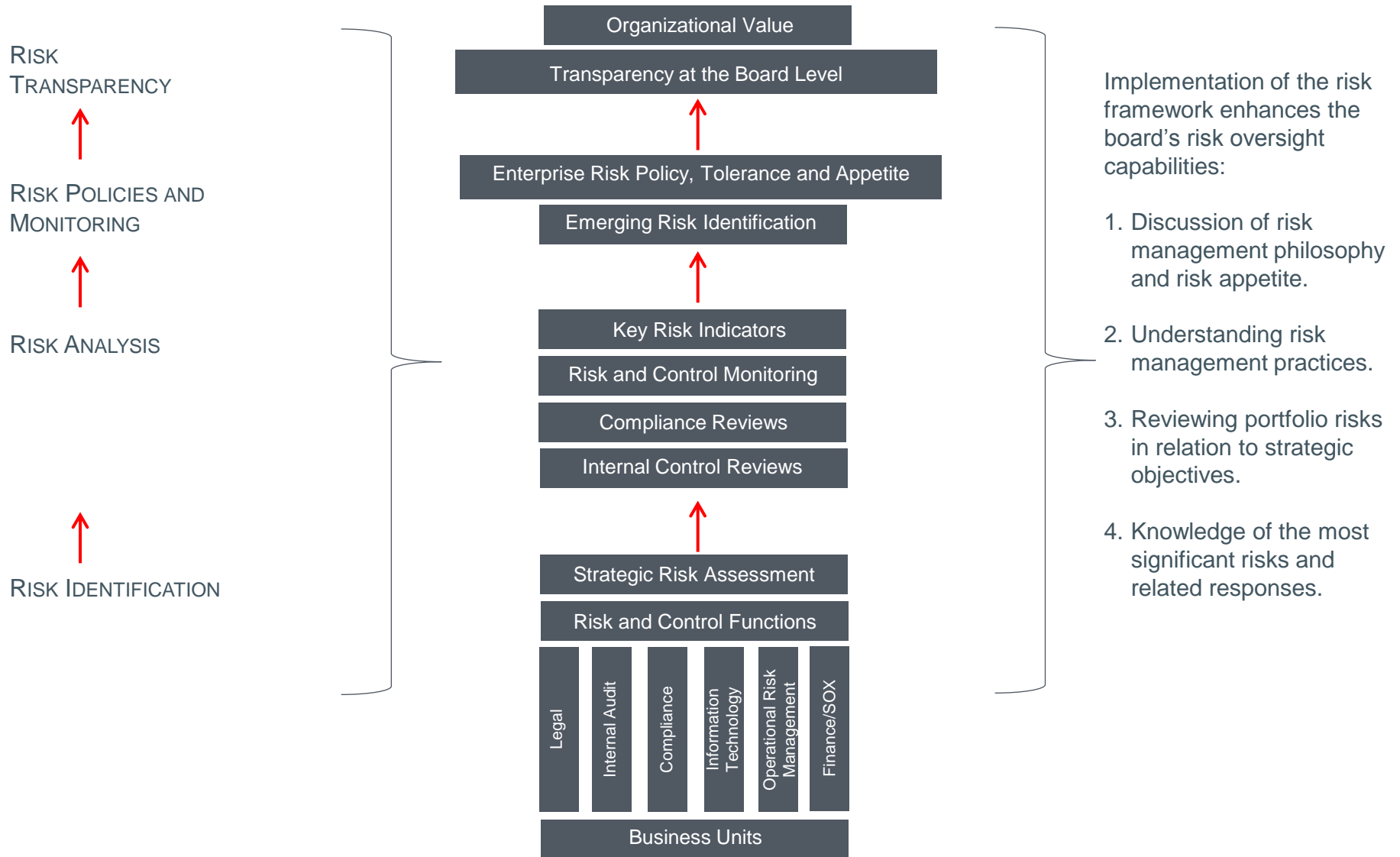
Risk Management Frameworks

	RISK GUIDANCE & DISCLOSURE/REGULATION	HIGHLIGHTS	APPLICATION	DISCRETIONARY OR REQUIRED
GUIDANCE	Standard & Poors (S&P)	<ul style="list-style-type: none"> Evaluate risk management culture including framework, policies/procedures, metrics/analysis. Evaluate strategic risk management including frequency and nature of risk updates and role of risk management in strategic decisions. 	S&P rated organizations	Discretionary - included in S&P Debt Rating Analysis most likely late 2010 (May 2008, July 2009, and June 2010)
	National Association of Corporate Directors (NACD)	<ul style="list-style-type: none"> Define the board's objectives for risk oversight including understanding framework, risk appetite and culture of risk. Link risk information to the organization's strategic and operational objectives. Monitor potential risks in the organization's culture and incentive structure. 	All companies (public & private)	Discretionary (October 2009)
	AICPA Audit Committee Effectiveness Center	<ul style="list-style-type: none"> Audit committee involvement in risk management oversight Effective risk management starts with a conversation Risk management must be driven from the top and risk analysis should be integrated with strategic planning 	All companies (public & private)	Discretionary (various dates)
DISCLOSURE/REGULATION	SEC Proxy Disclosure Enhancement	<ul style="list-style-type: none"> Disclose compensation policies and practices as they relate to risk management Describe the board's role in the oversight of risk. 	SEC registrants	Required (effective February 2010)
