Graystone Consulting

Wealth Management Investment Resources | September 4, 2019

The Evolution of Operational Due Diligence

Introduction

One essential Warren Buffett quote easily characterizes some investor pitfalls: “Risk comes from not knowing what you are doing.” However, risk doesn’t simply apply to investment risks such as picking the wrong stocks; it also applies to asset managers’ operational and business risks. In alternative investments, Operational Due Diligence (OpDD) is broadly defined as an evaluation of noninvestment risks related to an investment manager, including such areas as business continuity, staffing, service providers, internal policies and procedures and technology. OpDD is a distinct discipline apart from Investment Due Diligence (IDD), which generally focuses on assessing the skill of the fund manager and team. Today, we considered it a best practice to have an independent OpDD review for alternative assets managers including hedge funds, private investments and alternative mutual funds. While IDD focuses on investment risks and potential returns, investors are not compensated for taking additional operational risk—the risk without return. Instead, investors should seek to avoid managers with high operational and business risks, as those who “do not know what they are doing” could lead to unforeseen consequences.

Morgan Stanley Wealth Management (MSWM) has a dedicated OpDD team, which is part of Global Investment Manager Analysis (GIMA). The operational due diligence process and procedures outlined in this paper are representative of the team’s practices during its OpDD reviews of alternative managers.

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This paper is an update of a previously published report.

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Overview

Beyond the gathering and review of key documents relating to the operational infrastructure of the firm and fund, an OpDD review should include an on-site visit at a manager's office with the senior noninvestment staff of the firm including the chief financial officer, chief operating officer, chief compliance officer, head of operations and head of technology. An on-site visit not only allows for an analyst to evaluate the organization but to also establish a deeper understanding of the investment manager's expertise and processes. An in-person meeting provides insight that would otherwise be missed during a review of the firm's/fund's documents and a conference call.

In Exhibit 1, we highlight the general step-by-step OpDD process, covering document gathering, initial due diligence, independent committee approval and ongoing monitoring. Exhibit 2 on page 3 outlines the typical topics covered in an OpDD review. Note that OpDD does not stop after the investment committee's approval of a new fund, but entails ongoing monitoring of a manager that includes on-site updates and additional due diligence should there be changes that could increase operational risk.

An OpDD analyst will often identify potential issues which may prevent the fund getting approved for investment. Often, these operational issues are shared with the manager and there is a willingness to improve their operations to meet a standard that further mitigates risk to investors. Following some high-profile operational failures during the financial crisis, OpDD emerged as an equally important part of the manager due diligence process.

According to a recent Ernst & Young Global Hedge Fund and Investor Survey, more than 80% of investors said operational due diligence can eliminate a manager from consideration regardless of the investment due diligence results. Two-thirds of investors said their operational due diligence team has used its veto power.

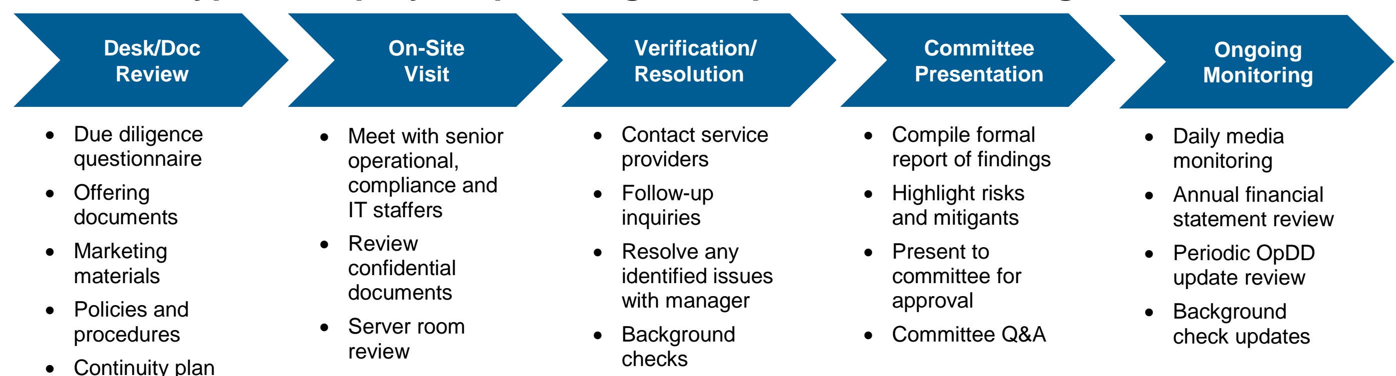
Another essential aspect of the OpDD review is a third-party background check to verify the credentials and integrity of the key investment and operational personnel at a firm. To ensure a thorough and complete background check, the services of a third-party firm that specializes in background investigations should be utilized; however, some allocators find this cost prohibitive and attempt to conduct background checks themselves. The number of subjects reviewed will vary by firm based on size and organizational structure, but generally include the key members of the investment and business teams that have decision-making authority and control of assets such as the ability to move cash. These checks not only include verification of education, employment and professional licenses, but also include criminal history, bankruptcies, regulatory checks, and past or present litigation.

