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Operational Due Diligence:

Matching Expectations, Improving Outcomes

NOVEMBER 2012

Operational due diligence ("ODD") is a relatively recent component of the due diligence process for many hedge fund professionals.

It wasn't until 2008 that the industry began to see widespread guidance on the topic, and it has only been in the last three years that a number of investors have formed separate ODD teams. Because the concepts and processes behind ODD are still in their nascent phases, there is still a fair amount of uncertainty around best practice guidelines, causing frustration for both managers and investors alike.

In an effort to begin to establish a better framework for the operational due diligence process, Rothstein Kass gathered five investment managers and eight institutional investors to discuss this important topic. This Operational Due Diligence Working Group met for two days in May 2012, and shared candid remarks and, at times, had heated discussions. The group's goal was twofold:

- Identify the inefficiencies and roadblocks within the ODD process, and
- Create a set of guiding principles designed to improve and streamline the ODD process.

The Importance of Operational Due Diligence

Most investors and managers are aware of the adage, "more funds fail due to operational issues than trading or portfolio management issues." However, we wanted to get to the crux of what investors are looking for in the ODD process.

The Working Group investors indicated that the ODD process has the following objectives:

- Attempt to identify indicators of fraud and minimize potential for fraud
- Assess competency of the operational personnel (specifically the CFO, the CCO, and the COO)
- Assess the tone at the top, the culture of compliance, the internal control environment and the ethics of the firm
- Identify conflicts and risks associated with:
  - Affiliates
  - Multiple products
  - Separately managed accounts
  - Valuation
  - Trade allocations
- Understand compliance policies and procedures

In order to meet these objectives, investors will request and read available documentation, including financial statement footnotes and publicly available information to identify any inconsistencies, gaps or other problems. The key is to be able to verify that there are strong operational processes and procedures in place to safeguard investors' assets.

The investors in the Working Group also stressed that they want to assess, understand and flag issues, but are not generally interested in getting managers to comply with "cookie-cutter" controls and processes.

Operational Due Diligence Working Group Participants

- Howard Altman, Rothstein Kass
- Westley Chapman, CEO & Co-Founder Cole Hill Alternatives
- Michael Gismondi, COO, TPG Axon
- Mendy Haas, CFO, Third Point
- Christian Hildenbrand, COO, Merchant's Gate
- Meredith Jones, Rothstein Kass
- Edward Klees, General Counsel, UVIMCO
- Jeff Kollin, Rothstein Kass
- Lara McKinney, UTIMCO
- Julian Sale, CFO, QVT
- Brian Tsai, COO, Working Group Facilitator
- Representatives from:
  - $8 billion West Coast University Endowment
  - $7 billion East Coast University Endowment
  - $3.8 billion East Coast Fund of Funds
  - $1.85 billion East Coast College Endowment
  - New York-based Corporate Pension Plan

The First Goal: Identify Operational Due Diligence Roadblocks

One of the primary goals of the ODD Working Group's discussion was to identify the problems and inefficiencies around current operational due diligence practices.

Fragmentation of the ODD Process

Working Group members agreed that there is no standardized approach for an operational due diligence review. They also noted that there are competing ODD checklists from the Managed Funds Association, the Alternative Investment Management Association, the Hedge Fund Standards Board, and the Open Protocol Enabling Risk Aggregation (OPERA) Standards. In addition, internal checklists created by many (often larger) institutional investors haven't made the process easier.

There was also some dissatisfaction amongst the investors in the Working Group about how managers treat the disparate Due Diligence Questionnaires (DDQs). More than one investor stated that managers either didn't fill out the investor-specific DDQ, or that managers cut and pasted information from other DDQs. The information pasted in would sometimes adequately address the question asked, but more often would not.

In addition, the investment managers pointed to fragmented expectations amongst investors as a source of frustration. Allocating time and resources toward the ODD process proves difficult when you don't know if you are getting a one-hour, check-the-box investor or a full-day, deeply detailed investor, they said.

Lack of Communication

Working Group participants also identified lack of communication as a critical roadblock in the ODD process. Managers stressed the need for improved communication between the investor's investment teams and dedicated ODD teams, and between investor organizations and outsourced due diligence consultants, if applicable. While some overlap may be intentional, or at least unavoidable, the lack of communication can cause unnecessary repetition, especially if the investor's ODD staff arrives without sufficient knowledge of the strategy or fund.

