GLOBAL RISK PROFILE

TRUE DILIGENCE

Ten years after Lehman Brothers' collapse: why due diligence remains essential

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Preface

Lehman Brothers' failure will remain a reminder of some of the dysfunctions in the banking and regulatory apparatus that drove the global economy off a cliff.

Thousands of financial market participants were impacted.

The investment bank's bankruptcy was, in terms of assets, the largest in the history of corporate America. The consequences of the 2008 deals regarding issuance of residential mortgage-backed securities (RMBS) are still visible today. In January 2017, the US Department of Justice fined Deutsche Bank USD 7.2 billion and Credit Suisse USD 5.28 billion regarding RMBS.

Hence, 10 years down the line, why does performing enhanced due diligence remains essential?

This paper seeks to discuss some of the financial regulations entered into force in the USA and EU after Lehman Brother's collapse and its impacts on due diligence processes.

Second, a few arguments will be presented to identify political and economic issues that governments and regulators have yet to address.

Finally, insight will be provided on how and why *due diligence* is one of the answers for mitigating corporations' risks.

1. Financial regulations entered into force between 2008 and 2018

Too big to fail. Four words that became famous in the bankers' daily vocabulary following the aftermath of Lehman Brothers' bankruptcy, which roiled global markets in 2008.

Since then, regulators and governments have been pushing political agendas in an effort to overcome the financial crisis' effects on world economics. Although some of these laws or regulations were already under development before 2007, the financial crisis has largely influenced politicians and regulators on their content.

Three of them will now be discussed to evaluate their (un)expected impacts on due diligence processes.

1.1 Basel-III or the "clash" between technocrats and stakeholders

Basel-III refers to a set of international banking regulations designed by the Bank for International Settlements (BIS). Its purpose is to promote stability in the international financial system, notably by reducing the ability of banks to damage the economy by taking on disproportionate risk.

Basel-III regulations cover important changes for banks' capital structure: the minimum amount of equity – as a percentage of assets – will increase from 2% to 4.5%. By adding a 2.5% "buffer" required by the regulation, it brings the total equity requirement to 7%.
Hence, financial institutions are thereby committed to decrease the size of their balance sheets by holding more capital against their assets (and thus their ability to leverage themselves).

In late 2017, the Basel Committee on Banking Supervision (BCBS) took major reforms into consideration, seeking to restore credibility in the calculation of risk-weighted assets (RWAs).

But most banks use the standardised approach for evaluating credit risk. Following this line, supervisors are the ones who set the risk weights for banks to apply to their exposures and determine RWAs. Therefore, banks do not use their internal models to calculate risk-weighted assets: they mostly refer to credit ratings as well.

Enhanced Due Diligence (EDD)

- Obtaining additional identifying information from a wider variety or more robust sources and using the information to inform the individual customer risk assessment
- Carrying out additional searches (e.g., verifiable adverse media searches) to inform the individual customer risk assessment
- Commissioning an intelligence report on the customer or beneficial owner to understand better the risk that the customer or beneficial owner may be involved in criminal activity
- Verifying the source of funds or wealth involved in the business relationship to be satisfied that they do not constitute the proceeds from crime
- Seeking additional information from the customer about the purpose and intended nature of the business relationship

Simplified Due Diligence (SDD)

- Obtaining less information (e.g., not requiring information on the address or the occupation of the potential client), and/or seeking less robust verification, of the customer's identity and the purpose and intended nature of the business relationship
- Postponing the verification of the customer's identity

The Financial Action Task Force's definitions of Due Diligence (risk-based approach)

In this regard, the BCBS indicated in late 2017 that "banks must perform due diligence to ensure that the external ratings appropriately and conservatively reflect the creditworthiness of

the bank counterparties […] Due diligence analysis must never result in the application of a lower risk weight than that determined by the external rating".

Consequently, a shift of paradigm should be implemented on banks' standardized approach to credit risk (SA-CR) by reducing the reliance on external credit ratings. This would require banks to conduct due diligence when using those external ratings, or to have a sufficiently detailed on-ratings-based approach for jurisdictions that cannot or do not wish to rely on external credit ratings.

