

The AIMA logo consists of the letters 'AIMA' in a white, sans-serif font, centered within a dark blue square. A horizontal red bar is positioned directly below the square.

AIMA

TRUST BUT VERIFY

Operational Due Diligence from an allocators view point
Australia Investor Advisory Group

ABOUT AIMA:

www.aima.org/about.html

The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,000 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than \$2 trillion in hedge fund and private credit assets.

AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry.

AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 100 members that manage \$400 billion of private credit assets globally.

AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors).

IMPORTANT NOTE:

While every care has been taken in preparing the Information, except as required by law, no representation or warranty, express or implied, is made in relation to the accuracy or completeness of the information provided in this document. The Information is not intended for distribution or use in any jurisdiction where it would be contrary to applicable laws, regulations or directives and does not constitute a recommendation, offer, solicitation or invitation to invest. The Information may contain projections, forecasts, targeted returns, illustrative returns, estimates, objectives, beliefs and similar information ("Forward Looking Information"). Forward Looking Information is provided for illustrative purposes only and is not intended to serve, and must not be relied upon as a guarantee, an assurance, a prediction or a definitive statement of fact or probability. Actual events and circumstances are difficult or impossible to predict and will differ from assumptions. Past performance is not a reliable indicator of future performance. While every care has been taken in preparing the Information, except as required by law, no representation or warranty, express or implied, is made in relation to the accuracy or completeness of the information provided in this document. Photographic images used are for illustrative purposes only and may not represent actual images of assets or opportunities described in the Information. This Information, unless otherwise specified, is current at the date of publication and will not be updated or otherwise revised to reflect information that subsequently becomes available, or circumstances existing or changes occurring after that date. The information contained in this document represents the personal opinions of the respondents and must not be construed as the opinions of the firms they represent. By accepting this Information, you agree to be bound by these limitations, terms and conditions.



AIMA MEMBERSHIP

AIMA's Global Reach



Did you know that AIMA members are entitled to a host of benefits?

Committees and Working Groups

Working with peers to shape the industry and share expertise

Industry-Standard DDQs

Streamlines manager and service provider selection

Events and Networking Opportunities

Connect and network with peers at over 275 events held globally

Access to Experts

One-to-one contact with AIMA to discuss regulatory queries

Sound Practice Guides

Used to assist implementation of sound policies and processes in an increasingly complex operating environment

Government and Regulatory Affairs

Benefit from AIMA's advocacy work on a global scale

Research and Investor Guides

Shaping the industry narrative to promote a better understanding of the alternative investment sector

Communications

Keep up-to-date on AIMA's recent activity, industry news and regulatory change

AIMA Journal

Share your thought leadership with the global industry via our quarterly publication

To learn more about the benefits of AIMA membership, please visit www.aima.org

AIMA

Dear Member,

Of AIMA's many achievements since its launch more than 29 years ago, one of the key ones was the introduction of a standardised Manager Due Diligence Questionnaire (DDQ) for investors. This was introduced in 1997 and through its various incarnations still remains the industry standard. Both Investment Due Diligence (IDD) and Operational Due Diligence (ODD) are the cornerstones of an allocator's investment process, and ultimately an allocation. However, since the GFC, ODD has really come to the fore; in fact, many allocators give complete right of veto over an allocation to their ODD teams, even if the IDD case stacks up.

AIMA Australia's Investor Advisory Group (IAG) members are fully aligned to the critical role and importance that ODD plays in all investment allocations, along with the crucial role of ongoing reviews. The purpose of the IAG is to provide guidance on best practice for the local industry, and offer insights into product development, gleaned from exposure to international firms and trends. ODD falls clearly into these objectives and the IAG flagged its importance by putting together a "virtual roundtable", where allocators and some world class consultants have combined to share their thoughts on ODD.

Called, "trust but verify"*², the virtual roundtable provides a wide-ranging examination into ODD's importance in allocation decisions, who is responsible for it, along with looking at the use of external consultants. "Trust but verify" also looks at what happens after the initial ODD process, monitoring managers from an ODD perspective, the use of fintech and various ODD models. On a practical note, "trust but verify" examines the core "red flags" to investors and their ODD priorities; it also looks to the future and asks "how do you think ODD reviews and analysis will evolve over the next 5 years?".