In addition, investment managers found that information contained in communications with the investment analysis team is not always shared with the ODD team, causing further stress and duplication of efforts.

Lack of Preparation for Meetings

Both the investors and investment managers in the ODD Working Group flagged lack of preparation as a significant irritant in the ODD process. While it was agreed that that there is no excuse for poor preparation by investment and ODD teams, some investors pointed out that there are certain key areas of ODD that might merit attention from more than one perspective, and warrant a full discussion by both groups. Investors also noted that managers may ask informally, "What do you want to know?" instead of guiding a process they have experienced numerous times.

On the other hand, managers found it hard to believe that ODD teams sometimes arrived without an agenda, or without proper preparation for the meeting. This was especially true when ODD teams had too many meetings in a single day. Some of the investors agreed, stating that, in their opinion, two meetings should be the maximum for a single day.

Resource Challenges

Most of the investors in the Working Group stressed that there are many investors with significant resource issues when it comes to ODD, particularly the investors with smaller assets under management (AUMs).

For most investors, the ODD team is the smallest part of the investment or operational management staff. For this reason, ODD does not usually commence until after there is a reasonable sense that the fund will meet with an investment committee's approval, particularly when the ODD team has a veto over potential investments.

The managers felt that investment analyst teams gathered some of the ODD information piecemeal, over initial phases of the due diligence process, only to have the ODD teams come in later and repeat and intensify that process. For the managers, this caused duplication of efforts.

However, the investors felt that some core topics require special attention. Also, in order to maximize the ODD teams' limited resources, the investors stated that it is often advisable to wait until the investment team has completed enough investment diligence to express interest in retaining the manager before involving the ODD team. They noted that the risk of some repetition is, overall, a more efficient approach then subjecting many more managers (and the investors' own ODD teams) to what would result in unnecessary work.

Document Requests

Finally, while most of the managers were willing to provide nearly full disclosure, there was some disagreement when it came to document requests. The managers agreed that they generally do not care to disclose their full compliance manuals, correspondence with the SEC, board of director minutes, International Swaps and Derivatives Association (ISDA) agreements, prime broker agreements, administrator agreements, valuation committee minutes and side letters.

The reasons for this reticence varied. In the case of the compliance manual, they felt that it is a detailed work product that requires a significant time investment, but that it is an internal issue in the running of their business.

For SEC correspondence, the issue of materiality is key. If an allegation turned out to be false, but was disclosed, the impact on a manager's business could be large, while the issue was comparatively small.

Take, for example, an instance where a manager is accused of insider trading. If the manager discloses that allegation to investors, the investors may then choose to redeem from the fund en masse. If the allegation is later proven to be false, then the manager has compromised current and future business based on speculation, not fact. However, if a charge is not disclosed and it turns out to be factual, then the manager is open to additional fraud charges.

Certainly, the issue of materiality was identified by managers as a difficult area to navigate. Managers in the Working Group pointed to public company disclosure as a potentially useful guidepost for what they should disclose to potential investors. For example, investment managers will make investments in public companies knowing only publicly available information. Why should the manager disclose information to a potential fund investor that would, in a public company context, not be available to a potential investor (e.g., the minutes of internal committee meetings, third-party valuation agent reports)?

The Second Goal: Improving the ODD Process

After the Working Group identified some of the key irritants in the ODD process from both the manager and investor perspective, it turned its attention to how the process could be improved, and identified a set of "best practice guidelines" that, if implemented in whole or in part, could significantly improve the process for managers and investors alike.

Gather pre-meeting documentation — Investors generally request a set of documents in advance of the ODD meetings, with many taking one to two weeks to review the documents prior to a meeting with the manager. Both managers and investors agreed that managers could (on request) send potential investors a standardized package of documents typically requested by investors that would best inform them about the manager's operations. This package, sent in advance, would create efficiencies in the ODD process.

Some of the items considered for the standardized list include:

- Due Diligence Questionnaire
- Biographies of the Principals
- Financials for the last three years (if applicable)
- Valuation policies
- Offering Memorandum
- Director minutes
- Compliance manual
- Business Continuity Plan (BCP)
- Functional organizational chart
- Investment Management Agreement
- Articles of Incorporation
- Asset and pricing verification report directly from the fund administrator

Some of these items (e.g., compliance manual and director's minutes) may only be made available during an on-site visit, depending on the manager or firm in question. However, a prepared package of the information above, along with an explanation of the procedures around any missing documentation, would save time during the meeting preparation phase of ODD.

