Hedge funds, once the secret club of the super-rich, are now a mainstream asset class. Whether held through employee pension funds, accessed directly through traditional private partnerships, or increasingly offered through liquid alternative mutual funds, virtually every investor has access to hedge funds, private equity funds, and other alternative strategies.

As the alternative asset industry has grown and matured, the discipline of operational due diligence (ODD) has become more prominent. Alternative asset investors no longer make decisions based on investment performance alone. Allocators are focused equally on the risk of operational failure—be it through honest error or, in the worst case, through dishonesty and fraud. Investors also recognize that weak business infrastructure creates an unavoidable drag on performance. An asset manager with weak controls will not have the data, technology, and operational efficiency to ensure optimal implementation of the investment strategy. For hedge funds in particular, operational effectiveness is paramount, given the high trading volumes and complex instruments included in many hedge fund portfolios.

Against this background, ODD, often an optional luxury before 2008, has become a mandatory component of alternative asset investing. Beyond the now-obvious need to steer clear of another Madoff, ODD is especially influenced by two factors. Firstly, alternative investments are impacted by a new regulatory environment: In the United States, for example, all but the smallest hedge fund and private equity managers no longer can avoid Securities and Exchange Commission (SEC) registration. Secondly, the institutionalization of the hedge fund and private equity (PE) industry has had a pervasive impact on ODD. Hedge funds and PE managers are no longer different, and institutional investors, often subject to fiduciary obligations, cannot accept lower operational standards simply because they are allocating to an alternative manager. As a result, it is becoming a baseline assumption that an alternative asset manager will match the operating standards and mitigate business risks in the same way as established, long-only money managers. ODD is the tool deployed by investors to ensure that alternative investment managers meet these evolving and more demanding requirements.

**ODD and Regulation**

A recent Deutsche Bank survey noted that new and changing regulatory requirements are already influencing ODD reviews, with a full two-thirds of those surveyed ranking a fund’s compliance and regulatory framework as a top focus area.¹

On the surface, the reasons are clear: In Europe, the implementation of the Alternative Investment Fund Management Directive, among other regulations, has added a range of new obligations and reporting requirements on hedge fund and private equity managers.

In the United States, private fund managers with regulatory assets under management in excess of $150 million now are required to both register and file regular reporting to the Securities and Exchange Commission (SEC). Alternative asset managers are also impacted by changes to rules established by the Commodities Futures Trading Commission and new laws such as the Foreign Account Tax Compliance Act.

The SEC’s focus, however, has done the most to change the landscape of ODD. In the wake of Dodd-Frank, the agency has increased significantly its focus on the alternative asset industry. The SEC has, moreover, strongly emphasized operational issues when stating its priorities for inspection and enforcement for alternative managers.

The SEC’s National Examination Program has, firstly, made the conduct of operational due diligence a specific part of its 2014 examination priorities. The SEC has, for the first time, revealed its expectations in terms of the ODD process for funds of funds and other advisors who allocate their clients’ capital to underlying pooled hedge and private equity funds.²

The SEC also has been active in the private equity space. In early 2013, Bruce Karpatic, then chief of the asset management unit of the SEC’s enforcement division, spoke of the agency’s shifting focus on certain operational practices and in many cases common conflicts inherent among private equity and other fund managers.³

Among the things he noted the agency was paying more attention to: overvaluation of...
assets, particularly during the PE fundraising stage; shifting of expenses from the management company to the funds; and conflicts inherent from managing different clients, investors, and products under the same umbrella.

The results already are being felt. In a speech to the Private Fund Compliance Forum in New York in 2014, the SEC Office of Compliance Inspections and Examinations Director Drew Bowden was reported as saying that U.S. regulators found illegal collections of fees and allocation of expenses or severe compliance shortfalls in more than half of the 400 private equity firms it had examined since 2012—“material weaknesses” or “violations of law,” in his words. As a result, ODD focus on private equity funds is expected to sharply increase, and the PE industry will face new scrutiny regarding its expense allocation practices in particular.