Whilst this paper was specifically designed by the Australian IAG, it follows AIMA's ongoing commitment to deliver DDQ's, Sound Practice Guides and Industry Guides. AIMA's extensive library of these can be found at www.aima.org for members.

Like the previous papers from the IAG, we expect the discussion from "trust but verify" will be thought provoking and, with feedback from you the membership, will provide some key topics that we can look to delve into in more detail in the future, including further thought pieces, roundtables, forums, or general discussion topics.

We would like single out and thank the members of the Investor Advisory Group, who contributed to the virtual round table; Grant Harslett (Maritime Super), Bobby Pometkov (CSC), Martin McCabe (Telstra Super), Alex Wise (Castle Hall), Angela Brown (Willis Towers Watson), and thanks to the other members of the Investor Advisory Group for their ongoing involvement and support.

We hope you enjoy the latest IAG virtual round table and as usual all feedback is welcome.

Michael Gallagher,
General Manager,
AIMA Australia

Alistair Rew,
AMP Capital & Chair,
AIMA Australia

CONTRIBUTORS



Alex Wise

Head of Australia & NZ,
Castle Hall

Alex leads the Australian efforts for Castle Hall, a global due diligence specialist firm. After commencing his career at Herbert Smith in the UK, Alex moved into finance with the Atlas Capital Group in London in 2002, as Head of Legal and later developing the firm's DD Strategy and Framework. Prior to Castle Hall, Alex headed the Multi-Manager and RE business at OneVue, including spearheading sale of the RE to Equity Trustees in 2018. Alex's career has also included roles as COO of Select Asset Management (acquired by OneVue) and five years as a consultant focussing on Operational DD and hedge funds in the Asia-Pacific region. Alex qualified as a lawyer in the UK and is a member of AIMA Australia's Executive Committee.



Angela Brown

Senior Investment Consultant,
Willis Towers Watson

Angela Brown joined Willis Towers Watson in January 2014 as an Investment Consultant with responsibility for conducting operational due diligence on fund managers. Prior to Willis Towers Watson, Angela was an Operational Due Diligence Analyst at Kenmar Olympia Group based in London. From October 2008 to May 2011, Angela worked for Matrix Group initially as an Analyst before becoming a member of the Operational Due Diligence team. Prior to that, Angela was an Operations Analyst at Grenfell PAI Ltd. having joined the industry in October 2002 as an Administrator for Matrix Registrars Limited. Angela is a Chartered Alternative Investment Analyst.

CONTRIBUTORS



Bobby Pometkov

Senior Investment Manager,
Commonwealth Superannuation Corporation

Bobby Pometkov is a Senior Investment Manager at Commonwealth Superannuation Corporation (CSC). CSC is managing a number of retirement schemes for the Australian Government employees and members of the Australian Defence Force. CSC assets under management at present are approximately AUD 37 billion. Bobby is responsible for the absolute returns strategies of the firm and has been with with CSC since 2005. Prior to that he worked for Charlemagne Capital (IOM) Limited - Hebrus Bank Jsc in the position of Manager of Product Management Department from 2002 until 2004. He holds a Masters Degree in International Management from Maastricht University and a Masters Degree in Economics from UNSS Bobby also holds Grad Diplomas in Finance and Psychology from ANU.



Grant Harslett

General Manager Investments & Finance,
Maritime Super

Grant has been General Manager Investments & Finance of Maritime Super since 2004. He has over 40 years experience in the Australian superannuation industry, having worked in a range of management and consulting roles covering actuarial, investments and finance areas. Grant is a member of the AIST working group on operational due diligence of investment managers.



Martin McCabe

Senior Operations Due Diligence Analyst,
Telstra Super

Martin is an experienced Risk and Compliance professional having extensive experience covering operations throughout front middle and back office investment environments. Martin has led Telstra Super's ODD efforts for the past two years including setting up an ODD framework and implementing an ODD policy. Martin is responsible for the reviews of both prospective and existing investment managers. Prior to joining Telstra Super Martin was Risk and Compliance analyst at the in-house investment arm at REST and a Business Risk and Control Manager for HSBC Fund Services UK.

IMPORTANCE; DARE WE ASK?



How important is ODD to your organisation and why?



