

**Question 1 of 30**

Which of the following is classified as a Level 2 asset?

- A.** an asset that may be valued using observable inputs
- B.** an asset that has values accepted with high degrees of confidence
- C.** an asset that may be valued using models with low degrees of confidence
- D.** an asset that may be valued using simulation models

**EXPLANATION** • Learning Objective 3.5.1

**ID:** L2-3.5.1-003

Level 2 assets may be valued using observable inputs.

Other responses -

- Level 1 assets are highly liquid assets, with prices accepted as values with high degrees of confidence.
  - Level 3 assets are illiquid assets, with values based on models with fairly low degrees of confidence.
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**Question 2 of 30**

Cypress Clan LLC, a family office, has \$7 million invested with Grove Creek Capital, a hedge fund manager. Cypress is preparing for a scheduled quarterly call with Grove Creek. Which of the following topics is most appropriately discussed with the hedge fund's Chief Compliance Officer?

- A.** regulation and litigation activity
- B.** disclosures on key performance drivers
- C.** expected subscriptions and redemptions
- D.** changes to the investment team

**EXPLANATION** • Learning Objective 3.5.5

**ID:** L2-3.5.5-002

The manager's CCO (or General Counsel) is generally the person to answer questions about regulation and litigation activity.

Other responses -

- Questions on subscriptions and redemptions and changes to the investment are typically addressed to the portfolio manager, CFO, or COO.
  - Performance drivers are typically discussed with the portfolio manager.
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### Question 3 of 30

Folgers Foundation is considering an allocation to a hedge fund with a long successful track record. Folgers is concerned that Ben White, the hedge fund's founder, may retire in the coming year. Which of the following should Folgers do to protect its investment against the potential adverse impact of Mr. White's retirement?

- A. Negotiate special redemption rights conditional on Mr. White's departure.
- B. Ensure the hedge fund's portfolio is not poorly concentrated.
- C. Sell a key person insurance policy.
- D. Require Mr. White have less reliance on his analysts for idea generation.

**EXPLANATION** • Learning Objective 3.5.2

ID: L2-3.5.2-008

Ways to mitigate key person risk -

1. Construct an investment process that is less reliant on one individual for intellectual capacity, knowledge, relationships, and decision-making.
1. Purchase key person insurance policy.
2. Use extraordinary redemption rights triggered by the departure of a key person.
3. Continuing new idea generation and diligence processes to develop a set of alternative investment opportunities and an adequately diversified portfolio.

### Question 4 of 30

After examining numerous firm practices, SEC staff identified which of the following issues as needing considerable improvement of management of cybersecurity risk by many firms?

- I. Vague policies and procedures
- II. Out-of-date operating systems
- III. Lack of adequate infrastructure

- A. I, II, and III
- B. I and II only
- C. II only
- D. III only

**EXPLANATION** • Learning Objective 3.5.6

ID: L2-3.5.6-001

SEC staff identified that firms need to improve the following.

1. Untailored (e.g., vague) policies and procedures
2. Lax firm adherence
3. Inadequate system maintenance (e.g., outdated operating systems)

### Question 5 of 30

A hedge fund's Dimensions of Risk report most likely includes which of the following components?

- A. geography, conflicts of interest, transparency, and portfolio's asset allocation
- B. succession plan, ESG issues, use of gates, and types of investments
- C. the fund's strategy, leverage use, valuations, and business operations risk
- D. key person, capacity, back-office staff, and portfolio's long and short position

**EXPLANATION** • Learning Objective 3.5.2

ID: L2-3.5.2-001

12 dimensions in a hedge fund's Dimensions of Risk report –

1. Strategy
2. Liquidity
3. Concentration (e.g., portfolio's long and short position)
4. Geography
5. Leverage
6. Transparency
7. Valuations
8. Key person
9. Business operations
10. Legal, regulatory, and compliance
11. Other risks (e.g., succession plans, capacity, and disclosed conflicts of interest)
12. Emerging (e.g., ESG issues)

Other responses: back-office staff, use of gates, and the asset allocation are typically not included as risk dimensions.

### Question 6 of 30

Which of the following are qualitative categories of information included in a due diligence tracking matrix for alternative investments?

- A. watch list summary and activities log
- B. historical risk measurement and descriptive information
- C. key information and historical performance
- D. activities report and asset allocation

**EXPLANATION** • Learning Objective 3.5.3

**ID:** L2-3.5.3-007

Qualitative risk measurement provides information about business operations, legal, regulatory, and compliance risks. Qualitative categories of information in a due diligence tracking matrix are -

1. Descriptive information
2. Key information
3. Other information
4. Watch or focus list summary
5. Activities log

Other responses: The incorrect responses include categories of quantitative information: historical risk measurement, asset allocation, activities report, and historical performance.

