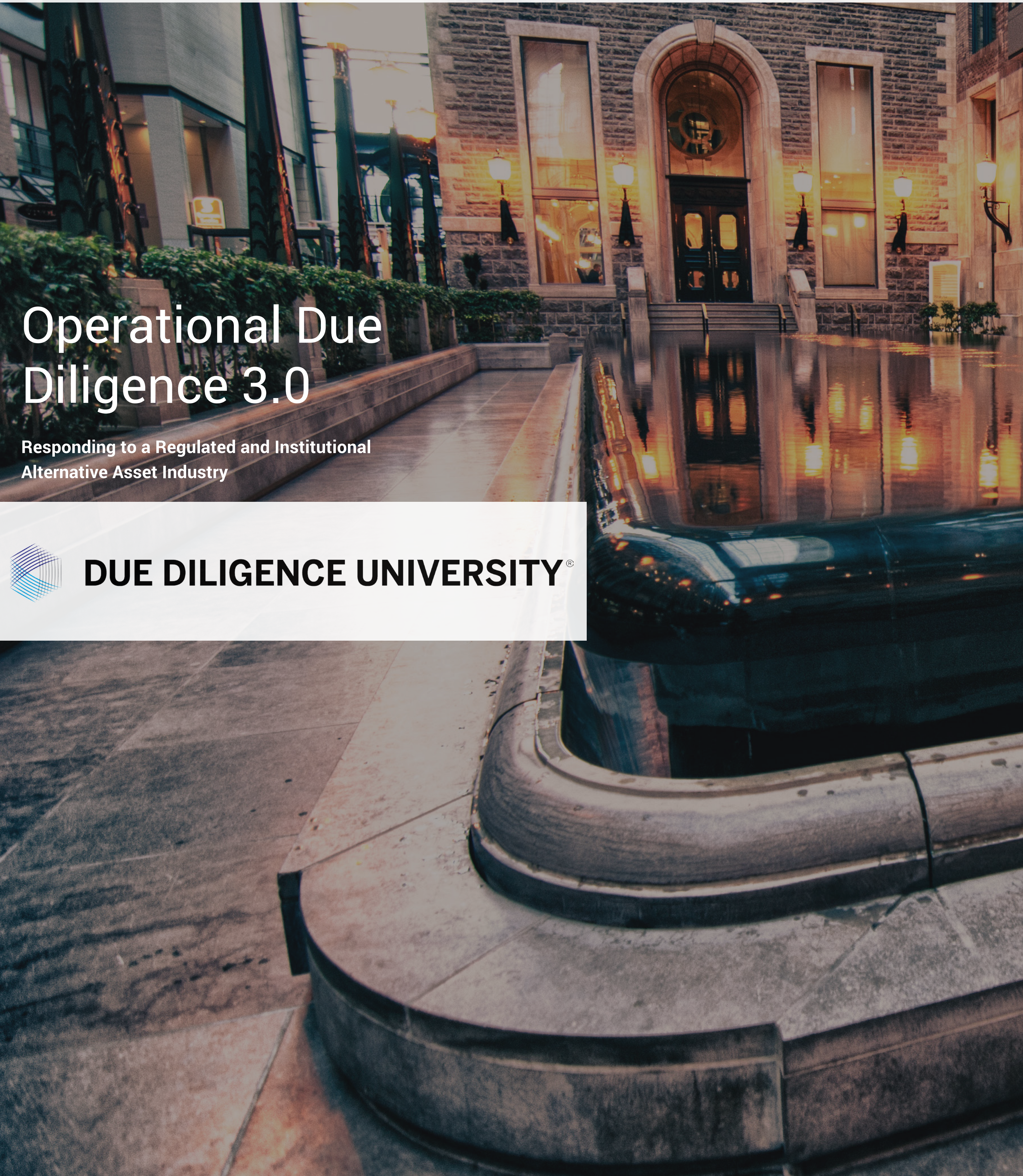
CASTLEHALL

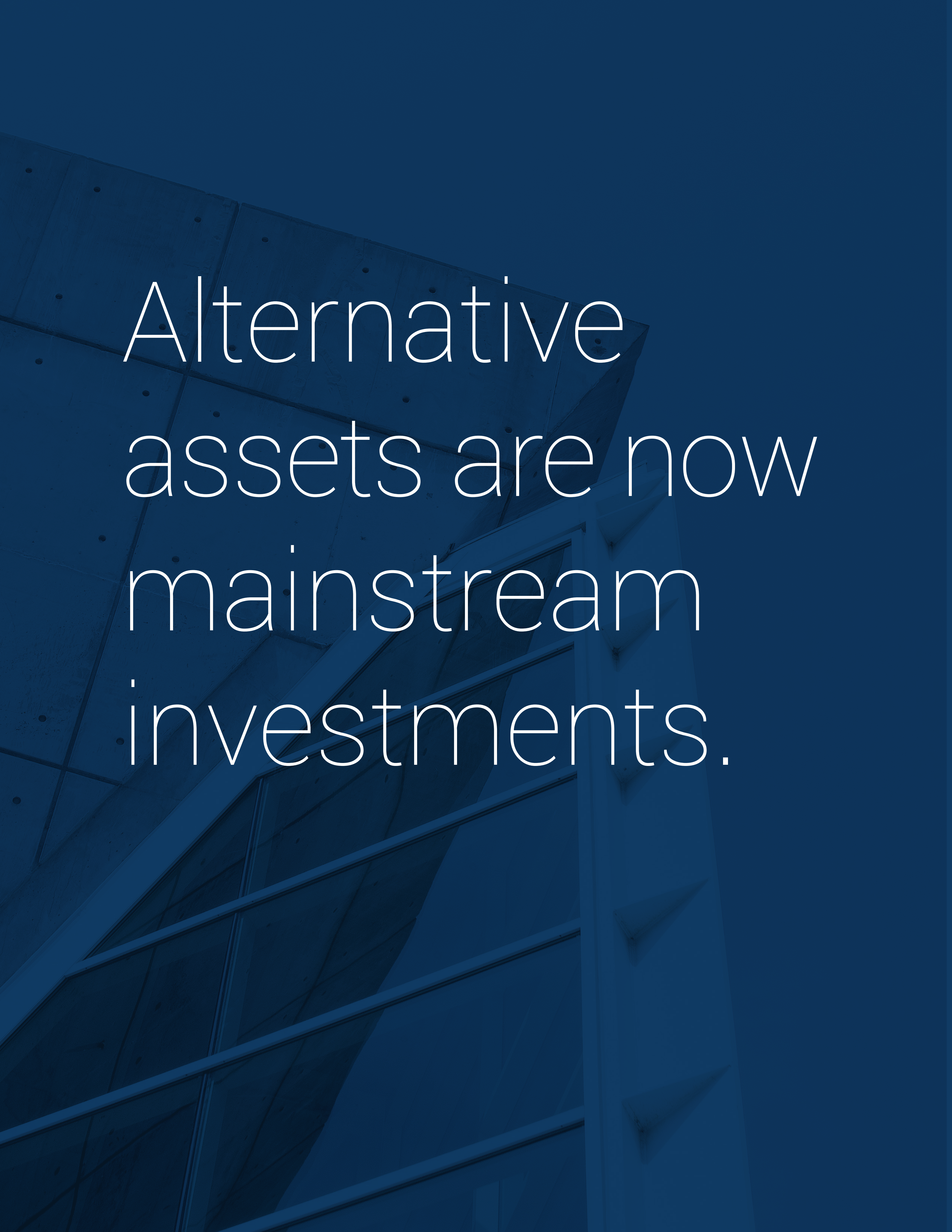
The Due Diligence Company

Operational Due Diligence 3.0

Responding to a Regulated and Institutional Alternative Asset Industry

DUE DILIGENCE UNIVERSITY®





Alternative assets are now mainstream investments.

Whether held through employee pension funds, accessed directly through traditional private partnerships, or increasingly offered through "liquid alts" 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 equally focused on the risk of operational failure—be it through honest error or, in the worst case, through dishonesty and fraud.