On Nov 09, 2010 Stefan Walter, Secretary General of the BCBS already suggested "addressing cliff effects from rating downgrades, reviewing the treatment of securitisations, and strengthening independent due diligence standards".

Bankers vs Basel

However, for some actors directly concerned, the standards are subject to interpretation and therefore need to be clarified. The European Commission launched a public consultation between Mar 16, 2018 and Apr 12, 2018 where several stakeholders took a position.

Hence, the Swedish Bankers' Association stated: "it would be clearer with a materiality threshold (as for CVA), e.g. that due diligence for external ratings is required only for bank/covered bond exposures above XX billion euros".

For the European Savings and Retail Banking Group, "the due diligence process cannot consist of comparing external ratings with a separate internal credit analysis for every single borrower in the form of mapping, for instance. We believe it should be sufficient to check at a higher level […] We would appreciate clarification of this point. For the reasons outlined above, we are opposed to due diligence which assesses individual borrowers in more in-depth detail than the credit risk analysis before granting a loan".

The German Banking Industry Committee also asked for certain clarifications: "We understand the requirement to perform due diligence "on a regular basis (at least annually)" to mean only that the analysis has to be performed at regular intervals, not on an ad-hoc basis".

Finally, the European Associative of Co-Operative banks goes further: "the description of the overall due diligence process is too vague to have a concrete grasp of supervisory expectations. The requirement to perform an additional due diligence process contradicts the fundamental principles of a standardised approach and should not be included in the transposition. Or at least non-complex banks should not be obliged to implement such a process".

The Hanson-Kashyap-Stein view

It's a matter of fact that banks do not like to raise capital. They will proceed only if they are forced to.

In 2011, three economists suggested something that has become "mainstream" in financial economics and could be one of the answers to the misperception of Basel-III requirements between bankers and regulators.

The Hanson-Kashyap-Stein approach may be summarized as follows: banks should be asked to hold enough capital at the peak of their cycle. By doing so, when they suffer losses, they will still have sufficient capital so that the markets do not think they will fail. Thus, the forced assets sales could not turn into a broader asset price decline (and trigger panic).

The authors also pointed out that "perhaps the most glaring weak spot in financial reform thus far – one that cuts across both the Dodd-Frank legislation and the Basel III process – is the failure of fully come to grips with the shadow banking system […] Instead, the task is to mitigate the fire-sales and credit-crunch effects that can arise as a consequence of excessive short-term debt anywhere in the financial system".

1.2 The Dodd-Frank Act and its collateral effect on Conflict Minerals

Better known by its shorter name, the Dodd-Frank Wall Street Reform and Consumer Protection Act is a US regulation signed into law in July 2010. At root, the law was designed to avoid the “too big to fail” phenomenon already experienced by Lehman Brothers.

Portrayed by many observers as the most significant change concerning the US financial regulatory environment since the 1930’s Great Depression, the Dodd-Frank Act addresses the following:

- No company can remain "too big to fail". Taxpayer bailouts of financial institutions must end.
- Wall Street and the federal government must be held accountable
- Consumers must be protected
- Systemic risk must be managed via profit & loss

Major proposals were made while making the law. In the end, the financial markets (especially the ones trading derivatives) were asked to increase their transparency level, in order to strengthen investor and consumer protection. The bill also created new authorities, such as the Federal Deposit Insurance Corporation (FDIC) and the Financial Stability Oversight Council (FSOC), under the umbrella of the Department of Treasury.

According to multiple law firms, the Dodd-Franck Act required the regulators to create over 200 rules. In turn, the regulators used the bill’s content to design hundreds of directives regarding systemic risk regulation, swaps, derivatives, regulation to advisors of hedge funds, and so on.

With this in mind, the Act had a big collateral impact on a specific due diligence topic we will now discuss.

Section 1502 requires publicly traded companies to ensure raw materials they use to make their products are not tied to the conflict in the Democratic Republic of Congo, by tracing and auditing their mineral supply chain.