	NYSE Corporate Governance	<ul style="list-style-type: none"> Audit Committee to discuss risk assessment and risk management policies Audit Committee to discuss major financial risk exposures and the monitoring and control of exposures 	NYSE members	Required (effective November 2003, updated November 2009)
	Dodd-Frank	<ul style="list-style-type: none"> Establish risk committees Committees responsible for risk oversight 	Financial institutions with total assets greater than \$10 billion	Required (effective October 2012)
	Basel III	<ul style="list-style-type: none"> Implement firm wide risk management framework Comprehensive identification, monitoring and mitigation of risk Comprehensive internal controls in place 	Financial institutions (supplemental Pillar 2 guidance)	Required (effective July 2009)

Section 2

Risk Management Program Framework & Approach

Risk Management Practices Framework



Risk Management Practices Model

RISK IDENTIFICATION → RISK ANALYSIS → RISK POLICY & MONITORING → RISK TRANSPARENCY



LINKAGE TO COSO ERM COMPONENTS:

- | | | | |
|---|--|--|---|
| <ul style="list-style-type: none"> • Internal Environment • Objective Setting | <ul style="list-style-type: none"> • Event Identification • Risk Assessment • Information and Communication • Monitoring | <ul style="list-style-type: none"> • Risk Response • Control Activities • Information and Communication | <ul style="list-style-type: none"> • Information and Communication • Monitoring |
|---|--|--|---|

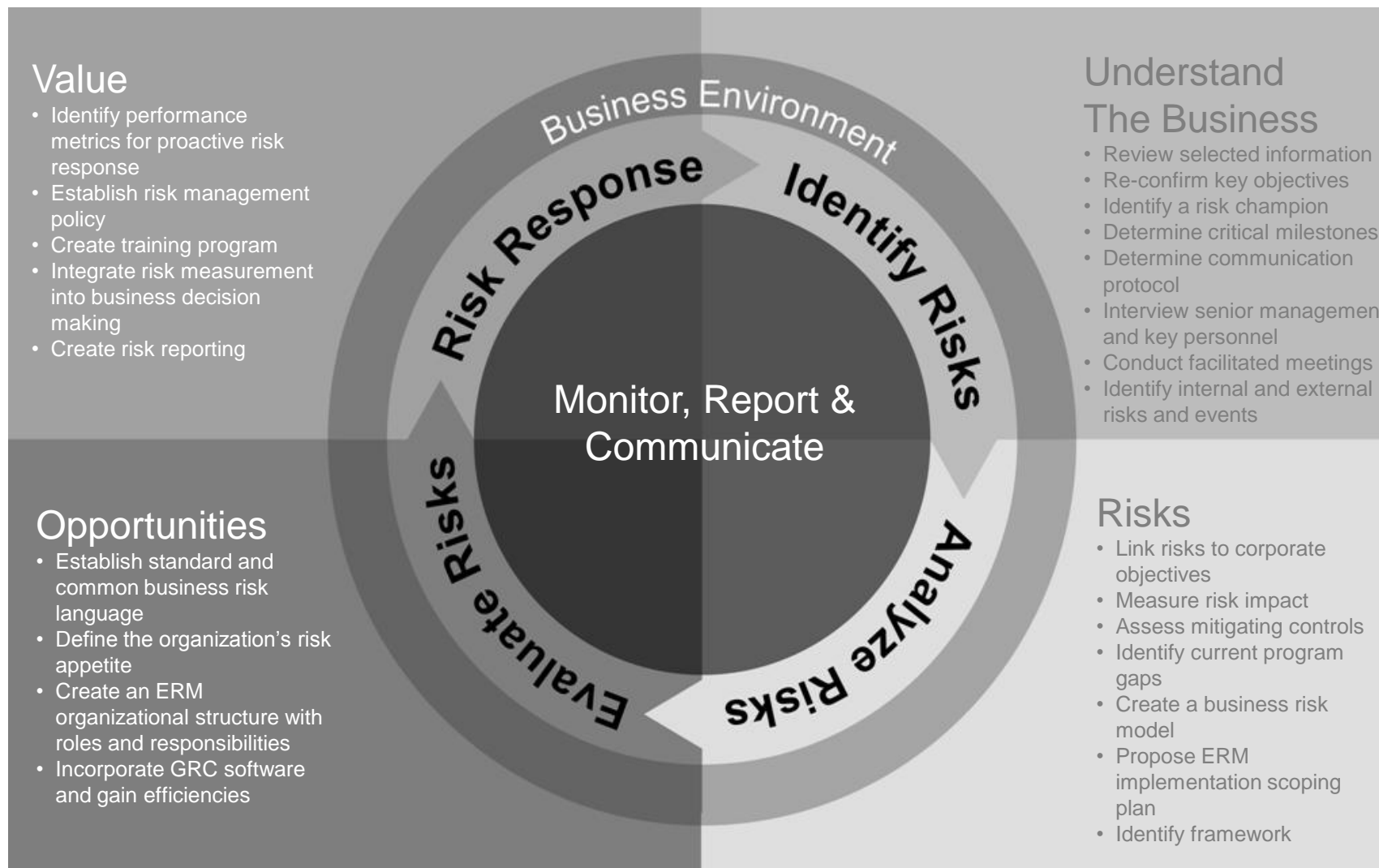
LINKAGE TO S & P GUIDANCE:

- | | | | |
|--|---|--|---|
| <ul style="list-style-type: none"> • Organization Structure • Roles and Responsibilities • Accountability | <ul style="list-style-type: none"> • Policies to include strategy, tolerance authority and disclosure • Infrastructure to include personnel, operations, data and technology • Methodology to include risk metrics, stress testing, validation and performance measurement | <ul style="list-style-type: none"> • Management awareness of risk • Global Approach to Risk • Understanding of future modifications to risk profile | <ul style="list-style-type: none"> • Emerging Risks • Quantifying Risk Tolerance • True assignment of credit rating and understanding of risk exposure |
|--|---|--|---|

LINKAGE TO ISO 31000 ARCHITECTURE:

- | | | | |
|---|---|--|--|
| <ul style="list-style-type: none"> • Mandate and Commitment • Design of Framework • Implementing Risk Management | <ul style="list-style-type: none"> • Risk Identification • Risk Analysis • Risk Evaluation | <ul style="list-style-type: none"> • Risk Treatment | <ul style="list-style-type: none"> • Monitoring and Review • Continual Improvement |
|---|---|--|--|

Risk Management Practices – Process



Risk Management Practices – Process (cont'd)

- Assessing the risk in the company's strategy.
- Defining the board's role with regard to risk oversight.
- Developing a business risk model which highlights the risk profile of the company.
- Understanding risk management practices specifically related to processes for:
 - Identifying, assessing and managing top risk exposure
 - Identifying emerging risks affecting objectives
 - Monitoring key risks related to core strategic objectives
 - Analyzing the risks with well designed key risk indicators.
 - Communicating risk information to the board.
- Comparison of the company's risk management processes to existing risk management best practices
- Developing a risk policy, risk tolerance and risk appetite.
- Assessing the organizational governance including committee structure, reporting, frequency, topics covered and documentation

Sound Risk Management Practices – Deliverables

- Design best practices investment policy, procedures and monitoring process (process maps and control matrix, testing results and governance assessment).
- Comparison of the company's risk management processes to existing risk management frameworks , ISO 31000 and Committee of Sponsoring Organizations (COSO) and to guidance form S&P, NACD and AICPA specifically focused on risk management programs.
- Assessment of the organization's committee structure, reporting, frequency, topics covered and documentation.
- Risk-based evaluation of risk events at the entity and process levels focused on alignment with strategic objectives. Mapping of strategic objectives to risks to performance indicators, and graphic of current and emerging risks in a risk model format.
- Design risk management framework including a risk policy, a customized business risk model, a risk assessment graphic and performance metrics for ongoing monitoring.
- Report summarizing company program related to monitoring, frequency and oversight of the transparency of information provided to the board and management

Sound Risk Management Practices – Benefits

Enhancing the organizations risk awareness and focus can assist management in the movement beyond reactionary responses into a proactive risk response.