Evolution of OpDD

Operational due diligence started out as transaction-testing in the 1990s and was initially only applied to hedge funds. However, the practice has since significantly expanded as the alternative investment industry has grown in size and complexity. Investment managers that launch firms are often talented investors, but do not necessarily have the expertise to develop and manage a robust business infrastructure that mitigates operational risk. As early as 2003, a study of 100 hedge fund failures in the preceding 20 years conducted by Capco showed that hedge fund failures are more likely the result of operational risk alone (50% of failures) than investment risk alone (38% of failures). Institutional-quality OpDD reviews are typically performed by experienced analysts who not only seek to evaluate business risk but also mitigate areas of concern about an investment manager's operational risk.

Although hedge funds have been subject to OpDD reviews for many years, many standard practices have not yet become part of the operational set-up of other alternative asset managers. In the 1990s, OpDD focused on trade-flow processes. By the mid-2000s, the scope and depth of topics covered had significantly expanded and included compliance, disaster recovery and service providers but the role of the OpDD analyst was usually limited to identifying potential risks. Since the financial crisis, OpDD analysts generally have wielded veto power over an investment decision and

Exhibit 1: Typical Step-by-Step Through an Operational Due Diligence Review



Source: Global Investment Manager Analysis

Please refer to important information, disclosures and qualifications at the end of this material.

Exhibit 2: Typical Topics Covered In an OpDD Review

- Governance of the firm and fund
- Competency, adequacy and depth of staffing; Alignment of interests
- Fund structure including terms and expenses
- Quality of service providers such as counterparties, administrators, auditors and lawyers
- Adequacy of internal controls and processes such as investment approval, trade flow and cash controls
- Independent valuation of investments
- Regulatory oversight and compliance infrastructure such as personal trading, expert networks and conflicts of interest
- Information technology issues such as cybersecurity, disaster recovery and business continuity
- Operational due diligence process of underlying investments for a fund of funds

Source: Global Investment Manager Analysis

importantly, the role of the OpDD analyst has expanded to one that actively tries to help the manager mitigate operational risk. When deficiencies are identified, the OpDD analyst may advise the manager to implement operational enhancements that enable them to further manage operational risk. For example, prior to 2008, large, established hedge funds were typically permitted to self-administer—handling all operational procedures in-house and maintaining all books and records without any independent oversight aside from an annual audit. Since the financial crisis, self-administration is no longer acceptable for any hedge fund managers and addition of a third-party administrator is a basic requirement.

Additionally, new risks and challenges will emerge as the industry changes. Today, OpDD is increasingly being conducted on other alternative asset managers including illiquid private equity, private debt and private real estate funds as well as the more-liquid alternative mutual funds. The industrywide practice of conducting OpDD on these other alternatives managers is still in the early stages and certain operational issues are being routinely identified during the course of initial reviews. This will change over time as OpDD reviews on all alternative asset managers becomes more commonplace, the managers become better educated regarding expectations and best practices are put in place across the industry.

Many investment organizations such as funds of funds maintain OpDD functions in their evaluation of alternative asset managers, but they are not staffed with skilled personnel that are able to conduct a deep evaluation of a firm's infrastructure. Quality OpDD evaluations require the oversight of seasoned professionals that are able to go beyond a "check the box" review and conduct a bespoke analysis that targets the specific risks of the particular manager. The goal of the OpDD programs needs to be one that seeks to be a proponent of change and operational enhancement. A top-notch OpDD program should work with managers to bring their infrastructure in line with sound practices as well as being a leader in the advancement of standard requirements. This is critical because OpDD analysts can often provide feedback to help an asset manager mitigate the operational risk at a firm that is otherwise a skilled investment management organization. The OpDD process needs to be transparent so potential investors can learn about the investment manager's operational capabilities. "Trust but verify" is a key tenet of the OpDD process to ensure managers are properly implementing their practices. In some cases, a lack of attention to a manager's own operational capabilities can speak to the mindset and culture of the firm with respect to how it treats investors.