Alex Wise

At Castle Hall operational due diligence is integral to our firm's DNA. The firm was founded in 2007 with a focus solely on ODD, whilst we have added other areas of diligence such as Risk or ESG, ODD remains intrinsic to our client service offering.



Angela Brown

At Willis Towers Watson we recognise the importance of a robust operational infrastructure and how it can influence returns, as well as the long-term viability of investment managers. Consequently, ODD forms an integral part of our delegated client offering. Our ODD program focuses on identifying material unmitigated operational risk, including business and fraud risk. Our aim is to help improve industry standards and to protect investors since they are not compensated for taking operational risk.



Bobby Pometkov

Investment returns compensate for Investment risk taken by Superannuation funds and Investors are not compensated for Operational risks. Operational risks can undermine the investment returns and also expose trustees to erosion in capital due to fraud or collusion risks. Hence, ODD is very important to CSC to protect the interests of our members, understand risk culture within investment managers, manage reputation risks and document operational process/controls and analyse weaknesses.



Grant Harslett

Very important. It is an integral part of our investment governance. Operational risk is a risk for which there is no reward/upside, only potentially severe downside risk, so we treat it seriously; we seek to understand it and minimise it. All our investments are outsourced to external managers so assessing and monitoring the operational risks to which we are exposed in these entities is critical to delivering the best possible outcomes to our members.



Martin McCabe

ODD is extremely important to our organisation. As a profit to member fund, our sole objective is for our members and we must evaluate all risks – including investment manager risk – carefully. We place as much importance on the operational aspects of an investment manager as the IDD review. We review operational aspects of a manager before we invest with them and then also on an ongoing basis. Among other things, we're particularly cognisant of the risks around fraud, valuation errors, cyber security and trade processing. We then also benchmark managers so we can identify areas of poor practice and seek remediation by the firms. We are also aware of increased regulatory scrutiny in this arena and have set up an ODD framework and policy with a dedicated resource internally.



What is your overall approach to operational due diligence, including key steps?



Alex Wise

Following the “Trust But Verify” mantra is the central to our diligence approach.

We encourage clients to establish a Due Diligence Policy as a starting point. This sets out the approach to both monitoring and point in time reviews. Across our global client base we have seen increased focus from sophisticated Asset Owners on the ongoing monitoring component, something which is often under-resourced in Australia.

Many institutional clients are also embedding a reputational screen into the process. Reputational diligence involves a search of the public domain (media, adverse web content, watchlists and legal databases), diligence professionals have little excuse if they have not uncovered what can be found online. Additionally, reputational matters tend to allow investors to screen out reputational red flags or failures early and avoid any further expense for example in the case of a series of disciplinary or even criminal allegations.

Whether in a point in time report or a monitoring reviews, we recommend a thorough analysis of materials sent by the Manager against a standard set or criteria or risk factors and verification of those representations to a third-party source where possible. From a fiduciary perspective if you haven't reviewed manager materials investors could find themselves in hot water if things go awry later.

Finally, our approach involves reaching out to the manager and being pro-active with information and document requests. For a point in time assessment this involves a lengthy conference call followed by an onsite visit to assess the office environment and verify key representations.

In respect of ongoing monitoring our approach include quarterly update calls with the manager and periodic fuller reviews. The phased and staged process allows a risk-based approach to be enshrined in a Due Diligence Policy that sets out the key steps.



Angela Brown

We operate a global ODD program which focuses on identifying material unmitigated operational risk. Our ODD process begins with a desk-based review of various documents pertaining to the investment manager, strategy and/or product which then serves as a base for the onsite visit. The onsite visit is our opportunity to meet with the investments manager's key operational staff and discussions typically cover a range of topics including, but not limited to, the organisation and background of the firm, trade/deal flow process, service providers and counterparty risk, valuation, cash controls, compliance and IT. The onsite visit also gives us the opportunity to view the investment manager's office space and systems along with policies and procedures which could not be provided electronically. Part of our process also includes, where possible, independently verifying information provided by the investment manager and this is done by conducting reference checks with key service providers, background checks and internet searches. Findings from the entire process are ultimately captured within an ODD report which is presented to and discussed by the entire ODD team as part of our formal rating process. We do also take an active approach in terms of engaging with investment managers where improvements are needed and providing general feedback. Following investment, ongoing monitoring is conducted on a scheduled and/or ad-hoc basis.