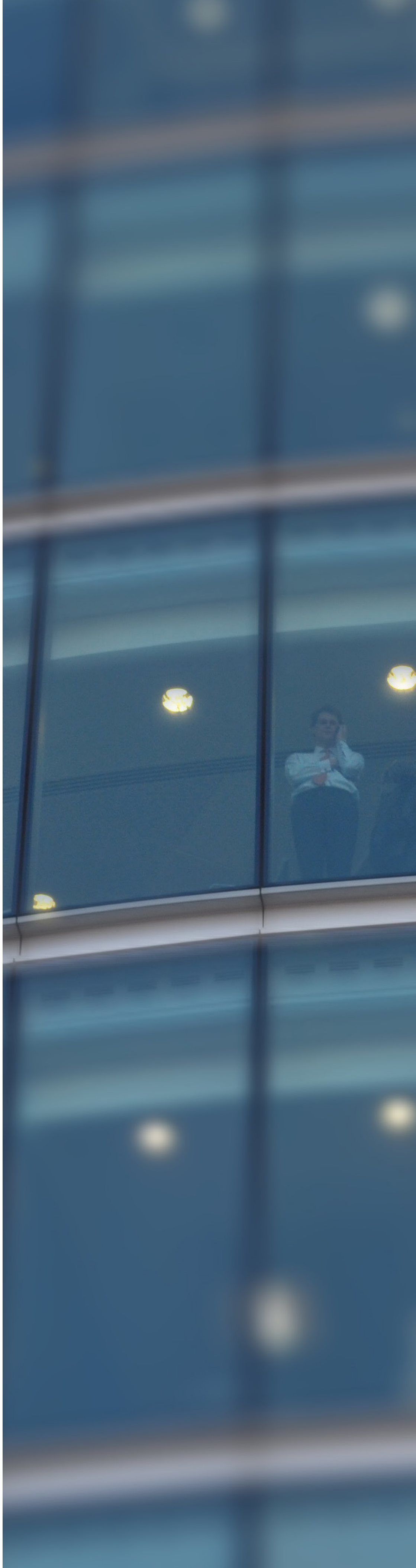
Investors also recognize that weak business infrastructure creates an unavoidable drag on performance. An asset manager with weak controls will not have the data, technology, and operational efficiency to ensure optimal implementation of the investment strategy. For hedge funds in particular, operational 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. 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.

What is Due Diligence 3.0 ?

Due Diligence 1.0: Pre Madoff. Before 2008, operational due diligence was an optional, "nice to have". For those investors who did conduct ODD, the process, scope and methodology of emerging ODD programs was very variable. Equally, there was a lack of commonality among hedge fund operating structures, exemplified by the existence of many self-administered funds.

Due Diligence 2.0: Post 2008. In the Diligence 2.0 world, some level of operational due diligence is now performed by virtually all asset owners. Diligence scope and methodology has also become somewhat more standardized, although some investors continue to have a "light touch". Equally, manager operational structures are now more uniform, benefiting from better systems and technology, a wider bench of experienced talent, and more transparency around the industry as a whole.



A New Model For Asset Owners

Due Diligence 3.0

MULTI ASSET CLASS

Operational Diligence should be applied across all third party asset manager relationships, not just hedge funds. Investors focused on governance, risk and compliance; now require consistent operational risk information across all fund and account holdings.

A RISK-BASED APPROACH

Operational risks for mutual funds, long only managed accounts, private equity funds and real estate investments are very different as compared to a traditional hedge fund. Different diligence procedures should be adopted to reflect different asset classes.

REAL TIME MONITORING, NOT SNAPSHOT REPORTS

Traditional ODD has focused on a schedule of in person diligence meetings, with the output of each ODD cycle often limited to a report memorializing information gathered during each meeting. This process is then repeated every 1-3 years. Diligence 3.0 introduces a new operating model: the foundation of an effective ODD program is now an active, real time monitoring program, where the annual onsite visit and resulting diligence report is just one tool in a far broader toolbox of diligence procedures.

FINTECH

Just as hedge fund managers no longer use Excel for accounting, ODD no longer relies on word processed meeting reports. Technology has become critical to process ever increasing amounts of public and private information. Systems, bandwidth to curate data, and quality reporting and dashboard capabilities are vital to give asset owners an effective view of portfolio risks.

Enhancing the ODD Process

In the context of 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.