Common OpDD Issues

As the alternative asset management industry evolves, certain risks and challenges continue to emerge that often need to be addressed. As such, the scope of the OpDD function will continue to expand and evolve. Lately, some areas of concern have been more common and often need to be met with operational enhancements to manage risks. These include valuation, cybersecurity, compliance and in the case of fund-of-funds managers, having a dedicated OpDD function.

The financial crisis also exposed the asset-liability mismatch of many hedge funds, which gave rise to more scrutiny over the valuation of illiquid assets. Leading into the crisis, some funds had invested heavily in nontraded assets and were unable to liquidate them to meet investor redemption requests. This led to fund managers "gating"—that is, limiting investor withdrawals—and gave rise to a surprising number of write-downs in the valuation of many of these illiquid investments. Notwithstanding these issues, investor's appetite for illiquid assets such as private equity and real estate assets has brought about new forms of asset-liability mismatches. Historically, these illiquid or "Level 3" assets were primarily in closed-end funds from which withdrawals were not permitted (see Exhibit 3, page 4). However, new products are being created that invest in these illiquid assets utilizing an open-ended structure with limited liquidity. Beyond the potential asset-liability mismatch risk that needs to be evaluated, rigid valuation practices around these illiquid assets need to be considered.

The nature of illiquid assets means that any valuation is an estimate with an open degree of subjectivity. In an open-end fund structure that allows for regular subscriptions and withdrawals, investors need to receive a fair price when buying or selling at the fund manager's net asset value. As such, the valuation procedures and methodology must adhere to sound practice standards and be verified by a third-party on a regular basis. Open-end funds that invest in illiquid holdings should be required to hire a known third-party agent to opine on valuations of assets on a frequency equal to the subscription and redemption period for the fund.

Exhibit 3: Fair Value Hierarchy

	Level 1 Assets	Level 2 Assets	Level 3 Assets
Liquidity Standard	Liquid	More Liquidity	Illiquid
Valuation Method	Valued at direct market prices, based on active trading of identical instruments	Valued using observable market inputs such as broker quotes	Valued using unobservable inputs such as discounted cash flows, multiples, comparables and appraisals

Source: Financial Accounting Standards Board, Accounting Standards Codification 820–Fair Value Measurements and Disclosures, Global Investment Manager Analysis

Recently, cybersecurity has been the most challenging OpDD issue as news stories regarding viruses and hacking have become commonplace. Proper cybersecurity policies and protocols are needed to protect client data and intellectual property from internal and external threats. According to PricewaterhouseCoopers' 2018 Global Economic Crime Survey, cybercrime is now the second most-reported crime, with 31% of organizations affected and 26% concerned that they will be impacted in the next two years. Insufficient cybersecurity protocols increase the risk of a firm's network being breached, which can result in disruption, financial losses and/or reputational damage. This includes loss of proprietary information such as investment ideas, loss of client data that leads to identity theft, and ransomware and viruses that prevent a firm from conducting normal operations.

Sound industry practices have long mandated certain basic cybersecurity requirements such as multifactor authentication, which provides an extra layer of security to verify a user's identity by requiring more than one credential to access an IT network. Another practice is to use firewalls, which are network security systems designed to prevent unauthorized access. As cyber-criminals have become more sophisticated, such measures are no longer sufficient. A proactive approach to defend against hacking suggests a quarterly vulnerability review of a firm's IT network as well as an annual penetration test. This testing can help the manager identify any weaknesses and address them before a firm's IT infrastructure is breached.

Protecting the firm from internal risks is just as important as protecting it from external threats. A closed-desktop environment is a sound practice standard needed to secure an IT network. This generally entails preventing employees from accessing their office computer's USB ports, third-party email, file sharing sites as well as placing limits on social media. Mobile devices have become an essential part of business and personal life, but their use raises additional data security and cybersecurity risks. Managers need to utilize mobile device management solutions that address these risks enabling firms to segregate and protect company information.