“Conflict Minerals” refers to raw materials or minerals coming from parts of the world where conflict is occurring and thus affect mining and trading in this industry. These minerals commonly named “3TG”, representing tin, tantalum, tungsten and gold. These raw materials are used by many industries including automotive, medical equipment, aerospace, jewellery, consumer electronics products and more.
In 2012, the US Securities and Exchange Commission (SEC) implemented the “Conflict Minerals Rule”. Therefore, Section 1502 of the Dodd-Franck Act became applicable to all Se-

curities and Exchange Commission issuers, including the foreign issuers, that manufacture or contract to manufacture products where “conflict minerals are necessary to the functionality or production” of the product.
The SEC estimates that about 6’000 issuers are directly affected by Section 1502, while many others are indirectly affected, including non-issuer suppliers.

As such, the compliance costs for listed companies regarding that single matter, are estimated to be between USD 9 and 16 billion by the US National Association of Manufacturers (while the SEC estimates it to be USD 71 million).

For some observers, the insertion of Section 1502 in a bill on financial sector reform was unexpected. The 3TG are “implicitly” modelled after a certification scheme for conflict diamonds, better known as the Kimberley Process.

In the frame of Section 1502, to be complaint, companies should publish a “Conflict Minerals Report” in both its annual report and on their website, in addition to the filing of three different forms with the SEC. Hence, firms need to conduct supply chain due diligence, including third-party verifications comprising the original site of extraction.

This example shows how a single provision of an 848-page bill may affect a wide range of different industries, collaterally binding them to perform due diligence.

As such, the Conflict Minerals Rule was fought before law.

On January 31, 2017 SEC’s acting Chairman Michael S. Piwowar stated that it was a “misguided rule. The disclosure requirements have caused a *de facto* boycott of minerals from portions of Africa, with effects far beyond the Congo-adjacent region.”

He added that “it is also unclear that the rule has in fact resulted in any reduction in the power and control of armed gangs or eased the human suffering of many innocent men, women, and children in the Congo and surrounding areas”.

A few months later, Piwowar implied that the SEC would cease enforcement of the due diligence and audit requirements of the Conflict Minerals Rule, rendering it largely toothless.

1.3 MiFID II and the sharpen notion of conflict of interest

The Markets in Financial Instruments Directive (2004/39/EC) is one of the European Union's (EU) cornerstones of the regulation of financial markets. Its purposes are to improve the financial markets' competitiveness by creating a single market for investment services and ensure a higher degree of protection for investors.

MiFID II is the revised legislative framework of MiFID, rolled out on January 3, 2018. Following the 2007-2008 financial crisis, the new provisions of the law are targeting the use of dark pools, overt-the-counter (OTC) trading and high-frequency trading (HFT).

Furthermore, MiFID II adds restrictions on inducements paid to investment firms by third parties in relation to services provided to clients. Brokers will need to provide enhanced detailed reporting of their trades, banks will no longer charge for research and transactions in a single bundle.

This new approach of transparency implies a drastic shift of paradigm for financial institutions: instead of perpetrating a business model based on remuneration of products sold and transactions carried out, the new model details how remuneration should depend on the service provided. However, the evaluation of quality of the service is largely based on elements that are difficult to quantify, as they are highly subjective.

(Source: The Financial Times)

In order to be MiFID II-compliant, financial institutions should therefore pay attention to the following:

¬ A maximum of 20% of a client's fund could be deposited at a third-party, within its own group

¬ Execution requirements compliance should not be in any conflict with access to research

¬ Keep your records up-to-date, as MiFID II brings more types of communications under its scope (e.g. phone calls) to help maintain transparency, and avoid conflict interest.

Although necessary for investment firms' compliance processes, conflict of interest is something which is not always easy to define. Under regulations such as MiFID or FCA's SYSC 10, firms are already required to deem and manage potential conflicts that arise and which could affect their clients, by implementing a strict policy.

However, MiFID II goes further.