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### Question 7 of 30

Which of the following are factors that result in reduced risk and increased risk, respectively, in relation to hedge fund investments?

- A. higher leverage; less diversification
- B. lower concentration; higher transparency
- C. lower transparency; lower liquidity
- D. higher liquidity; higher concentration

**EXPLANATION** • Learning Objective 3.5.2

**ID:** L2-3.5.2-012

Some risk dimensions for a hedge fund (related to increased/reduced risk) –

- Liquidity –
  - • • More liquid investments (e.g., ETFs) have lower liquidity risk.
  - • • Less liquid investments (e.g., unlisted, private, &/or direct) have higher liquidity risk.
- Concentration – risk decreases as diversification increases (i.e., as concentration decreases).
- Geography – developed economies with strong regulatory systems are generally less risky than emerging economies.
- Leverage – may increase or add default and counterparty risks.
- Transparency – increasing transparency is typically associated with lower risk.
- Valuations – valuation risk generally increases as position liquidity decreases.

### Question 8 of 30

Which of the following are among the best practices in cybersecurity risk management observed by SEC staff in their examinations of investment advisers?

- I. Incident reporting obligations for operators of essential services
- II. Strict schedules and processes for testing data integrity
- III. Enforced controls for access to data and systems
- IV. Maintenance of an inventory of data, information, and vendors

- A. I, II, and III only
- B. II, III, and IV only
- C. I, II, III, and IV
- D. I and IV only

**EXPLANATION** • Learning Objective 3.5.6

ID: L2-3.5.6-009

Policies and procedures (observed by the SEC) that firms may consider for cybersecurity risk management -

- 1. Maintaining an inventory of data, information, and vendors (IV)
- 2. Detailed cybersecurity-related instructions
- 3. Maintaining strict schedules and processes for testing data integrity and vulnerabilities (II)
- 4. Established and enforced controls to access data and systems (III)
- 5. Mandatory employee training
- 6. Engaged senior management

Other response (I): Incident reporting obligations for operators of essential services is one of the objectives of the EU's NIS.

### Question 9 of 30

Which of the following are cybersecurity-related compliance measures prescribed by the Directive on Security of Network and Information Systems (NIS) for members of the European Union?

- I. Training for all employees
- II. Approval by senior management
- III. Incident response plans
- IV. Identification of critical systems

- A. I, II, and IV only
- B. III only
- C. I, III, and IV only
- D. I, II, III and IV

**EXPLANATION** • Learning Objective 3.5.6

**ID:** L2-3.5.6-010

The NIS Directive requires operators of essential services to take measures to detect and manage risks to networks and information systems. Some of the compliance measures that entities should take -

1. Identify critical systems and those with confidential data. (IV)
2. Perform penetration tests and cybersecurity risk assessments.
3. Provide training and awareness initiatives for employees. (I)
4. Have an incident response plan. (III)

Other response (II): Engagement/approval by senior management is a policy that the U.S. SEC staff observed and considered that firms may wish to implement.

### Question 10 of 30

Which of the following geographical areas represents the scope of the Basic Act of Cybersecurity and the Act on the Prohibition of Unauthorized Computer Access?

- A. Asia-Pacific region
- B. United States
- C. Japan
- D. European Union

**EXPLANATION** • Learning Objective 3.5.6

**ID:** L2-3.5.6-008

Regarding cybersecurity, Japan has enacted the Basic Act of Cybersecurity and the Act on the Prohibition of Unauthorized Computer Access (and the Act on the Protection of Personal Information).

### Question 11 of 30

With regard to the management of cybersecurity risk, which of the following functions was implemented by less than half of advisers examined by the SEC's National Exam Program?

- A. penetration tests and vulnerability scans
- B. maintenance of cybersecurity organizational charts
- C. processes for ensuring regular system maintenance
- D. periodic risk assessments of critical systems

**EXPLANATION** • Learning Objective 3.5.6

**ID:** L2-3.5.6-003

According to the SEC's findings on the regularity of four cybersecurity functions among advisers, only one functions was conducted by almost half of the advisers: penetration tests and vulnerability scans. The other three functions were carried out by most advisers.

Other responses: The other three cybersecurity functions: regular system maintenance processes (used by nearly all advisers), and risk assessments of critical systems and cybersecurity organizational charts (conducted by most advisers).

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**Question 12 of 30**

Which of the following fund personnel are expected to participated in an annual investment due diligence update meeting?