1 ESTABLISH A DUE DILIGENCE POLICY

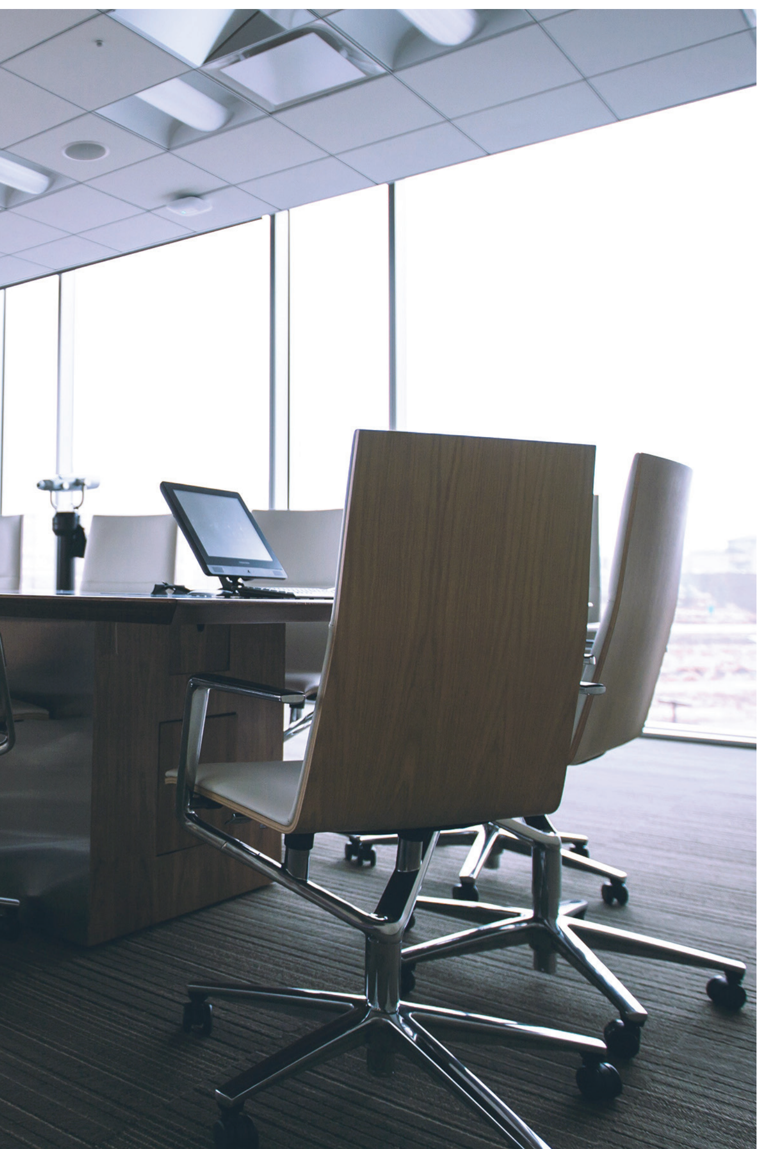
Managers and investors are familiar with compliance manuals, valuation policies, and disaster recovery plans, but the ODD policy is a relatively new concept. However, a policy document should be the foundation of the ODD process, outlining clear procedures for initial operational diligence on new allocations and, thereafter, policies for the conduct of ongoing diligence on invested positions.

A well drafted ODD policy will outline a risk-based approach, recognizing the different operational risk profiles of different types of investments (from long-only managed accounts, public and private pooled funds, hedge funds, private equity vehicles, etc.), and also take account of investment materiality.

As a core concept, however, a threshold level of operational diligence should be completed on all third party asset managers, both when new managers are on board and then as part of an effective ongoing monitoring program.

ESTABLISH RESPONSIBILITY FOR ODD 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 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 OPERATIONAL DUE DILIGENCE RISK AREAS

ODD seeks to identify, manage, and mitigate non-market risk. 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, theft of assets, and ensure that investment transactions are accurately recorded).

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

3.1 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.

3.2 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.

3.3 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.

3.4 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. It is, however, typically these assets – which are precisely the securities most susceptible to deliberate mismarking – where administrators are typically ready to accept manager originated, rather than independently sourced, prices.

3.5 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.

3.6 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 enhanced governance oversight.

3.7 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. Finally, cybersecurity issues will impact both the technology team and the compliance department.

4

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.

5

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 when the manager is onboarded. 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 should also 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 diligence is a challenging discipline. ODD requires significant resources, working within a well-defined process and methodology. Investors will increasingly 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 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.

