Introduction to Analysis of Fund Operations Through Operational Due Diligence

The fund management business is one of partnership between asset management firms and investors. Up until this point in the book, we have focused primarily on the best practices that fund managers can implement in order to establish and maintain their operational infrastructures. In the early days of the alternative asset industry, fund investors didn’t pay much attention to fund operations and, instead, the focus was on investment performance. Over time as fund operations became more complex and the risks associated with operational failures grew, both fund managers and investors began to devote more time to this subject. Historically, the pace of fund manager development of more sophisticated operations has outpaced investor interest and concerns in this area. Today this gap has been significantly narrowed and alternative investment investors are heavily focused on analyzing and monitoring fund operations during the pre-investment and post-investment due diligence through a distinct operational due diligence (“ODD”) process.

Increasingly, a trend in recent years has been that alternative investment fund managers are devoting more resources toward not just developing and maintaining complex operational infrastructures, but also to explaining those operational procedures to investors. In Chap. 10, we provided an overview of stand-alone operational due diligence questionnaires that fund managers are increasingly producing to showcase their operational strengths and more
directly address investor ODD inquiries. In much the same way that alternative investment fund managers have embraced performing mock compliance audits to prepare for regulatory inquiries, they are increasingly focusing on mock operational due diligence audits to prepare for investor ODD inquiries. Oftentimes these mock ODD audits are performed by in-house personnel, but some alternative investment managers do engage third-party specialist consulting firms to perform these reviews as well.

A key reason for this increased focus on ODD preparedness is that the stakes are often quite high for managers during operational due diligence reviews. Generally, by the time the full ODD process begins, investors have already conducted substantial investment due diligence and the ODD review is the final step. This means that if the fund managers can successfully navigate the investor ODD process, they will most likely receive an investment from the manager. In addition to the investor due diligence efforts to date, the fund manager has likely expended a great deal of effort helping the investor to build up a level of conviction so that they will undertake the ODD process.

To be clear, we used the term “full” ODD process because oftentimes much like they do on the investment side, investors will have a number of operational screening questions for fund managers. If they cannot answer these questions satisfactorily, then the investor would consider these managers effectively un-investable because of an ODD failure. An example of such a screening question would be an institutional investor asking all potential hedge fund managers they are considering for investment if they utilize a third-party administrator? If the answer is no, this would be considered to be a deal-killer issue and the institutional investor would not need to proceed with the rest of the ODD process. When a fund manager does not receive an allocation because of operational issues, it is a disappointing defeat, a bit like tripping right before the finish line at a race.

Therefore, it is in the fund managers’ best interest to ensure not only that they have best practice operations in place but that they are prepared to communicate their operational strengths and mitigate any operational weaknesses during the investor ODD review. It is consequently essential in the modern alternative investment environment for fund managers to maintain a detailed understanding of the ODD process. To facilitate this understanding, we will provide an overview of this process in the remainder of the chapter.
Who Performs Operational Due Diligence?

Different investors approach the ODD process with different resources. Some larger institutional investors maintain stand-alone operational due diligence groups. Other ODD approaches use a combination of in-house and third-party resources to provide ODD oversight. In these cases, specialty consulting firms are utilized that perform ODD reviews on behalf of investors. At other smaller investment organizations, individuals with responsibility for investment functions may also perform the ODD reviews. This is not ideal as it is considered best practice to have a dedicated ODD resource focused solely on ODD. Part of the reason for the preference for this dedicated model is because of the importance placed on the independence of the ODD function.

In many cases, the power of the operational due diligence review is reinforced by the presence of a veto function. By exercising a veto, the ODD function effectively stops an allocation to a fund manager because of operational concerns. At this point, this can be the end of the due diligence process and the manager will not receive an investment. Alternatively, a fund manager could decide to take corrective action to repair the deficiencies noted during the ODD review process. After these actions have been taken, the investor could then reevaluate and monitor the operational improvements. If satisfied that the remedial actions taken were satisfactory, then the investor could decide to make an investment with the manager at that point.

The Pre-Operational Due Diligence Processes

Pre-Due Diligence Step 1: Analysis of Other Due Diligence

The first step in the pre-due diligence process is for the individual(s) performing ODD to engage in a discussion with investment personnel to determine if there are any operational concerns as a result of the investment due diligence process. In many cases, some other forms of pre-investment due diligence may have already been performed such as legal due diligence. At this stage, it is usually very helpful toward steering the focus of the operational due diligence process if there is useful guidance that was garnered during these other due diligence processes that can be shared.
Pre-Due Diligence Step 2: Developing a Review Timeline

The second stage of the pre-due diligence process involves working with the fund manager to develop an estimated ODD review deadline. This allows the investor to manage their subscription pipeline. Additionally, this timeline allows the ODD review personnel to manage their review schedule so that we can prioritize managers in the ODD review pipeline as necessary.