- I. Chief investment officer
- II. Chief compliance officer
- III. General counsel
- IV. Portfolio manager

- A. II and IV only
- B. I and IV only
- C. I and II only
- D. I, III, and IV only

**EXPLANATION** • Learning Objective 3.5.5

ID: L2-3.5.5-001

Investment DD update meeting's expected participants are the investment management team: CIO, portfolio manager, and other investment decision-makers or support.

Other responses: These are expected participants at a business operations DD update meeting; COO, CFO Officer, general counsel, and/or CCO.

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**Question 13 of 30**

The majority of risk measurement focuses on which of the following?

- A. deviations from expected results and tracking errors
- B. tracking errors and capital market and related risks
- C. expected results and investment position levels
- D. deviations from expected results and capital market and related risks

**EXPLANATION** • Learning Objective 3.5.2

ID: L2-3.5.2-006

In practice, most risk measurement focuses on -

1. Deviations from expected results.
2. Capital market and related risks.

### Question 14 of 30

Which of the following are typically used to estimate short-term valuations for illiquid securities?

- I. Discounted cash flow models
- II. Customized indices
- III. Simulation models
- IV. Capital balance statements

- A. II and III only
- B. I, II, and IV only
- C. III and IV only
- D. I, II, and III only

**EXPLANATION** • Learning Objective 3.5.1

ID: L2-3.5.1-004

Three ways to approximate short-term values for illiquid securities -

1. Capital statement valuations (used to estimate changes in quarterly valuation estimates)
2. Discounted cash flow model-based calculations (used to approximate valuations during interim periods)
3. Customized index-based calculations (used to approximate valuations frequently)

### Question 15 of 30

An asset allocator calculates and each month reviews several quantitative measures. Which of the following are categories of information that the allocator most likely uses?

- A. fixed-income reports, amount invested, and historical performance
- B. historical risk measurement, managed futures exposures, and asset allocations
- C. asset allocations and capital balances, watch lists, and activities log

**EXPLANATION** • Learning Objective 3.5.3

ID: L2-3.5.3-001

Seven categories of quantitative information -

1. Historical performance
2. Historical risk measurement (e.g., minimum value, standard deviation, downside deviation, skewness, kurtosis, and correlation).
3. Asset allocations and capital balances
4. Gross contribution (manager, sector, strategy, asset class and, if extraordinary, position level)
5. Activity reports (e.g., investment mandate tracking, exception reports, exposure, purchase, sale, and manager turnover; overlapping and offsetting positions, allocations, top positions, cash, cash flow, and illiquid positions)
6. Fixed-income reports (includes e.g., yields, duration, convexity, credit, illiquidity, and gross and net exposure)
7. CTA and managed futures exposures (includes portfolio's diversification level across geographies, markets, models, time frames, and margin-to-equity).

Other responses: Watch lists, activities log, and amount invested are qualitative information.

### Question 16 of 30

Shen Yao, a junior quantitative analyst with a fund of funds, is examining a set of emerging hedge fund managers by studying their return distributions and computing their Sharpe ratios, Sortino ratios, omega statistics, beta and alpha relative to indices, and up and down capture statistics. Which category of quantitative information is Shen Yao analyzing?

- A. asset allocation and capital balances
- B. historical risk measurement
- C. gross contribution
- D. activity reports

**EXPLANATION** • Learning Objective 3.5.3

ID: L2-3.5.3-003

Historical risk measurement is one of the seven categories of quantitative information useful to gather and calculate monthly or quarterly. The risk measurement review measures statistics that describe the positions' and benchmarks' return distributions (e.g., minimum value, standard deviation, skewness); use performance measures such as Sharpe, Sortino, and omega; and use statistics that relate each investment to its benchmarks (e.g., correlation, beta, and up and down capture statistics).

Other response: Activity reports include investment mandate tracking, exception reports, exposure information, purchase, sale, and manager turnover; allocations, top exposures, cash, cash flow, and illiquid and miscellaneous position reports.

### Question 17 of 30

Which of the following are key dimensions of risk reporting for alternative investments?

- A. capacity risk, legal risks, and geography risk
- B. leverage risk, valuation risk, and liquidity risk
- C. concentration risk, commitment risk, and strategy risk
- D. business operations, emerging risks, and hedging risk

**EXPLANATION** • Learning Objective 3.5.2

**ID:** L2-3.5.2-007

Risk reporting is organized around twelve dimensions -

1. Strategy
2. Liquidity
3. Concentration
4. Geography
5. Leverage
6. Transparency
7. Valuations
8. Key person
9. Business operations
10. Legal, regulatory, and compliance
11. Other risks (e.g., idiosyncratic risks associated with the investment or investment manager)
12. Emerging risks

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### Question 18 of 30

How often should asset allocators generally renew third-party background and reference checks on external managers?