ERM continues to be the primary approach used to provide companies with a holistic, strategic method of understanding and managing risks. **Minimizing Surprises** - By providing this enhanced capability to identify potential events, assess risk, and establish responses, ERM reduces surprises and related costs or losses.

Qualitative
Improved risk awareness and collaboration across all governance functions
Risk threshold helps identify opportunities
Improved regulatory compliance
Protecting and enhancing the reputation of the organization
Increased visibility and transparency
Minimizing surprises

Quantitative
Reduce infrastructure, operating or resource costs
Integrate risk process with corporate processes
Build overall shareholder value
React faster and earlier to loss events
Increase company credit rating
Risk exposures clearly mapped with management consensus

Sound Risk Management Practices – Benefits

- Provides for a common risk language
 - Creating measurement and understanding across the organization.
- Aligns risk appetite and tolerance with the organization's business strategy
- Integrates the risk process with day-to-day corporate processes
- Helps business units assess and understand the risks in a succinct and objective manner
- Enhances the current risk identification process for known and emerging risks
 - This provides assurance that key risks are identified, assessed, monitored, and communicated in an integrated process across the organization.
- Prepares the system to react to risk events
 - Managers/Directors and Senior Leadership implement process procedures to address the events timely and effectively.
- Implements a proactive risk strategy versus a reactive response
- Provides a clear, standardized communication protocol
 - This allows management, staff, legal counsel, staff members, and the Board to manage risk.
- Assesses the various key risks that could stand in the way of attaining the organization's mission

Section 3

Risk Management- Investment Operations

Investment Framework & Process Objectives

Strategy & Governance

Develop an effective governance structure.

Design and implement strategies, goals, and objectives to meet the company's needs.

Implement a risk oversight process at the Board/Management level.

Portfolio Management

Investment Decisions

Utilize strategy, policies, risk tolerances, and objectives to identify potential investments.

Communicate investment opportunities and solicit needed credit risk analysis.

Select Investments that comply with approved investment policy, optimize ROI and minimize losses.

Credit, Market, Liquidity & Currency Risk Management

Research and perform analysis on credit worthiness of investment opportunities.

Quantify exposures for strategic decision making.

Adherence to risk limits and escalation of exceptions.

Purchase, Sale and Servicing of Investments

Initiate/process purchase or sale transaction.

Settlement/Valuation/Impairment/ Reconciliation of securities.

Document key assumptions, compliance with investment policy and intra-day monitoring.

Portfolio Planning, Analysis & Oversight

Monitor portfolio risk and oversee portfolio performance.

Implementation of a risk governance business model including key risks, risk type and business implications.

Evaluate scenario analysis and stress testing.

Accounting & Reporting

Record financial investment information within the investment Accounting system and manage the accurate transfer of information to the system.

Compile investment information needed for reporting to management, and key stakeholders.

Deliver reportable data to the Financial Division for inclusion in GAAP and Statutory filings.

Information Technology

Investment Operations – Risks

Framework	Area	Components	Key Risks
Strategy & Governance	Strategy & Governance (S&G): -Structure -Committees	<ul style="list-style-type: none"> • Global investment policy & strategy • Corporate and committee structure • Board and management oversight and reporting • Professional expertise • Investment planning 	<ul style="list-style-type: none"> • Structure does not allow for independent oversight bodies to challenge investment management. • Investment strategies operate outside of approved policies. • Reporting metrics are not communicated accurately or timely • Investment securities expertise is inadequate compared to the complexity of the portfolio.
Portfolio Management	Front Office (FO)	<ul style="list-style-type: none"> • Portfolio management • Analytics • Pricing/Valuation • Credit and market risk limits • Authorization/input • Compliance with investment policy • Intra-day monitoring 	<ul style="list-style-type: none"> • Lack of robust processes/systems resulting in inaccurate and untimely analytics and monitoring. • Documentation & controls for valuation and impairment are inadequate. • Daily activity not monitored by CIO resulting in inappropriate positions. • Investment policy components are not followed. • Stress testing tools do not provide accurate or timely assessment of volatility.
	Mid to Back Office	<ul style="list-style-type: none"> • Trade execution and capture • Confirmation process/ legal documents • P/L reconciliation • Settlement • Exception reporting • Reconciliations- Custodian, Banks and G/L • System interfaces, access and change controls 	<ul style="list-style-type: none"> • Investment activity not captured accurately or timely. • Investment activity not compared to terms at time of commitment resulting in inaccurate settlement & reporting. • IT controls not in place resulting in inappropriate access and changes. • Reconciliations with custodians not performed timely or accurately. • Reconciliation of P&L with front office not performed.