Pre-Due Diligence Step 3: Constructing a Review Team

The final stage of the pre-due diligence process involves construction of a team to manage the completion of each fund manager review. Many investors leverage off the functional expertise of our different internal divisions and third-party consultants in different areas such as legal and compliance, accounting and operations, and information technology. It is considered best practice to have a dedicated team of at least two people responsible for managing the overall progression of each review.

Alternative Investment Fund Manager Operational Due Diligence Process

After the pre-due diligence process is complete, the investor operational due diligence review process begins. The investor review process consists of four stages as outlined in Fig. 12.1.

Fig. 12.1 Four-Stage Operational Due Diligence Review Process
Step 1: Document Collection and Analysis

The investor operational due diligence document collection and review process typically begins with the investor requesting a list of documents from a fund manager. These documents often cover a wide variety of operational topics, ranging from previously prepared manager marketing materials and core fund legal documentation to audited financial statements and operations process manuals. While each manager may not possess all of these documents, this initial document list serves as the starting point from which further documents may be requested once the review is underway. Additionally, it should be noted that several of the requested documents may be combined into a single document with a different name. Specifically, the initial documents requested from each fund manager will typically include the following:

For each fund under review:

1. Offering memoranda
2. Subscription documents
3. Articles of association (if applicable)
4. Limited partnership agreement (if applicable)
5. Audited financials since inception
6. Samples of recent marketing materials (pitchbook, etc.)
7. Investor letters (i.e. monthly or quarterly) for the past two years
8. Performance track record
9. Position holdings
10. Biographies of all key personnel

For the fund management company:

11. Compliance manual
12. Personal trading procedures (if not included in compliance manual)
13. Anti-money-laundering policies and procedures (if not included in compliance manual)
14. Electronic communication policy (if not included in compliance manual)
15. Organizational chart
16. Business continuity and disaster recovery plan
17. Valuation policy and procedures
18. Certificate of incorporation and/or certificate of good standing
19. Details of insurance coverage (including copies of insurance certificates)
20. Copies of all International Swaps and Derivatives Association (ISDAs)
21. Copies of all service-level agreements in place with service providers (i.e. administration agreement, vendor contracts, prime brokerage agreements etc.)

If the fund manager is SEC registered:

22. Form ADV Part 1
23. Form ADV Part 2
24. Schedule F
25. Form PF

Affiliated Fund Document Requests

It should be noted that as part of the ODD document collection process, it is considered best practice to request documents not only for any particular fund vehicle that may be under review but for all affiliated funds managed by the fund manager. A common example would be for funds organized under a master-feeder structure. If, for example, an investor was considering an investment in a fund manager’s onshore vehicle, a best practice for the ODD process would typically review the legal documents and audited financial statements associated with both the offshore vehicle and master vehicle for the manager. This is done to present a more complete picture of any operational risks associated with the entire set of funds. In certain cases, risks associated with one fund (i.e. the offshore vehicle) can materially affect another affiliated vehicle (i.e. the onshore fund). Therefore, it is prudent to review all funds in a set as opposed to just focusing solely on a particular fund.

Asking the Fund Manager to Complete a Questionnaire

As part of their document request process, some investors will ask a fund manager to complete a proprietary questionnaire. It is more common practice today for an investor to start the ODD process by not typically initially request that fund manager complete a due diligence questionnaire because here are several potential problems with asking manager to complete such questionnaires as part of an operational due diligence review. Firstly, most managers already have some sort of due diligence questionnaire already
created. When they are asked to complete a separate questionnaire, this creates unnecessary work for the manager and lengthens the due diligence process. Secondly, it is important for ODD analysts to be conscious of the fund manager’s time and to try and not create unnecessary work for them, while still maintaining process integrity. Instead, it is preferred to perform all analysis from the ground up using existing manager documentation instead of asking the manager to complete a separate due diligence questionnaire. This results in a more authentic and detailed oriented operational due diligence review. After this fundamental bottom-up analysis has begun, specific follow-up questions can be submitted to the manager as required.