Bobby Pometkov

Generally 2 people work on the ODD information sourced from the Fund and analyse it independently. Internal review meetings are held to discuss and debate the processes, controls and segregation seen in the operating model of the fund. The fund operating model is compared and contrasted with peer group to understand the relative strengths and weakness. The outcome of the review process is finalised after review by the Executive Manager-Investment operations.

We initiate a desktop review based on questionnaire sent out to the fund. A follow on telephone call is scheduled to clarify and understand the fund inputs in detail. A risk assessment is made based on available data from the fund and overall rating is issued based on desktop review. A site visit to validate processes for ODD purposes maybe performed with desktop review or is performed within 18 months of funding based on the location of the investment manager.



What is your overall approach to operational due diligence, including key steps?



Grant Harslett

Our ODD policy is a component of our Investment Policy Statement. Under that governance framework, our ODD process has been established. At the highest level our ODD process involves an initial ODD assessment at the time a new mandate is being considered. For all existing mandates which meet the criteria, ongoing monitoring is carried out, based on an annual cycle.

The key steps: collection of relevant ODD reports; review of the reports and follow up of questions/concerns; assessment of all this ODD material (information/analysis/commentary) against our specific risk tolerances; decision/recommendation on appointment/continuation.



Martin McCabe

Our approach is to utilise expert consultants to review investment managers. These consultants are able to use their experience and global footprint to assess investment managers in many different asset classes. We also have an ODD function internally that is segregated from the Investment team. This allows us to review and independently scrutinise the consultant ODD reports. Our ODD function will then discuss key points raised in the ODD report with the ODD consultant and Investment Manager. From here we can seek further information if required and reach a conclusion on whether an investment manager meets the minimum requirements for ODD.

ASSIGNING RESPONSIBILITY FOR OPERATIONAL DUE DILIGENCE



Who completes it and how much time, on average do they spend on it? Does the ODD Team have veto over investments?



Alex Wise

Our firm has 85 people of which around 65 are involved in the Due Diligence process. Administrative tasks are handled by desk-based diligence analysts, whilst on-site visits require a senior manager or director with lengthy tenure at the firm. Typically our point in time process takes between 50 and 100 hours depending on the complexity.

Clients tend to have different set of risk tolerances and what is a “deal breaker” for one is not for another, and although we believe it is solid governance control to have an operational veto from a senior non-investment professional. As Castle Hall is not an asset consultant, we don’t recommend investments and we don’t have a veto in house.



Angela Brown

Our ODD team comprises of 11 individuals located across offices in New York, Stamford, London and Sydney and all members of the team are fully dedicated to performing operational due diligence functions. Each review typically takes between 6-8 weeks to complete; however, timelines can vary. Our ODD team maintains the right of veto over investments.



Bobby Pometkov

ODD is completed by Investment Operations staff separately. The time taken to complete the process depends on how much information has been made available by the fund in the first instance, review of all policy documents, time taken to prepare for site visit meeting and completion of report and analysis to come up with a rating. The level of transparency in information sharing and level of engagement during site visit also contributes significantly in completing this process in a timely manner. Since every fund is different the time taken to complete is hard to generalise.

Yes –investment managers with less than acceptable operational infrastructure cannot be funded.



Grant Harslett

The internal work on ODD is carried out by Investment Operations staff who report directly to the GM Investments. Much of the collection and analysis of manager information is outsourced, ideally to a specialist ODD provider generally under the AIST ‘manager-led’ model. Tax DD and legal DD is also outsourced. The time spent varies over the year but would probably average out to around 0.5 FTE.

The small team means that the ODD process is integrated into the wider decision process. Consequently ‘a right of veto’ exists and is set out in the Fund’s ODD policy.



Martin McCabe

As ODD is a priority for the Fund, we have dedicated internal ODD resources. The team are required to set up the internal procedures, review ODD reports, set up a review timetables, liaise with consultants/investment managers and other stakeholders. The ODD team does have the power to veto investments and has been used in the past to recommend not to invest in particular managers due to key operational issues that sit outside the risk appetite of TelstraSuper.

INHOUSE OR OUTSOURCED?



Do you use external consultants to support ODD, or are you entirely in-house resourced? What do you see are the advantages and disadvantages of your chosen approach?