Conduct a pre-meeting call — A pre-meeting call could help establish the amount of on-site time needed for the ODD meeting, as well as the number of meeting participants. If there are specific participants needed for the meeting (e.g., the COO, CFO, CCO, or head of information technology), they should be identified and invited at this time.

Publish a meeting agenda in advance — Setting an agenda for the meeting at this time would be helpful as well.

Coordinate notes and information from investment and ODD teams — This allows for full disclosure of information and cuts down on repetitive questions. In addition, it's an opportunity for the investor's investment team to identify any areas of the fund or firm that may need special attention from the ODD team.

Leverage available information — Investors and managers should leverage information already available to them, including, but not limited to:

- Existing due diligence questionnaire (investors can add a supplement for specifics they feel are not addressed by a pre-formatted questionnaire)
- Public documentation, such as Form ADV and Form 13F
- Form PF, if available

Prepare materials — Investment managers should compose standard answers to commonly asked questions about issues that don't change a great deal, including:

- Entities
- Vendors/service providers, such as auditors, fund administrators, prime brokers
- Systems, lifecycle of a trade
- Fees, shares, liquidity, terms
- Leverage
- References
- Risks
- Compliance
- Valuation
- Biographies of key personnel

Ask the right questions of the right person — Different people have different roles and expertise within a firm, and a COO, CCO and CFO are not interchangeable. Making sure that questions are directed to the appropriate people will ensure that the most complete and accurate information is gathered. If the "right person" is not in the meeting, consider following up separately rather than asking whomever is in the room.

Be mindful of the time, stay on topic, and consider having a facilitator for the meeting — Investor relations staff may be able to keep the meeting running smoothly, ensure that the right people are available and manage time once the meeting is in session.

Investors should consider including investment analyst staff in ODD meetings — This would both improve communication between the disparate due diligence groups and create additional efficiencies.

Initiate and implement "ODD Days" — ODD Days give a manager the opportunity to prepare documentation and hold ODD meetings for large groups of investors all at once. This is generally accepted to be most useful for smaller investors with fewer resources. One manager in the Working Group estimated that the ODD Days last year cut down on annual ODD visits by as much as 50 percent. Although large investors are somewhat likely to participate in these group investor meetings, they could still require a separate meeting as a result of their procedural requirements.

Provide monthly asset and pricing verification reports directly from the administrators — If these are sent along with monthly statements, it could give investors an additional degree of comfort. Some investors stated they would be willing to have the fund pay a reasonable expense for this information.

Proactive communication from managers directly to the ODD team — Managers should not assume that the ODD team reads their investor letters looking for nuggets of ODD information. These are generally reviewed by the investment analyst teams, and pertinent information often is not shared with the ODD team.

Provide and ask for feedback – Investors should give positive feedback to the portfolio manager, when it is warranted, at the conclusion of an ODD session. Investors should also ask for feedback (e.g., "What do we do that other people don't?") as a way of gathering information to improve their internal processes. Likewise, managers should ask what other managers are providing to investors so they can see if there is a significant disconnect.

Recognize that the concept of materiality is not black and white — Ask for information that is material and relevant, but recognize that the concept of materiality may be different for the manager, and may vary from manager to manager. If the disclosure of a particular issue or piece of information would not be actionable for the investor, think twice about requesting it.

Recognize that non-disclosure may create a "worst case scenario" reaction — Some of the investors in the Working Group indicated that they would pencil in a "worst-case scenario" answer for any questions that were left unanswered by the manager. They also may put the manager on an ODD "watch list" and notify the investment team.

Conclusion

Certainly, the field of operational due diligence is continuing to evolve. The issues and guidelines raised above reveal a process that is still experiencing growing pains on both the investment manager and investor sides. The ODD Working Group's discussion, however, and the discussions that will follow in the coming months, are not expected to generate a sweeping solution or an ODD panacea. Instead, we hope these recommendations for general principles will help investors and managers improve their ODD processes incrementally while encouraging continued dialogue.

If you would like to participate in a future Rothstein Kass facilitated working group, or if you have thoughts or comments you would like to share, please contact Meredith Jones at mjones@rkco.com.

About Rothstein Kass

Rothstein Kass is a premier professional services firm that has served privately held and publicly traded companies, as well as high-net-worth individuals and families, for over 50 years. Beyond audit and tax services, the firm provides a full array of integrated advisory services, including strategic business counseling, management consulting, regulatory compliance and risk management consulting, due diligence and family office services.

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