Investment Operations – Risks

Framework	Area	Components	Key Risks
Portfolio Management (cont'd)	Valuation (VAL)	<ul style="list-style-type: none"> • Portfolio segments • Documentation supporting fair value • Independent price and impairment validation • Third party pricing vendor methods and sources • Price tolerance ranges • Model control 	<ul style="list-style-type: none"> • Valuation of securities and related assumptions not independently validated. • Pricing and impairment approaches for illiquid securities not well documented or supported. • Valuation P&Ps not maintained. • Escalation policies for price variances in excess of tolerances not established. • Controls over changes to models not approved or monitored.
Portfolio Planning, Analysis & Oversight	Risk Management (RM): <ul style="list-style-type: none"> - Operational - Credit - Market - Currency - Liquidity Compliance/Legal	<ul style="list-style-type: none"> • Exposure definition and measurement • VAR, credit exposure and market exposure • Risk reports to the Board and management • Valuation, model review, approval and maintenance • Scenario analysis/Stress testing • Limit monitoring and risk assessment and reporting • Credit analysis methods • Documentation supporting credit decisions 	<ul style="list-style-type: none"> • Risk management not independent of the investment securities area. • Expertise to challenge valuation, models and assumptions is inadequate. • Assessment of risk in the portfolio (credit, tenor, liquidity, etc.) not performed adequately. • Communication of risk metrics does not occur timely, completely or accurately.
Accounting & Reporting	Accounting & Reporting (A&R): <ul style="list-style-type: none"> - Investment Acctg - Financial Reporting 	<ul style="list-style-type: none"> • GAAP/Regulatory reporting • Impairment analysis • Hedge accounting • Portfolio liquidity and risk based capital • SOX Documentation Refresh 	<ul style="list-style-type: none"> • Information for both internal and external financial reporting is not complete, accurate or timely. • Monitoring changes in GAAP and Statutory regulations does not occur. • Changes in investment valuation not identified.

Activities to Monitor/Mitigate the Risks

- Strategy & Governance
 - Create a Risk Committee of the Board
 - Implement an Internal Investment Risk Committee including members from the following areas:
 - » CIO investment group
 - » Risk management
 - » Investment accounting
 - » Legal & compliance
 - » Internal audit
 - » Chief Operating Officer
 - » CFO
 - Review the investment policy and strategy to determine that the fund activities are within the guidelines approved by the Board.
- Portfolio Management
 - Assess the frequency, quality and independence of valuation and impairment including methodology & assumptions.
 - Evaluate the accuracy and completeness of risk metric reports from the CIO area.
 - Review exception reporting (valuation, limits, reconciliations, trade processing, settlement) to look for any unusual activity.
 - Stratify the portfolio to identify hard to value assets, complex securities, concentrations and risk profiles.
 - Review scenario analysis and stress testing.

Activities to Monitor/Mitigate the Risks

- Portfolio Planning, Analysis & Oversight
 - Assess the independence of the risk management function from the CIO functions.
 - Determine that risk management performs its own calculations of exposures
 - Identify, review and approve valuation models and reasonableness of assumptions.
 - Stratify the portfolio to identify hard to value assets, complex securities, concentrations and risk profiles.
 - Assess the transparency, consistency and reliability of the pricing sources.
- Accounting & Reporting
 - Evaluate the controls (access, change, reconciliation of data feeds) for the systems that provide information for internal and external reporting.
 - Assess the accuracy of the internal and external reporting and disclosures.
 - Analyze changes in investment valuation and the impairment decisions.
 - Determine that reporting and disclosures reflect current accounting & regulatory pronouncements.