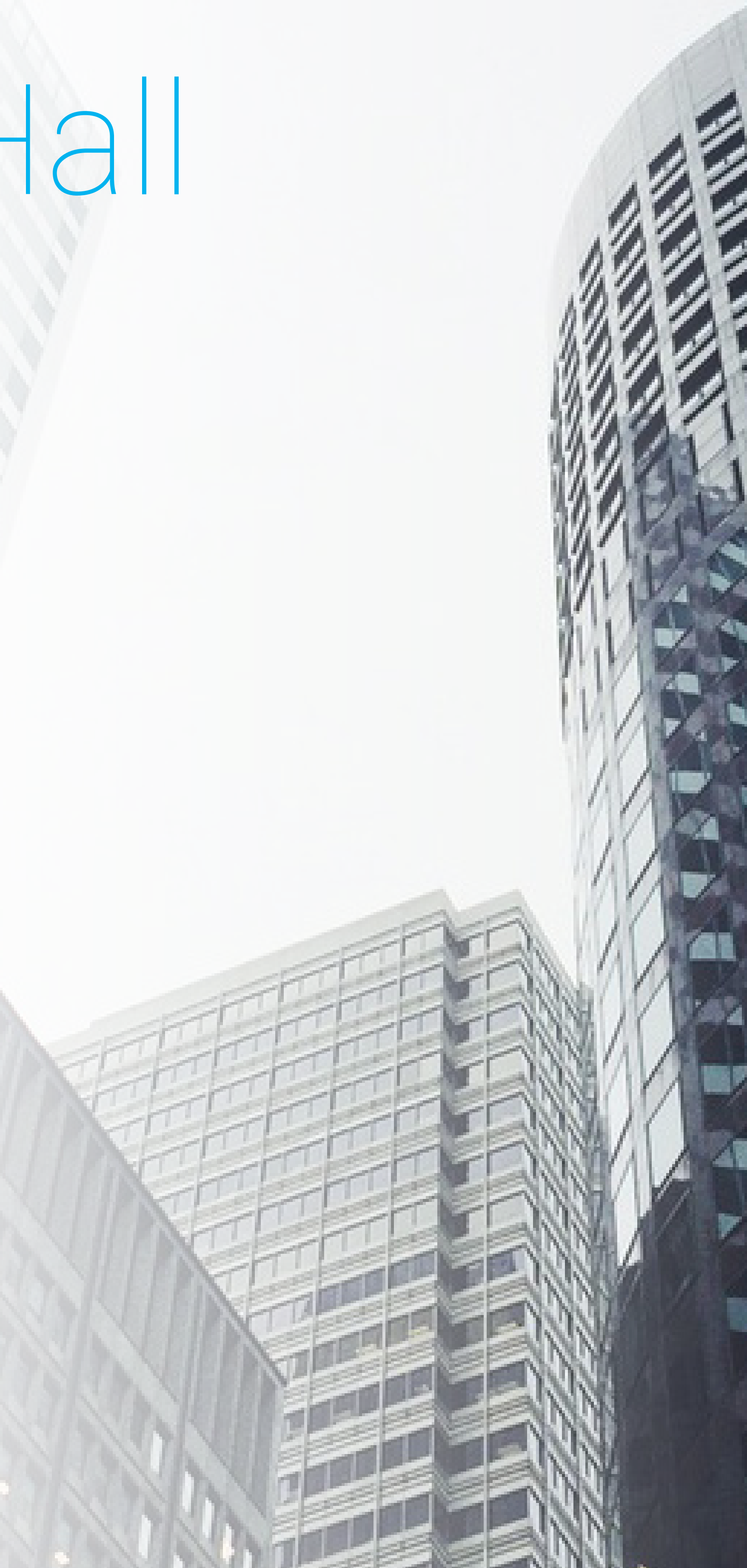
About Castle Hall

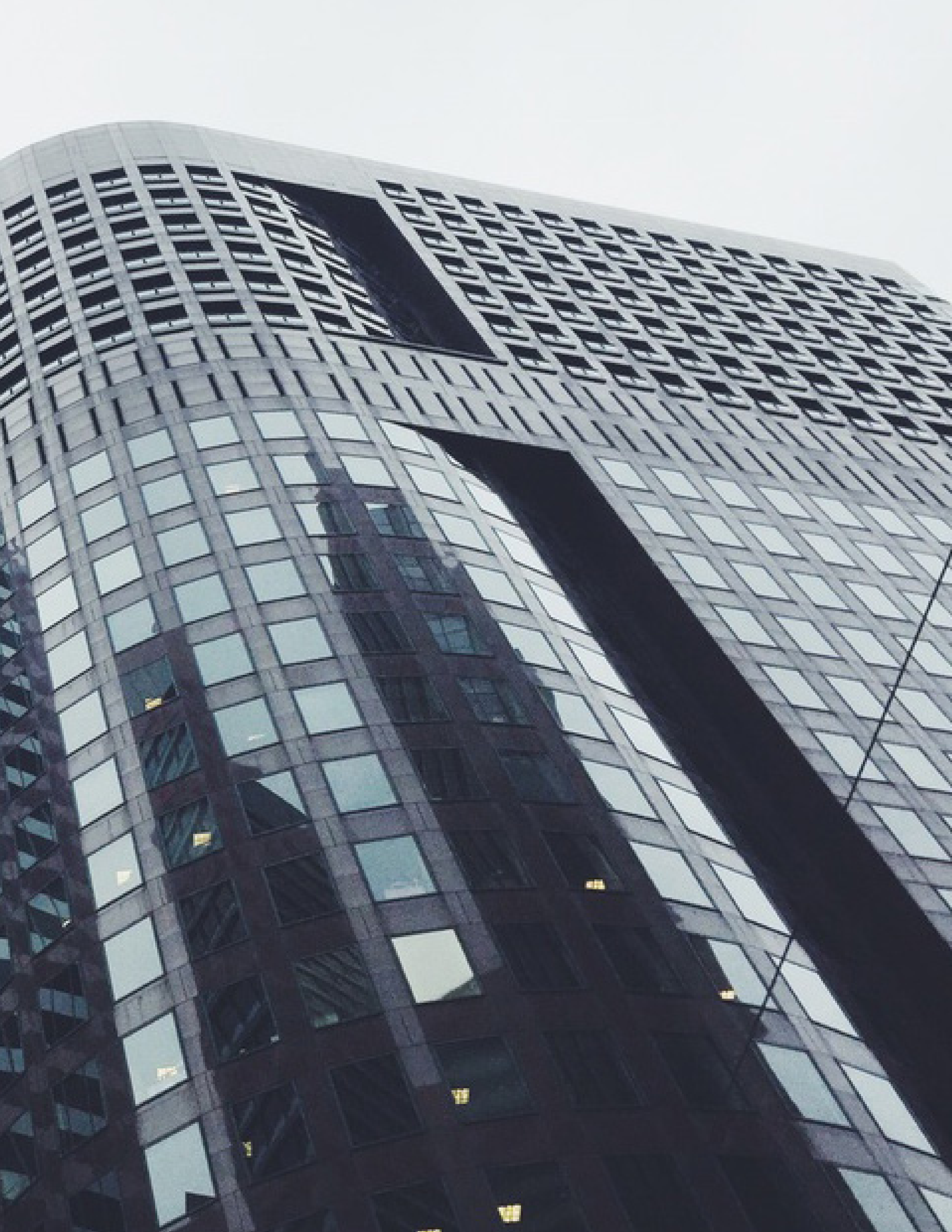
Castle Hall, The Due Diligence Company, is a leading specialist in the due diligence of alternative and traditional asset managers. Castle Hall emphasizes independence and lack of conflicts of interest throughout the due diligence process, providing services only to asset owners, not asset managers. Unlike the traditional investment consulting model, we also ensure full segregation of duties in the due diligence process: we do not provide front office investment recommendations or offer investment management services.

Castle Hall operates from offices in Montreal and Halifax in Canada; Zurich in Switzerland, Sydney in Australia and Abu Dhabi, UAE. Castle Hall's core competitive advantage is DueDiligenceProfessional™, our proprietary online diligence platform, which has helped our clients complete due diligence across several thousand funds and accounts.

Castle Hall, The Due Diligece Company, is proud to have been named the Best Global Operational Due Diligence Firm for four consecutive years.

2017 and 2016 Hedge Fund Awards; 2017, 2016, 2015 and 2014 Alternative Investment Awards.





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DUE DILIGENCE UNIVERSITY®

Operational Due Diligence continues to evolve. In an ever more sophisticated governance, risk and compliance environment, investors require up to date knowledge and access to industry metrics and best practice benchmarks.

To support these needs, Castle Hall, The Due Diligence Company, is pleased to introduce DUE DILIGENCE UNIVERSITY® – a growing ecosystem of white papers, online tools and other educational resources to support every aspect of the due diligence process.

Contact us for more information.
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