MiFID II set the rules requiring firms to examine their processes in a more detailed manner. Indeed, article to the directive's article 23, financial firms should take into consideration potential situations where they:

- Could beneficiate from a financial gain (or avoid a loss), at the expense of a client
- Could make a benefit if they put the interest of one client over the interest of another client
- Could gain an interest from a service provided to, or transaction carried out on behalf of, a client which may not be in (or which may be different from) the client's interest
- Could get a higher than usual benefit from a third party concerning a service provided to the client

In a due diligence point of view, one of the biggest difference is that until now, firms were asked to assess "material risks", as currently required by MiFID. To date, investment companies have then depended on disclosing those risks and not necessarily dealing with their mitigation, as opposed to managing them or managing he eventual arising conflicts.

Hence, MiFID II will bring about enhanced obligations in this respect.

2. Are regulators and governments addressing all issues ?

On May 28, 2015, while making his first public speech since the collapse of Lehman Brothers, Dick Fuld, former Chairman and CEO, hardly blamed bad regulations and short-sellers funds that believed the bank was vulnerable. The crash, he said, “started with the government. The government pushed for non-qualified home ownership. The government clearly ... wanted everybody to fulfil their view of the American dream.”

Madelyn Antoncic, Chief Risk Office of Lehman Brothers from 2002 to 2007, goes even further: “Lehman lost its way (…) Should Lehman have been saved? Yes, but it should have and could have been saved by itself”. Antoncic is referring here at the discussions between Lehman and the Korea Development Bank to acquire a 50 percent stake in August 2008. But between the lines, it is a clear allusion to the unwillingness of the US government to save the bank, rather than other entities such as Fannie Mae and Freddie Mac.

On the other hand, while it is true that Fuld still held a massive participation into Lehman Brothers common shares during the crash, he had already banked hundreds of millions by then. In 2009, three Harvard Law School academics published a paper estimating the financial operations of Fuld: between 2000 and 2008, he sold shares of Lehman for a global amount of USD 461 million - without cash bonuses. The Lehman’s top-five executives, counting Fuld, pocketed USD 1 billion.

“Lehman lost its way (…) Should Lehman have been saved? Yes, but it should have and could have been saved by itself”

- Madelyn Antoncic, Chief Risk Officer of Lehman Brothers from 2002 to 2007

However, despite those facts, a question should still be asked: are public bodies addressing correctly the 2008 financial crisis issues?

2.1 From the *Agora* to covert meeting rooms

Economics is not a hard science, and mathematical models would not explain why people behave as they do. A much broader perspective is needed, especially as economists were accused of not having anticipated the financial crisis.

Ten years ago, the financial sector's implosion put an abrupt end to two decades of economic stability. At first, the alleged guilty were quickly identified: banker's amorality on one hand, and the irresponsible indebtedness of certain households on the other.

Then, structural factors were questioned: a failing of governance system, an over-reliance on imperfect mathematical models, and insufficient supervision of banks, to name a few.

The issue was that no decision – at least coming from the political establishment – deviated from the "conventional thinking" that prevailed before the crisis.

Furthermore, since the last decades, some policy-making regarding the world's economics disappeared from the national parliaments. Indeed, it is easy to understand that governments prefer to negotiate deals instead of reshape the system.

Consequently, democratic institutions delegated some of their power to independent and technocratic bodies including central banks and particularly transnational organisations such as the FATF, BIS, IMF, WTO and OECD.

In an essay, Daron Acemoglu and James A. Robinson portrayed why politicians neglect economics according to three reasons: "the first is to maintain that politicians are basically interested, or induced to be interested, in promoting social welfare, for example, because socially efficient policy is what helps politicians to stay in power or get re-elected […] the second is to view politics as a random factor, just creating potentially severe but unsystematic grit on the wheels of economic policymaking […] ; the third justification recognizes that political economy matters, but maintains that "good economics is good politics," meaning that good economic policies necessarily relax political constraints".

The opposite is also true: too many economists tend to overthrow politics. In his speech to the American Economist Association, Nobel prize-winner Joseph Stiglitz implored economists to pay attention not just to what is theoretically feasible but also to "what is likely to happen given how the political system works".