**Service Provider Documentation**

As part of the ODD document collection process, it is considered best practice to also collect and review documentation from fund service providers such as administrators and prime brokers during the operational due diligence process. These documents typically include the following:

- Copies of SSAE 16 (formerly known as SAS 70) or similar audit reports
- Marketing materials or due diligence questionnaire
- Copies of engagement letters and fund-level contracts
- Biographies of key personnel servicing the fund’s account

**Document Analysis**

After the appropriate documents have been identified and collected, the next step is to perform a detailed review of each of these documents. This document review is the first stage in our analysis process and is the start of the process to:

- Assess the independence of net asset value (NAV) calculation
- Review of operations and infrastructure
- Review of regulatory and compliance

Specifically, it is considered best practice for the document analysis process, for each fund manager is a three-stage process as described below.
Stage 1: Functional Expert Review

The first stage in the ODD document review process is rooted in having individuals with core functional expertise review documents in their respective disciplines. As such, the documents for a fund manager would be divided among the team of ODD professionals, according to their functional expertise. These initial detailed reviews of the documents of each manager utilize the different ODD methodologies for each document type.

It should be noted that even though an investor may conduct separate legal due diligence, it is still considered best practice for the ODD process to undergo its own review of the legal documentation including the offering memoranda for each fund. By reviewing these documents in the context of the broader operational due diligence review, it allows the ODD analysts to be better equipped to analyze a fund manager’s operational risks. Additionally, during legal and compliance review stage, the ODD team can take the opportunity to verify and independently review the fund manager’s regulatory registrations.

The following is an example of a methodologies that could be utilized to review audited financial statements:

- *Audit opinion dates*—Analysis of the dates of audit opinions on a year-over-year basis to determine if audits are being produced early or late and if any lags have developed over time
- *Signing office of the auditor*—Analysis of the signing office of the auditor to determine if the auditor’s location is appropriate for the fund as well as to detail any changes in audit coverage
- *Review of key sections*—Analysis to ensure both their inclusion, as appropriate, and consistency with both the fund manager’s strategy and the best practice. Common section reviewed include the following:
  - Statement of assets and liabilities (aka balance sheet)
  - Statement of operations
  - Statement of changes
  - Statement of cash flows
  - Income statement
  - Schedule of investments
- *Review of notes*—Detailed review of financial statement notes including the following:
Ownership of affiliated funds
Fair value considerations
Tax disclosures
Related party transactions
Derivative contract disclosures
Fund commitments and contingencies
Subsequent year-end events

- FAS 157 levels—Analysis of assets and liabilities line item entries and total for Levels 1, 2 and 3 for each audit year and trends among years
- Expense reviews—Recalculation and analysis of expenses is performed. This is done utilizing fund expense and asset information from key financial statement components to classify expenses to independently calculate and verify fund expense ratios.
- Fee checks—Recalculation of fees (i.e. management fee, performance fee, administration fee etc.) to check accurateness and reasonableness

After each functional expert has completed, their reviews of any additional requests for documents would then be submitted to the fund manager by ODD personnel. The reason for these additional requests often comes about because a document that was initially collected might reference another document that the fund manager may not have initially provided.

Stage 2: Project Lead Review

After all the additional documents have been collected and reviewed by functional experts, the documents are then reviewed separately by, at a minimum, both members of the fund review team consisting of the project lead and supporting lead. The two-person team conducts completely separate reviews of every document collected. By conducting a second reviewing of all documents collected, this analysis affords the ODD process a more holistic view of any latent operational risks that may be apparent from the fund manager’s documents. Additionally, this additional level of review serves as a crucial element of the document review process, which compliments functional expert reviews, bringing another pair of eyes and a fresh perspective to each document.
Stage 3: 360° Team Review

The final stage of the document review process is for the functional experts and the fund manager review team to review their findings and conclusions together. This process has several benefits. Firstly, it allows for collaboration and discussion among the functional experts (i.e. the attorney who reviewed the legal documents and the accounting expert who reviewed the audited financials). Additionally, it allows the review team to gauge the functional expert’s opinions regarding any firm-wide operational risk areas.

The result of this 360° team review is a finalized detailed agenda, which will be used to facilitate the on-site meeting with the fund manager. Putting in this significant work beforehand allows the ODD team to conduct a thorough and efficient on-site interview process by asking targeted questions that get to the heart of operational risks present at each fund.

Step 2: On-Site Meeting

As part of the operational due diligence process, it is considered best practice to conduct an on-site visit or with each fund manager. For a number of reasons including the costs involved with traveling for on-site visits and social distancing efforts as a result of events such as the Covid-19 Coronavirus, investors may opt to perform a remote operational due diligence review by utilizing video conferencing software; however, this is not preferred. The ODD on-site visit process consists of four main phases:

- Phase 1: Interviews
- Phase 2: On-site document review
- Phase 3: System and process walkthroughs
- Phase 4: Office tour

Each of these phases is outlined in more detailed below.