Alex Wise

Castle Hall is external due diligence firm who works alongside client internal teams on a co-sourced basis. More generally, we think the co-sourced approach tends to work well for investors (whether with Castle Hall or other DD firms) as clients can leverage the scale and technology of consultant to empower the internal team to utilise highest and best use of their time. Additionally, many clients utilise Castle Hall to support their ongoing monitoring approach which empowers internal resources to deal with the issues rather than the administration of getting to the issues. As Castle Hall we don't produce reports that are paid for by managers and distributed to their client base as our global model is to be engaged by Asset Owners and fiduciaries.



Angela Brown

Operational due diligence functions are performed internally by our dedicated ODD team, although as part of our ODD process we do engage external providers to perform background checks on the investment manager and its key individuals. We have in place an experienced team which has been carefully constructed to include a diverse set of backgrounds resulting in an extensive depth of knowledge and complimentary skill sets. As a team, we work across all asset classes and review a vast number of investment managers, strategies and funds, all with varying characteristics. This has enabled us to design an ODD program which we believe to be best in class. It also allows us to be nimble in an environment that is subject to constant change. Despite these advantages, there can be significant costs associated with performing comprehensive ODD reviews internally.



Bobby Pometkov

We have external consultants covering ODD review on hedge funds after completing their site visit. Our model is "owner led" wherein we receive inputs from specialist consultants which we review and make an overall assessment. We initiated in-house ODD work on hedge funds in 2016 and this work is done by investment operations team separately. The advantages of this model is that we can build and develop skillset within our internal team and gain valuable insight on the operating models in the unlisted asset sector. Considering most investment managers are located overseas this sometimes poses a constraint in completing site visit by in-house ODD team prior to funding.



Grant Harslett

We are resourced internally but rely on the AIST model which effectively outsources the core work of ODD collection and commentary to third party, specialist ODD providers. Our internal resources area applied to the review and further interrogation of the ODD provider's report, including where appropriate further communication with the manager, and finally to the overall assessment against our risk criteria.

This approach is built around the concept that it is better for the industry as a whole (both funds and managers) to deliver the core ODD information and commentary in the most efficient manner; by minimising duplication of the core ODD work that is common to all investors. And more efficient means better outcomes for our members, noting that the external ODD providers are professional firms who deliver good quality ODD assessments.



Martin McCabe

We do use ODD consultants where we believe they can add value. For example the firms we use to complete reviews have a global footprint and have highly experienced personnel. However we still maintain an overlay function to review the consultants work. We feel this approach works well as the spread of investment managers globally would make it difficult for on-site reviews prior to investment. The consultants are agile enough to arrange on-site visits for the reviews at little notice. The main advantages are the timing for on-sites and the depth of knowledge in these firms to complete benchmarking. The disadvantage would be that not being on-site means that you miss the benefits of face to face meeting with the managers.

KEEPING AN EYE ON THINGS



How do you monitor managers after the point in time DD is complete, including how often are formal updates made to the ODD assessments?



Alex Wise

Diligence is ongoing and continual. As such on a daily basis we check the media and publicly available regulatory filings such as the US SEC Form ADV which contains a wealth of information. We also curate the media daily reviewing the results avoids the false positives. We encourage investors to use a dedicated media source which archives the stories - to avoid broken links in the future.

Then on a monthly (or quarterly) basis we check the manager's outbound communications for operational risk matters, often the performance is well scrutinised, but investment analysts might not be focussed on the fact that the auditor has changed, or the COO is now on sabbatical. Additionally, we also believe it is important to reach out (particularly to certain managers that might be categorised by investors as "higher risk") on a periodic basis to check not only the investment mandate but also a set of key operational and business risk factors. It also important to do this consistently across the portfolio to ensure fiduciary obligations are satisfied.



Angela Brown

We operate a risk-based approach to ongoing monitoring with such monitoring conducted on a scheduled and/or ad-hoc basis. For example, we review hedge funds on an annual basis and long-only funds every two years. Ad-hoc reviews may be done at any time and will depend on developing issues such as, but not limited to, litigation and regulatory action, changes to service providers, key staff turnover and system changes.



Bobby Pometkov

We do a refresh after 12 months of the initial review and review any changes to the operating model. The refresh review is done on an exception basis focussing only on any changes to the operating model. We also get site visit reports from our external consultants.