Key Principles of Effective Risk Oversight – Investment Operations

Principle	Investment Operations
<ul style="list-style-type: none">• Understand the company's key drivers of success• Assess the inherent risk in the company's strategy• Define the role of the BOD and the standing committees with regard to risk oversight• Consider whether the risk management system- people, process, technology- is appropriate and sufficient• Work with management to develop relevant risk information• Encourage a dynamic and constructive dialogue• Closely monitor the risks in the culture and incentive structure• Monitor critical alignment of strategy, risk, controls, compliance, incentives and people• Consider emerging and interrelated risks• Periodically assess the BOD oversight processes	<ul style="list-style-type: none">• CIO Strategic Plan/Investment Policy• CIO Strategic Plan/Risk Assessment & Scenario Analysis• Investment Committees• Risk Management Process/Independence from CIO• CIO Board/Management Reporting• Regular Meetings with CIO• CIO Communication/Management Style & Knowledge of Incentive Plan• Risk Management Process• Portfolio Stratification/External Risks• Review/Benchmark Board Processes

Section 4

Best Practices- Risk Management Programs

Leading Practices – Risk Management in Investment Operations

- Consistent focus and commitment by the board and senior management
- Creation of an action plan that builds and improves on the organization's current capabilities
- Establishment of a risk council that includes a mission statement, defined membership roles and responsibilities, and frequent meetings.
- Identification of a “risk champion” to help drive the process and its implementation (this role is often titled “Chief Risk Officer”)
- Disciplined approach – with a customized common risk framework and risk language – that is focused on well designed risk processes, monitoring and accountability
- Accountability for business units to manage risks they take within the established framework

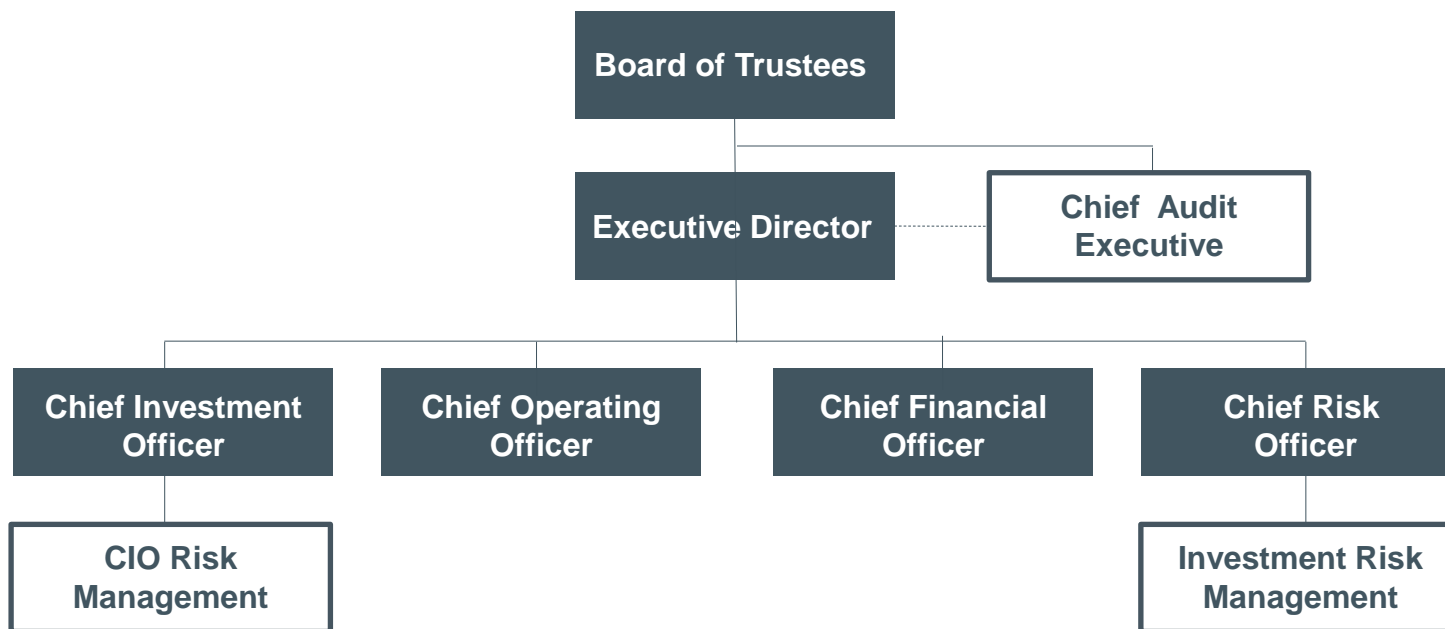
Leading Practices – Risk Management in Investment Operations