Phase 1: Interviews

During the on-site meeting, it is considered best practice for the ODD analysts to meet with the key individuals responsible for the overseeing and carrying out operational functions within the firm. When determining which individuals to meet with, the ODD analysts must consider both an
individual’s job title and their actual operational duties. This is particularly important for smaller firms, which only employ a few individuals who may have broad roles. At many alternative investment managers, individuals may wear multiple hats and be involved in both investment and operational activities. As such, an ODD analyst should not exclude certain individuals from the on-site interview process solely because of their involvement in nonoperational (i.e. investment) -related activities. The titles of the individuals ODD analysts typically meet with include the following:

- Chief operating officer
- Chief financial officer
- Chief compliance officer
- General counsel
- Chief technology officer

It should also be noted that it is considered best practice for the ODD analysts to attempt to “drop-down” a level. In addition to interviewing senior operations management, this process involves interviewing individuals who are often actually performing the bulk of daily operational work. For example, in addition to meeting with a chief financial officer, the ODD analysts would request to meet with a controller and fund accountant. These additional on-site interviews often provide valuable insight into the actual nuts and bolts of a firm’s operational activities.

After a list of individuals with which the ODD analyst would like to meet with has been determined, the ODD analysts would then communicate to each fund manager the topics they anticipate covering during the meeting as well as a listing of the individuals they would like to meet with. This is a collaborative process and one in which the ODD analysts should actively engage with the manager in order to appropriately manage expectations. When such communication is not clear, certain managers may either be unprepared for the types and scope of questions to be asked or, alternatively, we find that some managers may attempt to hijack the on-site meeting process by making certain individuals unavailable or by not having certain documents or systems available for review. These actions may make the on-site visit less productive, and ODD analysts should avoid these issues by clearly communicating meeting expectations to the manager.

During the interview process, the purpose of these interviews is to:

- Determine a clear understanding of operational policies and segregation of duties
• Evaluate the implementation of operational practices
• Verify the description of any operational process described in the fund manager’s documents
• Diagnose operational challenges and evaluate how the fund manager has attempted to deal with them
• Determine any future operational changes or improvements which the manager may face

In particular, during on-site interviews, ODD analysts should discuss the NAV calculation process with the manager as applicable. This should include a review of third-party pricing feeds as well as any internal valuation memorandum produced. The ODD analysts should then utilize this information to verify the fund NAV calculation and verification process with service providers such as the fund administrator as applicable.

**Phase 2: On-Site Document Review**

For a variety of reasons including confidentiality concerns, fund managers may not want to share certain documentation outside the office. It is considered best practice for ODD analysts to negotiate with managers to collect the so-called *compromise documentation* prior to the on-site visit such as a table of contents for a compliance manual. Example of the other types of documents which a fund manager may not want to send to ODD analysts in advance may include ISDAs, regulatory communications, copies of committee meeting minutes and signatory sheets for items such as cash transfers. It is considered best practice to take the time to review full versions of these documents on-site and not overlook this important step in the operational due diligence process.

**Phase 3: System and process walkthroughs**

During the interview process, it is considered best practice for the ODD analysts to perform operational testing in order to verify operational systems and procedures. As appropriate, the ODD analysts should ask the manager to provide documentation or evidence of the implementation of certain policies and procedures.

As an example, certain documents that the fund manager may be asked to produce are outlined in the following Table 12.1.
After conducting on-site interviews, it is considered best practice for ODD analysts to leave the conference room to conduct further procedure and systems tests. These tests typically include sitting at the desks of different employees and shadowing them for a period of time as they utilize different systems and perform common operational tasks. These system demonstrations allow the ODD analysts to obtain a detailed understanding of actual system usage practices as well as determine if any redundant or manual processes are in place that poses any operational risks. Specifically, the systems typically reviewed include those for the following functions:

- Portfolio management, trading and order management
- Fund accounting
- Compliance
- Risk management

### Phase 4: Office Tour

The final part of the ODD on-site visit process is to take a tour of any areas not covered during the other part of the on-site visit. This allows us to have a complete understanding of the firm’s physical office space and make determinations including the following:

- If any appropriate physical barriers are in place to ensure segregation of duties and prevent inappropriate information sharing among groups
- Determine scalability of the firm’s space

During the office tour, ODD analysts should also review the firm’s information technology hardware on-site. This is typically stored in a server closet