In recent years, compliance has also been a key area of scrutiny for regulators. Certain investment managers such as real estate advisors and venture capital firms are not required to register with the SEC. Often, this results in little to no compliance infrastructure. Although a manager may not be required to be SEC registered, the firm is still required to abide by certain laws and regulations pertaining to the advisement of investor assets.

For this reason, sound industry practice is to have an "SEC-like" compliance environment. The typical solution utilized by non-SEC registered managers is to hire a compliance consultant and implement a formal compliance program which includes, among other requirements, a detailed compliance manual, a designated internal chief compliance officer and oversight of employees' personal investment accounts.

Without a robust set of policies and procedures in place to outline permissible conduct of the firm and/or its employees, there is an increased risk of improper or illegal conduct that can lead to regulatory inquiries, enforcement actions, fines, reputational damage and prison sentences in extreme cases. Proper codes of conduct and internal controls provide protection to an organization by detecting and preventing improper activities and promoting adherence to regulatory, legal and ethical obligations. They set the tone of a firm's culture and shape employee conduct.

Another recent issue relates to the evaluation of certain manager's own OpDD functions. Sound industry practice is for managers to have a dedicated OpDD function to conduct reviews of underlying holdings of multimanager products. The OpDD function for the fund-of-hedge funds industry segment is relatively mature and almost all established managers have a dedicated OpDD function. However, for illiquid funds of funds—which includes primary private equity, primary private credit, co-investments, secondaries and real estate—dedicated OpDD functions are less common. On a positive note, more illiquid funds of funds have been adding OpDD functions. We have increasingly seen investors demanding a dedicated OpDD professional within these illiquid strategies and typically consider it to be a standard due diligence requirement.

OpDD's Continuing Evolution

Skilled investment managers are aware of the risks of their investments, but may be less aware of how their firms' operational and business risks could impact clients. As the investment industry continues to become more complex, the requirements to formulate a robust business infrastructure with proper policies, procedures, oversight and controls will continue to evolve and require enhancements. Since the financial crisis, compliance has been a key focal point with increased regulatory scrutiny of investment manager practices. Although compliance is not expected to become any less important in the near future, the exponential

spread of the internet into every aspect of our lives has made cybersecurity and data protection a critical part of a manager's infrastructure that requires due diligence. The manager also has to conduct appropriate due diligence on vendors that have access to the manager's network and client data. Additionally, as new and more complex products become available, new operational risks will need to be evaluated proactively. Investing with environmental, social and governance (ESG) goals has become an important criteria for many investors. The need for OpDD to inquire about a manager's policies and procedures in ESG-related topics such as sexual harassment, pay inequality and diversity policies has begun to emerge.

OpDD's value added is difficult to quantify and largely becomes apparent only when there are issues. However, as with any risk-mitigation, it's best to have a hands-on, preemptive approach that addresses deficiencies in a manager's operational infrastructure, which provides additional assurance against potential losses from future operational failures.

GIMA seeks to minimize and mitigate business and operational risks of alternative managers that obtain approval on the MSWM platform. The GIMA OpDD team utilizes a proactive approach during the course of its due diligence process to obtain operational enhancements from managers such that they can be substantially compliant with the sound practice standards discussed in this paper. ■

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- Volatility of returns;
- Restrictions on transferring interests in a fund;
- Potential lack of diversification and resulting higher risk due to concentration of trading authority when a single advisor is utilized;
- Absence of information regarding valuations and pricing;
- Complex tax structures and delays in tax reporting;
- Less regulation and higher fees than other investment vehicles; and
- Risks associated with the operations, personnel, and processes of the manager.

In addition, the primary risks of investing in private credit include:

- Illiquidity risk – investments in private lending are typically highly illiquid and may require capital to be committed for an extended period of time, i.e. several years;
- Credit / default risk – non-payment of interest and/or or principal payments;

Interest rate risk – changes in market interest rates are reflected as a change in the spread which loans in a portfolio pay over the base rate (U.S. Treasuries), which in turn impacts the perceived value of the loans in the portfolio and thus the value of the portfolio itself;

- Prepayment risk – loans which are originated with relatively high interest rates may be paid off early if more attractive financing rates can be found;
- Credit rating analysis risk – many borrowers have not issued other debt which has been rated by a recognized rating organization (e.g. Moody's, S&P, Fitch), as such the determination of the credit worthiness of such borrowers is dependent on the analysis performed by a portfolios' managers or advisors.

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