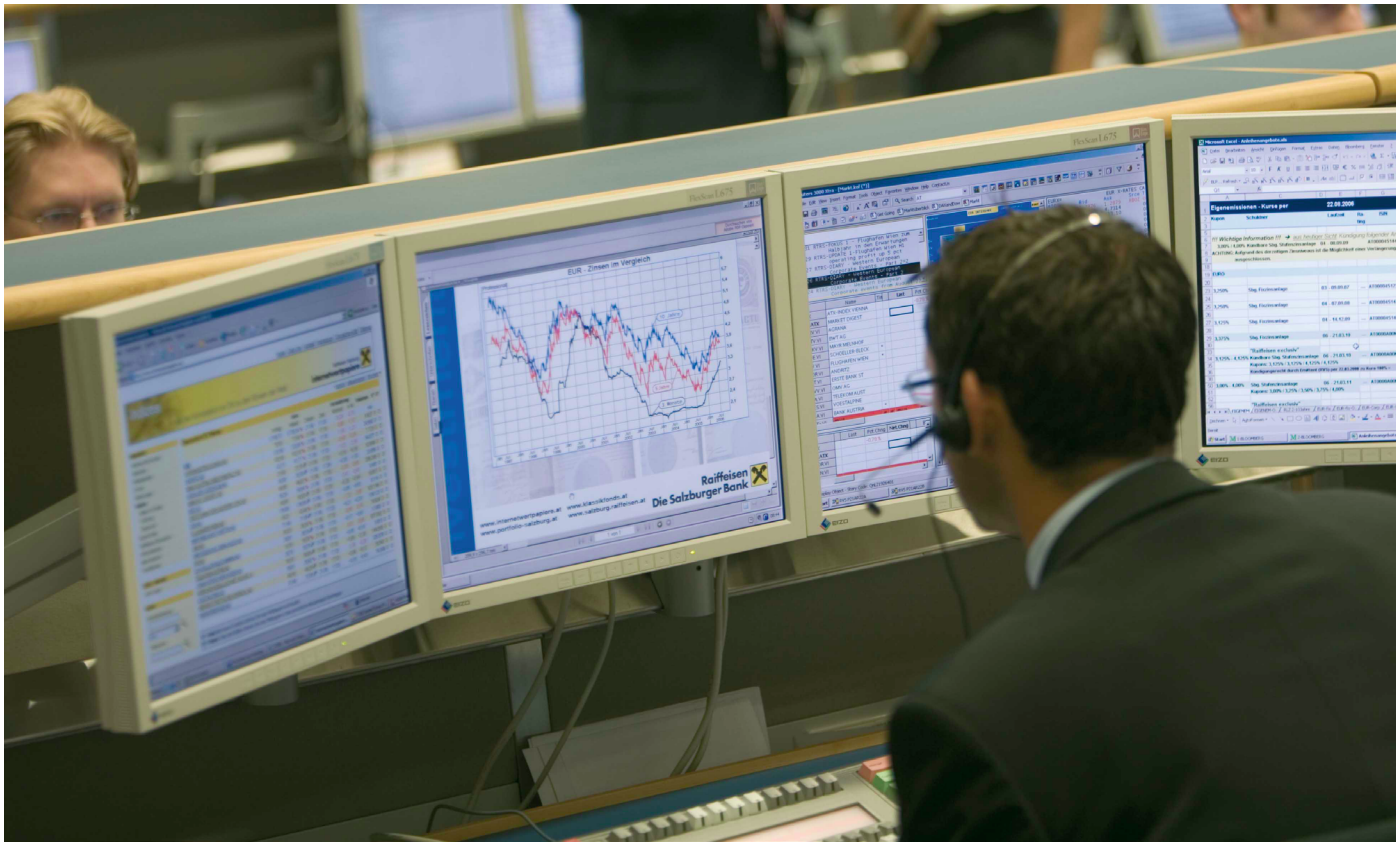

Jason Scharfman on Hedge Fund Operational Due Diligence

Jason Scharfman is the Managing Partner of Corgentum Consulting, LLC. He is recognized as one of the leading experts in the field of operational due diligence and is the author of *Hedge Fund Governance: Evaluating Oversight, Independence, and Conflicts* (Academic Press, 2014), *Private Equity Operational Due Diligence: Tools to Evaluate Liquidity, Valuation and Documentation* (John Wiley & Sons, 2012), and *Hedge Fund Operational Due Diligence: Understanding the Risks* (John Wiley & Sons, 2008). Prior to founding Corgentum, Jason oversaw the operational due diligence function for the $6 billion alternative investment allocation group Graystone Research at Morgan Stanley. He was also a senior member of a team that managed Morgan Stanley's hedge fund operational due diligence efforts, allocating in excess of $13 billion to a firm-wide platform of over 300 hedge fund managers across multiple investment strategies. Prior to joining Morgan Stanley, he held positions at Lazard Asset Management, SPARX Investments and Research, and Thomson Financial.

Jason received a B.S. in Finance with an additional major in Japanese from Carnegie Mellon University, an M.B.A. in finance from Baruch College's Zicklin School of Business, and a J.D. from St. John's School of Law. He is admitted to the practice of law in New York and New Jersey. He has consulted with the U.S. House Judiciary Committee on hedge fund regulation, has provided training to financial regulators, and serves as an adjunct professor at New York University. Jason is a member of several industry organizations including the Information Systems Audit and Control Association (ISACA), the American Bar Association, the New York State Bar Association, and the New Jersey State Bar Association.

AIAR Content Director, Barbara J. Mack, had an opportunity to speak with Jason last winter.

BJM: In addition to managing Corgentum, you have done a lot of writing on the alternative investments industry; how did you take on this dual role as author and consultant?