Institutionalization of Hedge Funds
Alongside increased regulatory oversight, ODD has been influenced by the institutionalization of the alternative asset industry. Inflows of capital into hedge funds and private equity funds increasingly are driven by sovereign, public, and corporate pension funds, banks, insurance companies, and other institutions. This changing investor base has led to a corresponding increase in the sophistication of operational oversight over alternative investment managers.

In a 2012 report compiled with KPMG titled, “The Evolution of an Industry,” the Alternative Investment Management Association found that includes in institutional investment have led to more thorough due diligence and greater demands by investors for transparency. The survey found, for example, that 90 percent of respondents reported an increased demand for due diligence since 2008. Equally, 84 percent of respondents indicated they had increased transparency to investors over the same time period.

The report also found that hedge fund management firms almost universally had increased investment in regulatory compliance since 2008, with 98 percent of firms hiring additional staff in this area. And the amount of time managers say they spend handling due diligence inquiries from investors has doubled since 2008.

Enhancing the ODD Process
In the context of more regulation and a more sophisticated, institutional ODD agenda, investors continue to seek guidance as to implementation of a best practice operational due diligence program. Investors can consider a number of areas when enhancing their ODD programs.

Establish a Due Diligence Policy
Managers and investors are familiar with compliance manuals, valuation policies, and disaster recovery plans, but the ODD policy as an additional governance document is a relatively new concept. However, a policy document should be the foundation of the ODD process, outlining clear procedures for initial operational diligence on new allocations and, thereafter, policies for the conduct of ongoing diligence on invested positions. The ODD policy likely will outline a risk-based approach, recognizing the different operational risk profiles of different types of investments (regulated mutual funds, long-only managed accounts, hedge funds, private equity vehicles, etc.), and also take account of investment materiality. With a clear roadmap, the investing organization will be able to identify resource needs, meet compliance obligations, and execute a well-designed ODD program.

Establish ODD Responsibility as Part of Governance, Risk, and Compliance
One of the key elements of the due diligence policy is to establish which functional area within an organization has responsibility for ODD.

As ODD has gained importance and adoption, it has become firmly entrenched in the governance, risk, and compliance (GRC) agenda. Placing ODD in the protective, risk-mitigating framework of GRC highlights, in particular, the need for segregation of duties between front- and back-office diligence. Given the evident conflict between market and business risk—what happens when a hedge fund has attractive returns but weak operational controls—ODD should not be performed by investment teams that are compensated for portfolio performance. The same conflict also impedes the ability of external investment consultants, who are equally focused on investment returns, to conduct effective operational diligence. ODD should instead be performed by risk specialists and report directly to GRC functional areas such as compliance, internal audit, and risk management.

Identify ODD Risk Areas
ODD seeks to identify, manage, and mitigate non-market risk. In the world of alternative investments, this focuses on three primary categories:

- the business risk of the management company (the entity responsible for investment decision making);
- the legal risk of the fund entity (the product owned by the investor); and
- the operational risk of the control environment (the controls and procedures in place to prevent fraud and ensure that investment transactions are accurately recorded).

Specific areas that should be included in each operational diligence review include the following:

Security over the existence of assets.
Diligence should identify and verify custodians, prime brokers, and derivative counterparties. Additional procedures are required for noncustodied assets such as private equity holdings and direct loans.

Controls over cash movements.
Investors should require asset managers to implement robust controls around transfers of client money held in funds and other client accounts. A single professional within the asset manager should not, for example, be able to disburse fund assets on his or her sole signature; rather, client money controls should require dual signatories and a segregated prepare/approve/release procedure.
Controls around asset valuation.
Diligence should evaluate the fund’s valuation policy, the role of the valuation committee, and procedures adopted to ensure accurate valuation adopted by the investment manager, the fund administrator, and third-party valuation agents, if any. Extensive diligence attention should be given to illiquid, hard-to-value securities. The risk of deliberate misvaluation is clearly far greater with respect to assets that lack an active trading market and have no transparent, independent pricing sources.