In the end, numerous issues and discussions shaping economic decisions left the public political arena in favour of concealed symposiums far from nations' capitals: Davos, Basel and Jackson Hole have now became the post-modern Athens. These forums bring together

central bankers, academics, top executives and other kinds of specialists working for international organizations or public agencies.
These structures are represented by bicephalous elite, strong believers in statistics but vigilant to governments' needs, working hard to establish standards that are hardly negotiated. On the other hand, they keep faith in the assumption of an efficient market, driven by rational agents.

Unfortunately, the recent crisis revealed how the economic system is becoming more complex and opaque, much so that we risk facing a major political crisis rather than another economical crisis.

The truth is that national parliaments must now accept the norms as they stand in order not to risk an ostracisation of their economy: politics have moved from a risk management system to a crisis management system… far from the public agora.

"Economy is, above all, a tool for analysis and research a posteriori *rather than making predictions. Hopefully, economists cannot predict the word's history; otherwise, people would no longer be free".*

- Nicolas Baverez, historian and economist

2.2 Too big to jail?

Lehman Brothers' bankruptcy examiner ultimately concluded that "there is sufficient evidence to support a colourable claim that: (1) certain of Lehman's officers breached their fiduciary duties by exposing Lehman to potential liability for filing materially misleading periodic reports and (2) Ernst & Young, the firm's outside auditor, was professionally negligent in allowing those reports to go unchallenged".

In addition, "the Examiner concludes that colorable claims of breach of fiduciary duty exist against Richard Fuld, Chris O'Meara, Erin Callan, and Ian Lowitt, and that a colorable claim of professional malpractice exists against Ernst & Young".

On one hand, Ernst & Young reached a USD 10 million settlement of accounting fraud together with the New York State Attorney general, Eric T. Schneiderman.

On the other end, none of the individuals listed above – or anyone else – had to answer any criminal nor any civil charges in connection with Lehman Brother's collapse. In the end, the Securities and Exchange Commission took the decision not to pursue any civil charges in that case in 2012, as reported by the *New York Times*.

In an article dated Sep 12, 2013, five years after the beginning of the crisis, the *Washington Post* compiled a list of Wall Street CEOs prosecuted following the financial crash: there were none.

"So, yeah. Zero Wall Street CEOs are in jail. But we did promise you a list:

1. No one.
2. LOL.
3. Wall Street's lawyers are amazing.
4. Etc. Etc."

- The Washington Post, Sep 12, 2013

Why's that?

According to many economists and observers, prosecutors and state attorneys spent years to investigating such cases but, in the end, feared the possible political or economical consequences.

Most of the observers refer to the US congressional report issued on July 11, 2016 titled "Too big to jail", published in the aftermath of the non-prosecution of HSBC for serious violations of US anti-money laundering (AML) and sanctions. As a result, the failure of HSBC's AML policy implementation led to at least USD 881 million in drug trafficking proceeds by the Sinaola Cartel (Mexico) and the Norte della Valle Cartel (Colombia), among other serious consequences.

The US congressional report's authors pointed out that "senior DOJ leadership, including Attorney General Holder, overruled an internal recommendation by DOJ's Asset Forfeiture and Money Laundering Section to prosecute HSBC because of DOJ leadership's concern that prosecuting the bank would have serious adverse consequences on the financial system".

Hence, as reported by Edward J. Kane, a professor of finance at Boston College, known for his strong expertise on regulatory failures, "the fact that so many of these cases are settled rather than going to court means we don't get an airing of facts and challenges of facts". The congressional report should be viewed as "evidence of an abuse of the regulatory system and unless proven otherwise, this is just the tip of the iceberg".

In March 2018, US Senator Elizabeth Warren (D-Mass.) introduced a bill titled "The Ending of Too Big to Jail Act". The bill requires top executives of financial institutions larger than USD 10 billion to certify annually that they have conducted due diligence and found no criminal conduct or civil fraud within their institution.

However, as stated by US press, Senator Warren's motion seems unlikely to pass in the current anti-regulation environment.