Grant Harslett

Our policy is to generally review our ODD assessments annually. Therefore we seek annual updates of the initial ODD provider's report to assist in this review, with the annual update reflecting the prior risk assessment and findings, as well as subsequent changes to the manager's operations. Monitoring between annual updates is also part of our process, so we can be aware of any material information which could require an earlier re-assessment.



Martin McCabe

Ongoing reviews are completed using a risk based approach, higher risk managers will be reviewed more frequently. All Managers will be reviewed at least every 3 years if not before. The ongoing reviews are completed in a similar method to the reviews for a new manager appointment. We send out annual questionnaires to review any organisational changes and review documentation such as certificates of currency.

FROM SPREADSHEETS TO ARTIFICIAL INTELLIGENCE



Does your organisation use fintech and analytics to review managers?



Alex Wise

Yes, very much so. Our platform DiligenceHub has a range of Fintech tools that we use to review and monitor fund managers. For example, we AI to review the ADV filings each day, flag for changes and then automatically analyse key operational risk factors on over 18,000 managers.

We also encourage clients to use analytics to analyse concurrent risk factors at a manager. For example, an investor can look for a fund which has say, a change in auditor, an increase in illiquid assets and a change of CFO. The combination of these factors could trigger a deeper review from the investor.

Analytics on a portfolio level are also useful to benchmark risk factors against a peer group or portfolio of managers or to identify manager that meet certain characteristics. For example, if a manager does not have a written cyber security policy, the investor can use analytics to clearly tell the manager that it is in the 20% of the portfolio that doesn't have such a document. The analytics create actionable intelligence.

Further if an investor is looking across their portfolio they should be able to use analytics to show for example all the managers in outflow with a reduction in headcount and an increase in illiquid assets as a percentage of NAV.



Angela Brown

From an ODD perspective we do not currently use fintech and analytics to review investment managers. Nevertheless, this is an area which we continue to evaluate.



Bobby Pometkov

Currently CSC does not utilize a standalone Fintech solution to perform ODD, but we are exploring Fintech to improve efficiencies around the data gathering and reporting. Analytics are performed both internally and by our external consultants.



Grant Harslett

Not directly. We only have less than 40 managers under ongoing ODD review and new manager appointments are not a frequent event. But indirectly some of the specialist ODD providers use data and analytics to make the commentaries on weaknesses, potential risks and on relativity to best practice against the relevant manager universe.



Martin McCabe

As a supplement to our formal ODD processes we also use a fintech firm for daily public disclosure monitoring.

RED FLAGS AND PRIORITIES



What are some of the core red flags that you look for in your ODD reviews and what is your number 1 ODD risk priority right now?



Alex Wise

While there are many nice to haves, there are 4 must haves in ODD: existence, valuation, cash and conflicts. Have I got what I say I've got, is it worth what I say its worth, can anyone steal the money, and are there disclosed or undisclosed conflicts of interest?

Valuation of the fund vehicle continues to be a key factor as well as cash controls. They have remain as fundamental issues in ODD, but many diligence reports barely cover them at all which I always find surprising.



Angela Brown

As each investment manager, strategy and fund is unique, red flags can stem from various avenues. Furthermore, our ODD program is holistic and focuses on identifying all forms of material unmitigated operational risk therefore we do not generally have specific ODD risk priorities. Some common red flags we come across include: lack of controls surrounding cash movements; inadequate staffing; lack of segregation of duties; weak compliance frameworks; inappropriate valuation policies and procedures; and, conflicts of interest.



Bobby Pometkov

Poor segregation of duties around cash controls, Concentration of responsibility for oversight over most functions with 1 person, minimal operational and technological infrastructure to support fund's strategy.



Grant Harslett

We consider a number of operational risk areas, as summarised in the AIST Guidance Note. Within those broad areas, those of particular current focus include: lack of policies or weaknesses in policies relating to investment trading and personal trading; lack of staff awareness of relevant policies; controls around cash; segregation of duties between portfolio decisions and compliance functions; and complex fee/cost structures.



Martin McCabe

Core red flags include :

- Weak cash controls
- Poor governance
- Immature cyber security controls
- Valuation and accounting risks
- Segregation of duties
- Manual processing (e.g. using spreadsheets instead of systems)
- Conflicts of interest
- BCP and DR weaknesses.