Controls around trade capture and accounting. Internal to the manager organization, each asset manager should implement appropriate controls around trade execution, confirmation, settlement, and reconciliation. To the extent that mid- or back-office functions have been outsourced, investors should gain a thorough understanding of the responsibilities of external vendors and evaluate their resources, systems, and overall effectiveness.

Service providers. Alternative asset funds may use external fund administrators, valuation agents, information technology providers, and compliance consultants. Appointments should be verified, and the function and capability of each vendor evaluated. Issues such as legal and contractual liability should be considered. A recent trend, for example, is for fund administrators to seek to limit their liability even in the event of a loss to investors caused by their gross negligence.

Governance. The role of external fund directors should be examined using the “6 Cs” of governance—director and board competence, capacity, composition, choice, compensation, and control. Recent changes in the Cayman Islands have, for example, focused more attention on the role of external directors. This has resulted in positive trends for more-frequent board meetings and a general acceptance that professional corporate directors should provide transparency as to the number of board positions they hold.

Compliance procedures. Given the new compliance paradigm faced by alternative asset managers, investors expect to see hedge and private equity managers appoint an experienced chief compliance officer (CCO), maintain robust compliance documentation, conduct frequent compliance training, and create an overall culture of compliance across the firm. The CCO often will be supported by a compliance consultant able to assist the asset manager with documentation, training, and services such as mock regulatory inspections.

Develop an Effective Reporting Process
Even if the ODD process is effective in terms of gathering information and conducting diligence interviews with managers and service providers, findings and action points arising from the ODD process also must be documented. A consistent weakness of many ODD programs is poor documentation, with investors often struggling to keep reports up to date, or preparing only brief ODD documentation in the form of annotated questionnaires. Effective reporting should, firstly, be consistent across all funds in a portfolio; thereafter, it should provide an overall assessment, highlight strengths and weaknesses, and identify action points and follow ups. Quality reporting evidences the investor’s diligence process (vital if the investor is itself subject to regulatory oversight) and supports ODD as an ongoing process of engagement and monitoring with each invested manager.

Develop an Effective Ongoing Monitoring Process
ODD is not only a process conducted before investment. Post-investment diligence will, over the lifetime of an investment, require significantly more resources than the initial review at the date of original allocation. Certain ongoing monitoring procedures likely will be annual, starting with annual updates to each diligence report and detailed review of annual fund financial statements. Intra year, many investors schedule diligence updates with invested managers, focused on issues such as changes in assets under management and product range, staff turnover, and any regulatory or other legal events. Investors typically monitor changes in counterparty composition and valuation profile intra year, with administrator transparency reports being an excellent tool to support monthly and quarterly oversight over these metrics. Investors also should complete real-time monitoring to identify regulatory, news media (and increasingly social media) commentary with respect to their asset managers.

The Way Forward: Embracing Operational Alpha
Operational due diligence is a challenging discipline. ODD requires significant resources, working within a well-defined process and methodology. In addition, investors increasingly will need to make investments in new technology solutions to streamline data-gathering and enable systematic identification and monitoring of operational risks.

Looking forward, investor ODD programs will continue to be driven by two motivations. Firstly, many investors that are increasing allocations to alternative assets, such as corporate and public pension funds, operate within stringent fiduciary standards and are exposed to significant regulatory, business, and political risk. For this class of investor, the reputational and governance impact of investing in a hedge or private equity fund that suffers a loss due to operational failure likely will far exceed the impact of a loss solely due to investment underperformance.

More positively, as we have already discussed, investors recognize that operational quality will support investment outperformance, a concept that has been referred to as “operational alpha.” Other things being equal, it is reasonable to assume that, of two equivalently skilled investment professionals, the one supported by the more robust operational infrastructure will, over time, generate higher performance. This is the central value add of operational diligence, and it illustrates why more and more investors aspire toward top-tier ODD.

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