- A. Every two years
- B. Every six months
- C. Every three years
- D. Every year

**EXPLANATION** • Learning Objective 3.5.5

**ID:** L2-3.5.5-003

Allocators should renew third-party background and reference checks on external managers every three years from the date of original investment.

Instead of doing this for all managers every three years, some allocators perform the reviews on one third of the external managers every year.

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### Question 19 of 30

Daily risk measurement should be focused on which of the following tasks?

- A. reviewing portfolio construction, regulatory and compliance certifications, and third-party background checks
- B. measuring positions and performance; and updating cumulative position, performance, and risk measures
- C. managing risks across all portfolio levels and augmenting risk data with additional risk measurement and monitoring activities

**EXPLANATION** • Learning Objective 3.5.4

**ID:** L2-3.5.4-001

Daily risk measurement should be focused on measuring and updating position, performance, and risk measures, as appropriate.

- Performance determined for each position is then calculated for each manager, strategy, etc. and aggregated to get performance and valuations for sub-portfolios and the total portfolio. Performance of indices and benchmarks are also obtained for positions and all levels of aggregation.
- Daily tracking of asset weightings compared to strategic and tactical portfolio allocations is helpful.
- Key word alerts (including names and terms of the investments and investment managers) should be monitored on different search engines and/or news services.

Other responses -

- Carried out quarterly: managing risks across all levels of the portfolio and augmenting risk information with additional risk measurement and monitoring activities.
- Carried out annually: reviewing regulatory and compliance certifications, and third-party background checks; and sometimes reviewing portfolio construction.

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### Question 20 of 30

Risk measurement activities that focus on calculating and reporting exposures using position information from daily performance data involved collecting data over which of the following periods?

- A. monthly
- B. annually
- C. weekly
- D. quarterly

**EXPLANATION** • Learning Objective 3.5.4

**ID:** L2-3.5.4-001

Each period of risk measurement uses information compiled and calculated in the shorter time periods. Therefore, risk measurement that calculates and reports exposures using daily performance data involves weekly data collection.

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### Question 21 of 30

An asset allocator is participating in a quarterly call with one of her investment managers. Which of the following best indicates what the focus of the call should be?

- A. information based on legal, regulatory, and compliance issues
- B. information that allocators cannot get from public sources
- C. information on significant changes to stated investment strategies
- D. information that may change significantly in the long term

**EXPLANATION** • Learning Objective 3.5.5

**ID:** L2-3.5.5-004

The manager call should be focused on information that allocators cannot get from public sources.

Other responses -

- The call should also be focused on information that can change significantly in the short term.
- Legal, etc. issues and updates to investment strategies should be discussed in the call; they are just not the focus of the call.

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### Question 22 of 30

How often should institutional investors typically make investment manager calls for risk measurement purposes?

- A. annually
- B. semi-annually
- C. quarterly
- D. monthly

**EXPLANATION** • Learning Objective 3.5.5

**ID:** L2-3.5.5-001

Investment manager calls should be made quarterly.

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### Question 23 of 30

Which of the following are key aspects of risk measurement?

- A. how often data is collected, what risk is collected, and to whom the risk data is reported
- B. why the risk data are collected, when the risk data are collected, and where the risk data is processed
- C. where the risk data are collected from, why the risk data are aggregated, and how the risk data are collected

**EXPLANATION** • Learning Objective 3.5.1

**ID:** L2-3.5.1-002

Five components of risk measurement related to five interrogative terms: where, when, how, what, and who.

1. Investment/position level – from where the risk data are collected.
2. Frequency of data collection – when (i.e., how often) the risk data are collected.
3. Aggregation and systems development – how the risk data are collected.
4. Dimensions of risk – what risk data are collected.
5. Risk reporting – for whom the risk data are collected.

### Question 24 of 30

Which of the following is LEAST likely considered a drawback of separating risk management from portfolio management?

- I. Inappropriate prioritization of risk management decisions
- II. Focused identification of an investment's risks
- III. Vague understanding of an investment's role in the portfolio

- A. II only
- B. II and III only
- C. I only
- D. I and III only

**EXPLANATION** • Learning Objective 3.5.7

ID: L2-3.5.7-002

Potential drawbacks of separating risk management from portfolio management -

- Imprecise understanding of an investment's risks, investment's role in the portfolio, and risk measures in the risk reports.
- Risk management decisions may not be appropriately prioritized when in competition with running the firm.

### Question 25 of 30

Which of the following is not a common model of an unbiased risk management structure separating risk management from portfolio management?