Table 12.1 Documents that the Fund Manager may be Asked to Produce during an Operational Due Diligence On-Site Visit

| Procedure being tested                        | Document requested                                      |
|-----------------------------------------------|---------------------------------------------------------|
| NAV calculation independence                  | Third-party pricing feeds, administrator                |
|                                               | reconciliations and internal valuation memos            |
| Compliance controls and employee personal trading | Results of any compliance testing procedures and        |
| Cash transfer controls                        | executed preapproval clearance form                    |
| Trading controls                              | Executed wire transfer form with appropriate            |
|                                               | signatories                                             |
|                                               | Copy of trade confirmations from counterparties         |
or similar room. Viewing the firm’s on-site hardware allows the ODD analysts to assess the appropriateness and scalability of information technology infrastructure. Additionally, during this process the ODD analysts can observe whether any security or backup protocols are in place for technology including the following:

- Secure access to servers
- Cameras monitoring server room entrance
- Presence of redundant power supplies are in place
- Fire protection capabilities (i.e. sprinklers) etc.

**Step 3: Service Provider Confirmation and Review**

As part of the operational due diligence process, the ODD analysts should conduct a detailed review of each fund’s service providers. Common service providers typically reviewed include administrators, prime brokers, custodians, auditors, legal counsel and compliance consultants. Specifically, the fund’s service provider review process will follow three stages as outlined in Fig. 12.2.

A key goal of the service provider review process should be asset verification and ensuring independence in NAV calculations for the funds. The service provider review process begins with the ODD analysts independently attempting to verify the relationship between the funds and its service providers. The results of this verification process should be documented in the written operational due diligence report. As noted above, the next stage in the process is to collect and review documentation from the service provider. After the service provider document collection and review process is complete, the ODD analysts will then commonly conduct interviews with key service providers such as administrators and prime brokers. These service provider interviews should be conducted independent of the manager, to prevent the manager exerting any biases on the opinions expressed by the service provider.

![Fig. 12.2 Three-Stage Service Provider Review Process](image-url)
Additionally, it should be noted that it is considered best practice to take measures to speak with individuals at the service provider who work directly on the manager’s account (as opposed to general salespeople from the service provider). This is particularly important for fund administrators where the ODD analysts should take measures to interview both the fund accounting and shareholder service employees that are directly involved in servicing the fund’s account. These direct conversations often provide valuable insight into the actual operational processes being followed and can further highlight any operational deficiencies.

**Step 4: Report Generation and Recommendations**

The result of the investor operational due diligence process is typically a written report that details the operational strengths and weaknesses of each manager. This internal report can take different forms from a narrative memorandum to a more structured report. It is a relatively recent trend that many investor ODD reports also employ quantitative ratings scales. These ratings seek to assign quality assessment scores across each operational category such as compliance, information technology and NAV calculation independence as well as an overall operational quality scores to each fund manager.

**Ongoing Operational Due Diligence**

Once initially operational due diligence is complete, it is considered best practice for ongoing ODD to be performed. The frequency of the ongoing ODD can vary based upon a number of factors including the results of the initial ODD process, any new operational risk factors that may have emerged since the time of the completion of the initial ODD review, and the level of interaction between investment personnel and the fund manager. At a minimum, it is considered best practice that all ODD process be updated on at least an annual basis; however, as noted above, more frequent updates may be required.

The ODD update process includes revalidating the original operational risk findings and reanalyzing the firm across each operational risk area. Additionally, the update process typically includes a new on-site visit with the manager at least annually as well as an analysis of fund documentation including any newly released audited financial statements or offering memorandum supplements. Additionally, it is considered best practice to reconfirm existing service provider relationships and review any new relationships.
Future Operational Trends

As the complexity of fund operations increases across many different areas including compliance management and information technology operations, it is highly likely that the sophistication of investor operational due diligence approaches will similarly increase. Furthermore, as operations become more complex, there is a trend to further specialize the approaches taken toward managing these operational risks. These specialized approaches increasingly rely not only on the use of in-house operations personnel but also on increasingly technical third-party consultants. This is especially true in the areas of compliance and information security. Additionally, based on a continued industry-wide focus on data privacy, there will likely be continued efforts in-house both at alternative investment managers and at their service providers, on data security going forward.

Chapter Summary

This chapter provided an overview of the process by which investors analyze fund operations through the operational due diligence process and future alternative investment manager operation trends. At the beginning of this chapter, we discussed the importance of the operational due diligence process for alternative investment fund managers in securing investor capital. We then discussed which individuals and groups typically perform operational due diligence. Next, we proceeded to discuss the operational due diligence process including document collection and analysis, on-site manager meetings, service provider confirmation and review, and, finally, report generation and recommendations. Finally, we discussed future operation trends including the continued increasing complexity of fund operations and a likely focus on data privacy and security among both fund managers and their service providers.