- Continuous evaluation of underlying assumptions
- Support for an open communication process so that people are comfortable discussing risk at any level in the organization
- Sound scenario and stress-testing practices
- Measurement of the impact and speed of the organization's responses to identified risks
- Evaluate your governance structure early on in the implementation to determine the current committees and information flow and then again at the end of the implementation to ensure the structure is customized to your organization.
- Systemic thinking is key to the process.
 - Inherent risk vs. residual risk discussions, and mitigating controls, risk universe vs. audit or “silo” approach to risk.
 - Integrate with Strategic Planning to identify emerging risks.

Leading Practices – Risk Management in Investment Operations

- Creating a Valuation Committee and determining potential committee responsibilities;
- Expanding initial due diligence and on-going monitoring of investment managers' valuation procedures;
- Utilizing initial due diligence and monitoring information in the valuation process;
- Acknowledging responsibility for determining Fair Value in situations where the investment manager or custodian does not provide a basis for determining value;
- Improving internal modeling support in situations where investment managers do not deliver fair value estimations;
- Utilizing independent valuation experts, as appropriate, in the valuation process; and
- Reviewing and assessing the compliance of underlying managers' valuation policies.

Sound Risk Management Practices – Structure



Section 5

Case Study Illustrations

Pension Fund
Hedge Fund

Pension Fund Case Study

Implications from New Guidance Puts Pressure on LPs for Fair Value and Speed

- New guidelines issued by the FASB/AICPA clarifies the need for more ongoing valuation due diligence and more thorough documentation by investors.
- Investors cannot abdicate the fundamental governance role that they are responsible for estimates in their own financial statements.
- NAV needs to be as of the same date as the investors measurement date.
- Investors need to determine that the investee fund manager has an effective process and related internal controls in place to estimate the fair value of its investments that are included in the calculation of NAV and that such controls and processes result in NAV which is derived from the fair value of underlying investments.
- Investors unfamiliar with ASU 2009-12 and the AICPA TPA may have difficulties with their auditors as a result of not demonstrating rigor in their policies, processes and procedures for estimating fair value.

Overview of Investment Operations Evaluation

Accounting Guidance	Scoping	Procedures	Key Control Deliverables
<p>For the process/control review, the following accounting topics/guidance provide the basis for our scope and procedures:</p> <ul style="list-style-type: none"> • Topic 820- Fair Value Measurements and Disclosures (FAS 157) • Topic 946- Investment Company Guide (AICPA Audit & Accounting Guide, Investment Companies) • Accounting Standards Update (ASU) 2009-12- Investments in Certain Entities that Calculate NAV (or its equivalent) • AICPA Technical Information Service (TIS) 2220- Long Term Investments • AICPA Practice Aid- Alternative Investments, Audit Considerations 	<p>Validate an understanding of the key risks in the operations and the portfolio through discussions with Investment, Finance & Operations :</p> <ul style="list-style-type: none"> • Security Types • Key Controls including <ul style="list-style-type: none"> – Initiation /Processing – Settlement – Reconciliation – Valuation/Impairment – Income Recognition – Investment Decisions • Level of Documentation <ul style="list-style-type: none"> – Valuation policy – Reasonableness of key judgments/ assumptions – Benchmark to processes in the marketplace • Organizational Structure 	<p>Perform the following procedures to assess the investment policy:</p> <ul style="list-style-type: none"> • Review the existing LP and underlying GP valuation policies • Interview key members of the investment, finance & operations teams • Process flow and key control matrix for each security type and derivatives • Review committee structure, discussion topics and information packets • Recommendations for process improvement plan • Select a sample to test operating effectiveness of the controls 	<p>Provide ongoing feedback to Management regarding final deliverable.</p> <ul style="list-style-type: none"> • Based on the procedures performed prepare a draft report presentation for Management review • Report will typically include: <ul style="list-style-type: none"> – Conclusions – Issues & Solutions – Scope & Procedures – Process Maps – Control Matrix • Address any further open items, including comments from Management and Operations regarding our analysis

Project Scope Detail

LP's are generally required to estimate the Fair Value of all investments at each reporting (measurement) date for financial reporting purposes. LP's also regularly determine the Fair Value of investments for other purposes, such as incentive compensation and asset allocation.