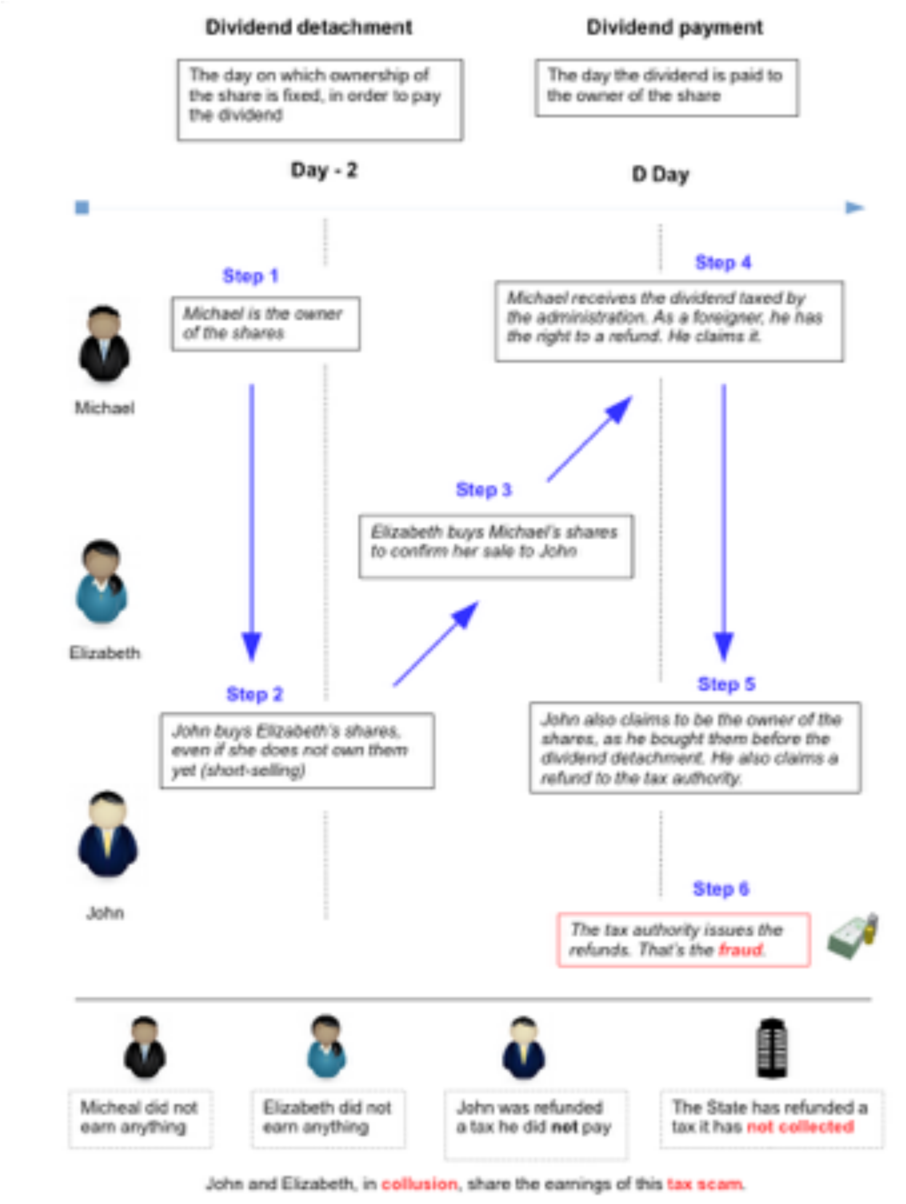
Madelyn Antoncic, former Lehman Brother' Chief Risk Office (2002 to 2007) said in an opinion article that "no living will can solve the "too big to fail" problem for a highly complex global financial institution. We still do not know to address the failure of a large international financial firm with hundreds of entities across the globe. To do so would require harmonizing the bankruptcy legislation of all the world's major financial centers, something the European Union has not be able to achieve in 50 years."

2.3 The necessary establishment of a culture of corporate compliance

Recently, another tax scam operated by some of the EU's top banks has been put under the spotlights: the "cum-ex" investigation has shown a massive fraud estimated at EUR 55.2 billion.

German fiscal authorities and departments of public prosecution are conducting systematic investigations against domestic and foreign banks on suspicion of tax evasion following the use of the so-called cum-ex share trades.