Currently our number one risk priority is the specific operational risks of alternative assets. In particular we're looking to ensure we are collaborating with our consultants to uplift operational processes in less mature markets. We are also mindful to focus on emerging risks e.g. cyber security issues and key risk indicators.

WHATS "TRENDING" IN OPERATIONAL DUE DILIGENCE



In terms of areas of growing focus, what newer areas are you actively delving into? For example, are you focussing on assessing better cultural alignment with managers, focussing on ESG, or cyber security?



Alex Wise

Cyber security is also vitally important as data breaches continue to occur at fund managers and administrators. We are seeing investors now start asking for specialised Cyber reviews, particularly when investors have experienced a manager in their portfolio having a data breach or other cyber failure.

Also from an ESG perspective we are seeing investors now looking at the ESG characteristics of the manager, not just the investment process. ESG Diligence at the manager level is a strong indicator of culture at the manager. For example, has there been a recent #MeToo case, does the manager use members money to entertain investors on a private jet? Whether it has been the recent scandal in the US about college admission bribery or the sting on a massage parlour in Florida, both have ensnared senior fund management people. Investors are increasingly making judgements on the culture at managers based on these types of events.



Angela Brown

Topics such as culture and ESG form an important part of our investment process and in some instances we have specialists responsible for assessing such aspects. From an ODD perspective, areas of more recent focus include cyber and information security and overall compliance culture. We will continue to delve into these areas as we believe there remains room for improvement within the industry. Over the past few years there have also been a number of material regulatory developments across the globe and we have spent a lot of time assessing investment manager preparedness and related impact and such focus will continue as the regulatory environment continues to change.



Bobby Pometkov

Increasingly hedge funds are using data science models and the governance and independent oversight process around validation to changes to model parameters has been an area of focus. Also controls built-in around the use of Algos by funds is an area of focus.



Grant Harslett

ODD is not constant. Areas which are becoming more important include cyber; privacy and data security management; culture within the manager and hence alignment with the client (ultimately our members).

We see ESG policy as more within the investment scope of the mandate, with implementation and monitoring of the ESG policy relevant to the operational scope.



Martin McCabe

A growing area of focus for us is organisational culture. You can have all the right answers on paper but ultimately culture will set the way an organisation operates. We look to collaborate with our Investment teams to help measure the culture of Managers prior to investing. We also have another dedicated resource for ESG so this sits outside of the ODD remit. We are very much focusing on cyber security as part of the ODD process and benchmark managers according to their size and scale.



How do you think ODD reviews and analysis will evolve over the next 5 years?



Alex Wise

At Castle Hall we believe DD will become far more fintech and analytical. The days of unwieldy spreadsheets for monitoring and Word reports at a point in time are officially over!

Personally, I think operational diligence will evolve to include wider specialist areas such as ESG and Cyber Security. We also see the move to a more integrated 360-degree Fintech solution that includes investment compliance, reputational DD and ongoing manager monitoring to ensure clients are on top their investment management vendors at any point in time.



Angela Brown

ODD is, and will continue to be, an area subject to continuous evolution given the ongoing nature of change within the investment industry, regulatory landscape and best practice standards. ODD is also a time consuming process which involves the collection and analysis of a vast amount of information and data. We have started to see a focus on creating efficiencies within the process, both for investors and investment managers, and we expect this will continue. This may include more collaboration between investors, investment managers and/or industry bodies and more use of technology to streamline processes and create efficiency and scalability.



Bobby Pometkov

As more investors in the industry build in “minimum” ODD rating requirements as a key criteria to fund new investments, greater scrutiny and expectation from clients will drive funds to migrate to operating systems, controls and processes that is seen as market standard or acceptable in the industry. This may potentially drive operating standards higher.



Grant Harslett

The whole ODD process; reviews, monitoring and assessment, will need to become more comprehensive, more real-time and more efficient; we need to keep member best interests at the forefront in terms of both quality and efficiency.



Martin McCabe

ODD reviews and analysis will evolve significantly – smaller more targeted reviews and continuous ongoing monitoring will be done. Firms will no doubt be required to increase headcount in ODD teams to deal with the stakeholder management of investment managers, consultants and regulators.



AIMA AUSTRALIA
Tel: +61 412 224 400
Email: apac@aima.org