JS: The area that I have focused on for the bulk of my career and the practice I run now is operational due diligence, and it is a very practical subject, but not one that has historically gotten a lot of academic attention. This pushed me to publish some studies and that led to my first book on hedge fund operational due diligence. From there (after 2008), the area was starting to receive more attention in the industry because investors were losing money and the Madoff scandal happened, along with a whole series of other failures in alternative investments, so these events all strengthened the need to focus on this subject.

BJM: You probably also think about compliance, which has an incredible trend in the job market right now…

JS: Compliance is a very interesting area — many people think it is a rote exercise in the sense that, for a U.S. fund you could ask, "What does the SEC say that I am supposed to do? OK, I'll check the boxes and move on." Yet, within the confluence of operational due diligence and compliance, there is a lot more that can be done when you try to move beyond minimum regulatory standards and towards best practices. That is where the better compliance people are and where the better jobs are.

BJM: If you consider high profile case studies, you could look at the Flash Crash or Knight Capital and see, in the midst of all the rumors that get started, what actually happened once there is time for reflection and analysis of the event itself.

JS: Sure, with something like that, you could have the best tech team in the world, but the situation is two fold — it's not just that the technology can have flaws; it's that the governance, policies, procedures may not be adequate for overseeing the technology. If I have a great system and it's flashing red flags, but only one person is monitoring that and chooses to ignore or excuse them, then it doesn't matter. You have to build in appropriate redundancies and oversights.

In high frequency trading, for example, where we do a lot of due diligence on algorithmic trading funds, latency is a huge issue that will affect results.

They can have the best algorithms in the world, but if they have poor operations, which are fueled by a lack of policies as well as a lack of robust and redundant technology, then that can cause major problems.

BJM: Looking at your career path, you have a BS in Finance, but you also have a degree in Japanese at CMU; what is your view on Japan or Asia now?

JS: I started my career in M&A at Thomson Financial, and I worked extensively in Asia and Japan. Then I moved into the Japanese hedge fund industry. It's very interesting, coming back to due diligence — there is still this culture of insider trading in Japan. There have been reforms, but the problem is, a lot of these reforms are going against the channels of historical business practices, when you look at structures like the keiretsu, the large Japanese conglomerates that grew out of the post-WWII environment. Even though the culture is changing and there is some effort towards more transparency, the large players still turn to what we would call material non-public information that's acted upon and so there is a broad gray area in practice.

Even so, I commend the Japanese government for their work in this area, but it's a very long, slow process. They have started to investigate a few cases where allegations were made, but the fines are often not enough to cause anyone to change their behavior. They have not developed a structure of systematic reforms that would be the equivalent of Dodd-Frank in the U.S. There is a great opportunity, and we see people who are doing hedge fund allocations in Asia, but certainly that is a big risk. It's sort of par for the course; if you are going to invest there, you have to understand how to deal with that risk appropriately.

BJM: There is also the question of having a good team on the ground to really be immersed in the day-to-day environment.

JS: Yes, we hear that a lot — "I want to invest in mainland China or Singapore." And this is a marketing pitch that many Asian managers will use, "Well, we have boots on the ground." We also hear from U.S. managers, "We just want to invest in a U.S. fund of funds, we don't want to invest in Asia — it's too far away."

That being said, it depends on what you are talking about — from the operational due diligence perspective, you go on site with a manager and depending on how frequently you stay in touch with them, much of the follow up can be done remotely through documentation. On the one hand, the boots on the ground is valuable from a research perspective, but on the other hand, it can also be more costly than is necessary.

BJM: In terms of people who have the CAIA designation or are working towards it, would you have any advice or observations looking out over the markets and where alternatives are right now?

JS: The way we gauge it in our business, when people allocate, they are doing due diligence; it could be related to new allocations, or they may be turning existing capital over from one manager to another. We have seen a lot of growth in domestic real estate funds from international pension funds, for example. So that is an indication that they're bullish on the U.S. real estate market. On the private equity side, we tend to see allocations to venture capital and infrastructure. On the hedge fund side, people are revisiting their allocations in many areas. Part of this is a function of demand; we'll see people continuing to allocate to a bigger name and there is also a trend of allocating towards spinoffs, agnostic of strategy. But what we see in some of these cases from an operational perspective is that unless the fund really hits the ground running, the top people might not stick around. We also see some of them stretched a little too thin, because they are focused on fundraising as well as managing the funds — it can be a real distraction. So there are always risks in what we are assessing.

For CAIA Members, it's good to see that there is demand for more well rounded analysts now. When I first started working in the industry, you would hear, "I'm a credit person," or "I'm a venture person." Now it's important to understand the whole business; you have to have a basic grasp of compliance, and also what happens after a hedge fund executes a trade. And that is where the CAIA designation is useful, because it introduces people to a wider gamut of things than they may encounter in their immediate job.

BJM: Well, to wrap up, do you have any hobbies, or have you been on any exotic adventures lately?

JS: Yes, absolutely. I like languages and I love to experience new cultures — when I'm on a business trip, I always try to spend an extra day or two to explore. We do a great deal of work in Europe, Switzerland, Asia, and many other places — there are fund managers all over the world, so I'm on the road quite often.

Corgentum Consulting is a specialist consulting firm which performs operational due diligence reviews and background investigations of fund managers.
The firm works to support the operational due diligence work of institutional and high-net-worth investors, including fund of funds, pensions, endowments, banks and family offices to conduct the industry's most comprehensive operational due diligence reviews. The firm's work covers all strategies globally, including hedge funds, private equity, real estate funds, and traditional funds. Corgentum's sole focus on operational due diligence provides clients with comprehensive industry-leading deep-dive reviews.

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