In the course of these investigations, criminal tax proceedings are being commenced and searches are being conducted of the banks concerned.



Foreign banks, which allegedly undertook "cum-ex" trades, were forced to answer written requests for information from the Federal Central Tax Office.

Moreover, Denmark's top lender, [Danske Bank](), allegedly funnelled some EUR 200 billion of "suspicious" Russian money into other jurisdictions via Estonia, the investigation showed.

The worst is that the tax information exchange between EU states could not prevent the multi-billion euro fraud.

New regulations ahead

In the light of this new scam, which occurred about ten years after the 2007 financial crisis, it has become even more important for governments, regulators, the civil society and corporations to establish, jointly, a culture of corporate compliance.

In Europe, some countries such as France, the Netherlands, the UK and Switzerland are pushing the political agenda in favour of the implementation of compliance processes in a broader sense, not limiting them exclusively to the banking industry.

The art. 54 of the UK Modern Slavery Act of 2015 extended the notion of supply chain due diligence "in relation to slavery and human trafficking" for UK companies.

In the upcoming months, Swiss citizens will have to decide if they support the political initiative concerning whether multinationals should be subject to stricter implementation of human rights and environmental risk assessments. This initiative calls for a duty of care obligation for firms headquartered or having their principal office in Switzerland.

In France, the law "Sapin II" entered into force in June 2017. Those concerned are companies with over 500 employees, or which are part of a group with headquarters in France and with an annual gross revenue exceeding EUR 100 million. The law strengthens French anti-corruption regulations and is described by lawyers, consultants and financial advisors as a "game-changer".

The Sapin II's jurisdiction extends outside France and includes the country where the offence has been committed, be it by a French national or a person with an operating commercial activity in France (even partial) or a person residing in France. In addition, the concept of dual criminality has completely disappeared: French prosecutors will gain greater flexibility in pursuing foreign bribery breach. Furthermore, the notion of influence peddling, be it active or passive, is now extended to foreign officials.

Developing a culture of compliance should not be only in the view of regulators or governments. As such, conducting due diligence on clients is a requirement of the ISO 37001:2016. Beyond this example coming from the civil society, compliance should be part of every employee's corporate culture, and not just an activity handled by a few officers within a firm.

Thus, sharing KYC/AML/CFT knowledge through multiple business units is nowadays a must-have for companies, regardless their business activities.

Indeed, as of today, a sales manager within a multinational willing to close a deal in Myanmar with a sub-contractor should not ignore that the country is under sanctions, notably by the European Union.

Similarly, a banker or a lawyer entrusted to conduct a loan for a client who is willing to start a hospitality business in Cuba with local partners should check the last release of the US Restricted Entities and Subentities Associated with Cuba: a significant part of this business is indeed forbidden.

Softwares and IT solutions are available on the market to address such needs. Semi-automated data mining, strategic monitoring or specialized databases listing PEP or sanctions are part of the due diligence analyst' toolbox. Reliable third-party providers help firms to mitigate their risks and share their insights on designated topics.

However, how to spread those insights in a large corporate structure?

- **Raise awareness** about compliance issues within your firm.
  The training of employees through e-learning processes or the coaching of managers is essential to share everyone's experience, challenge that knowledge and develop critical thinking skills.
  When doing so, rely on narrative: a story is worth a thousand words. Ask your personnel to participate to the brainstorming on compliance issue and to tell their own stories.

- **Draft, review or update** your Guidelines, Policies and Code of Conduct.
  As such, defining how to assess risks within your company's supply chain and extend that matter to environmental or human rights issues is becoming a requirement for certain types of industries. ISO 14000 or SA8000:2014 are standards to consider to achieve that goal.

- **Simplify** the diffusion process of information but **repeat your message** in various ways.
  Choose a channel to communicate the right information to the right people and stick to it. Use data, insights, infographics or reports to address your audience, in the simplest way possible. Diversify the tools, keep the same channel.
  Another solution could be to create platforms or *task forces* involving different departments to maintain a higher level of communication between people handling different tasks.