The scope for an investment operations evaluation may include, but not be limited to, the following:

- Review the LP valuation policy as it currently stands;
- Provide observations and suggestions for improving the valuation policy and Fair Value estimation procedures consistent with industry best practices, Topic 820 (FAS 157) and ASU 2009-12;
- Provide comments on improving the LP valuation monitoring process and internal communications;
- Review and provide suggestions for improving information provided to the Fund's limited partners on the Fair Values of the underlying investments consistent with industry best practices.
- Evaluate the design of the processes and internal controls in place in the front and back offices to estimate the fair value of its investment portfolio including the alternative assets and derivatives.
- Evaluate the operating effectiveness of the processes and internal controls for fair value
- Provide observations and suggestions for organizational governance including committee reporting structure, frequency, topics covered and documentation.

Project Procedures Detail

- Read, evaluate and comment on the existing LP valuation policy;
- Review documentation relevant to LP valuation process and procedures;
- Review the valuation policies of the Underlying GP's for compliance with Topic 820(FAS 157);
- Interview key members of LP investment, finance, and operation teams concerning valuation policy and procedures to identify and prioritize critical risks and processes;
- Develop process maps for critical processes from the front office to the back office :
 - Assess the initiation, processing, settlement, reconciliation, valuation/impairment, income recognition, investment decisions and reporting;
 - Identify the strengths and weaknesses of the processes and internal controls including identification of design gaps;
 - Propose solutions for remediation of design gaps and process improvements
- Assessment of the roles and responsibilities of the front and back office;
- Evaluate the organizational governance including committee reporting structure, frequency, topics covered and documentation;
- Create a process control matrix highlighting risks and related controls;
- Test the operating effectiveness of the critical processes.

Hedge Fund Case Study

New Guidance Summary - Accounting Standards Update (ASU) 2009-12 and AICPA Technical Information Service (TIS) 2220

Summary:

- Investors need to determine and document that the GP has an effective/robust process and related internal controls in place to estimate the fair value.
- NAV needs to be as of the same date as the investors measurement date.
- Investors cannot abdicate the fundamental governance role that they are responsible for estimates in their own financial statements.
- Significant additional disclosure is required (aggregated by major security type) for all interests in alternative investments reported at fair value, even if NAV is not used to estimate fair value.
- The guidance is effective for periods after December 15, 2009.

GP implications for fair value:

- GPs that utilize a more rigorous fair value estimating process, and who report timely, may limit the amount of independent work that the investor finds it necessary to perform.
- Therefore, ASU 2009-12 and the TPA, indirectly, may result in investors being more likely to invest with GPs who report NAV based on rigorous, timely, fair value estimates.
- The guidance provided in the AICPA Technical Guidance clarifies that an investor reporting under ASU 2009-12 cannot blindly accept NAV reported by the Fund without independently evaluating the fair value measurement process utilized by the investee fund manager.

Operations Evaluation – Scope

Understand Current Practices

- Review of the Fund’s corporate documents including:
 - Organizational structure- governance & oversight
 - Policy and procedures (investments, valuation, operations, accounting)
 - Operational risk management framework
 - Compliance manual
 - Service level agreements with providers
 - SAS 70 reports
 - Joint venture agreements, if any
 - Due diligence of Hedge Fund managers questionnaire
- Interview key members of Hedge Fund’s investment, finance, and operation teams. Also, consider interviewing/visiting outsourced providers.
- Complete a customized, diagnostic risk management questionnaire including the control environment; organizational structure; roles & responsibilities; risk identification and assessment; risk response; control activities; information and communication; and, monitoring.

Operations Evaluation – Scope (cont'd)

Document and Evaluate Risks, Processes and Controls

- Evaluate the design effectiveness of the following processes:
 - Investment
 - Trading: execution, exception escalation and resolution
 - Accounting/Reporting
 - Strategy & Research
 - Fund Administration: clearing, settlement, valuation (NAV), fund accounting/reporting
 - Risk management
 - Front and back office functions: valuation, authorization, confirmations, reconciliations
 - Compliance including anti money laundering
 - Information Technology
- Assessment of the roles and responsibilities of the front and back office
- Create a process control matrix highlighting risks and related controls
- Test the operating effectiveness of the critical processes.

Evaluate the organizational governance including committee reporting structure, frequency, topics covered and documentation.

Prepare a report summarizing the issues and suggested solutions