- A. Chief Investment Officer as risk manager
- B. Chief Executive Officer as risk manager
- C. Chief Financial Officer as risk manager
- D. Chief Compliance Officer as risk manager

**EXPLANATION** • Learning Objective 3.5.7

ID: L2-3.5.7-001

The Chief Compliance Officer is not the risk manager.

Three models of separate, dispassionate risk management structures -

1. Chief executive officer (CEO) or President as the risk manager
2. Chief operating officer (COO) or chief financial officer (CFO) as the risk manager
3. Chief investment officer (CIO) as the risk manager

### Question 26 of 30

By which year did European Union member countries have to comply with the Directive on Security of Network and Information Systems?

- A. 2016
- B. 2018
- C. 2020
- D. 2015

**EXPLANATION** • Learning Objective 3.5.6

ID: L2-3.5.6-006

The Directive on Security of Network and Information Systems (NIS) was the first EU legislation on cybersecurity, enacted in August 2016. Countries had until May 2018 to implement it.

### Question 27 of 30

For which of the following reasons would an asset allocator place an investment manager on a watch list?

- A. to ensure no front-running of client trades
- B. to check on scheduled organizational changes
- C. to monitor for poor investment performance

**EXPLANATION** • Learning Objective 3.5.3

ID: L2-3.5.3-005

Managers are put on a watch list when investors want to monitor the managers more closely due to concerns about investment performance or organizational changes that may soon justify investors making redemptions.

### Question 28 of 30

Which of the following are tasks that allocators should perform annually in the risk evaluation of all of their alternative investment managers?

- I. Renewal of compliance certifications
- II. Review of manager investment mandates
- III. Review of portfolio construction
- IV. Background and reference checks

- A. I, II, III, and IV
- B. I, II, and IV only
- C. I, II, and III only
- D. III only

**EXPLANATION** • Learning Objective 3.5.5

**ID:** L2-3.5.5-002

Tasks carried out annually on external investment managers -

- II: Review and potential revision of manager investment mandates and investment advisory agreements.
- III: Review and potential revision of portfolio construction (based on performance, diligence activities, market conditions, etc.)
- I: Renewal of regulatory and compliance certifications.

Other response (IV): Third-party background and reference checks on each external manager should be performed every three years. Some may perform reviews on one third of their external managers each year, but the question asks about "all" managers.

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### Question 29 of 30

As part of a risk measurement program, an asset allocator typically reviews manager turnover reports over which of the following time periods?

- A. weekly
- B. quarterly
- C. monthly
- D. annually

**EXPLANATION** • Learning Objective 3.5.4

**ID:** L2-3.5.4-001

Manager turnover reports are typically reviewed monthly.

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### Question 30 of 30

Asset allocators should collect which of the following data on a monthly basis?

- A. illiquid positions' valuations, position size, and reference updates
- B. benchmark data, audits of illiquid positions, and return data
- C. manager changes, position changes, and regulatory risks
- D. compliance risks, keyword alerts, and business risks

**EXPLANATION** • Learning Objective 3.5.1

**ID:** L2-3.5.1-010

On a monthly basis, manager changes, position changes, and non-investment qualitative risks (e.g., business, legal, regulatory, and compliance risks) should be collected.

Other responses -

- Collected daily: values, returns, position size, volume, index and benchmark data, and keyword alerts.
- Collected quarterly: manager calls and reports, and valuations of illiquid positions.
- Carried out annually: site visits, audits of illiquid positions, and reference updates.

### Answer Key

Question #	Question ID	Correct Response
1	L2-3.5.1-003	A
2	L2-3.5.5-002	A
3	L2-3.5.2-008	A
4	L2-3.5.6-001	B
5	L2-3.5.2-001	C
6	L2-3.5.3-007	A
7	L2-3.5.2-012	D
8	L2-3.5.6-009	B
9	L2-3.5.6-010	C
10	L2-3.5.6-008	C
11	L2-3.5.6-003	A
12	L2-3.5.5-001	B
13	L2-3.5.2-006	D
14	L2-3.5.1-004	B
15	L2-3.5.3-001	B
16	L2-3.5.3-003	B
17	L2-3.5.2-007	B
18	L2-3.5.5-003	C
19	L2-3.5.4-001	B
20	L2-3.5.4-001	C
21	L2-3.5.5-004	B
22	L2-3.5.5-001	C
23	L2-3.5.1-002	A
24	L2-3.5.7-002	A
25	L2-3.5.7-001	D
26	L2-3.5.6-006	B
27	L2-3.5.3-005	C
28	L2-3.5.5-002	C
29	L2-3.5.4-001	C
30	L2-3.5.1-010	C