- Take **advice** from **experts**.
  A reliable third-party provider may give you guidance on how to implement a culture of corporate compliance within your company. Due diligence firms are also specialized in transforming challenges into opportunities.

3. Next Steps - Enhanced Due Diligence to mitigate risks

Performing due diligence is one the ways to prevent a firm to conduct misguided business: an enquiry regarding any counterparts or third-party may unveil unknown issues, and thus, risks. Indeed, most of the companies that made it through the crisis had implemented policies, which helped them to overcome its negative effects.

Some of those policies' elements are summarized in the following suggested framework:

Managing credit risk and market risk

Management should have timely, aggregated views of market and credit risk exposure. Tools to aggregate information, report risk exposures, and improve overall transparency should be implemented.

This may include or developing solutions based on robust models to measure market, liquidity, and credit risk. Both tools and models should by linked with governance practices to establish risk appetite, and to monitor, manage, and report risks.

No risk tool or model, however well designed, will produce consistently fully objective results without high-quality data and robust, independently verified price information. Thus, firms should review their data management, evaluation processes, and operational risk exception reporting processes. In some cases, this may require substantial investment to replace legacy infrastructure and/or bring enterprise data management up to industry standards.

Counterparty risk

Brokers should prepare for heightened client attention to internal controls. Funds should ensure they have complete, timely views of aggregate exposure to counterparties and procedures to reduce excess exposures. Diversifying prime brokerage responsibilities among several firms is also prudent, and should be considered as an additional means of reducing counterparty risk.

Hedge funds are gradually seeking to obtain comfort that their custodians and prime brokers have established specific financial and operational controls. Custodians and prime brokers should anticipate increased scrutiny by investment managers, since their investors are demanding increased transparency. The ability to provide judicious assurance regarding internal controls and related processes may present an opportunity to gain a competitive advantage.

Firms should have adequate systems and reports to monitor counterparty exposure. Counterparty exposure reports should account for the most up-to-date exposures across all markets and instrument types (e.g., OTC derivatives, unsecured deposits, and prime brokerage balances) and should also account for all credit enhancements. The overall risk management policy should prescribe counterparty credit exposure limits and mitigating actions if exposures exceed prescribed limits.

Asset verification

Ensure that a firm's internal records agree to third-party safekeeping and custody reports, and that assets and securities positions are being held in accordance with contractual terms.

On a daily basis, perform reconciliations and run appropriate follow-up procedures to resolve identified discrepancies. Timely reconciliations will help to ensure compliance with contractual terms.

Some hedge funds are working with service providers to establish ways to segregate assets or to avoid the transfer of title to assets held as collateral under lending arrangements.

This model may not be accurate for all funds and asset classes, so certain fund clients may want to obtain more robust periodic asset reconciliations from their prime brokers.

Clients may also want to ask for additional assurances about the broker's internal controls over the safekeeping of cash and securities, and about maintaining complete and accurate books and records.

Who are we

Through its state-of-the-art Due Diligence solutions, Global Risk Profile helps its clients to mitigate risks and comply with regulatory standards.

From simple screening to thorough investigations, our reports are effective means to assess risks associated with every type of third party involved in your business model.

Based in Switzerland and mastering over a dozen languages, our core team of experienced analysts performs quality research worldwide.

Our network of local informants (former police or military force members, lawyers, private investigators) enables us to gather information from the target's immediate environment.

The Information you need

Risks may arise at any step of a business process.

We offer exhaustive checks on:

- Suppliers / Subcontractors / Distributors
- M&A and Joint-Ventures
- Existing and potential clients (KYC reports)
- Current staff and potential hires (Background Checks)
- Any other person / corporation of your interest

On demand, we also provide our clients with specific tailor-made services.

Get the Most out of the "Big Data"

Our reports comprise all legally available information on individuals or companies around the world, retrieved from thousands of sources at our disposal:

- Commercial Registers
- Official Gazettes
- PEP Databases
- Sanction & Regulatory Enforcement lists
- Court records
- Media archives
- Proprietary Archives
- Local Search Engines
- Web Analytics
- Monitoring Technologies

More information at: www.globalriskprofile.com