

## OPERATIONAL DUE DILIGENCE – AN UPDATE

By Phillip Chapple, Executive Director with KB Associates UK

It is widely recognised across the hedge fund industry that the operational due diligence process performed by investors and potential investors on their hedge fund investments has expanded exponentially over the last few years.

Previously, operational due diligence was often a “check-the-box” exercise where a set of pre-defined criteria had to be met with a detailed review undertaken by only a handful of investors. Non-compliance with the pre-defined criteria would sometimes be overridden where the investment returns were attractive, effectively bypassing the due diligence process.

In the past three years the landscape has been transformed. The very structure of the investment process itself has changed. Now operational due diligence teams usually have the power to veto investments. This veto, or “due diligence fail”, can be triggered not only by failure in respect of significant due diligence issues, but also by anything which the due diligence analyst considers to be a “concern”. This gives an extremely wide discretion to fail a potential fund. Managers must therefore ensure that they maintain both an appropriate operational infrastructure and all of the due diligence materials to demonstrate such infrastructure to potential investors.

Another growing feature of the current market is the lack of investor feedback given to managers following completion of the due diligence process. The majority of investors will not tell a manager when they have failed a due diligence review, let alone provide feedback on reasons for not investing. Most investors do not believe that providing this type of feedback fits within their mandate.

The due diligence process can therefore be a daunting and opaque prospect for many managers, particularly those running small funds. As a fund grows in size, communication between investors and management develops and improves, thus opening channels for clear and helpful feedback. Until managers reach that position, it can be very difficult to work out what investors may require.

Due diligence has become a process that is carefully tailored to the individual requirements of each fund and potential investor. There are, however, some common themes in operational due diligence development which managers should be aware of and which are discussed in more detail below:

### CORPORATE GOVERNANCE

Investors in different geographies appear to place varying degrees of importance on governance structure at a fund level. UK and European investors have increased their focus on the board of directors of funds into which they invest. Investors now tend to review the composition of the board and examine the skill-set and background of each director. It is extremely important that directors are adequately prepared to talk to

potential investors and to discuss knowledgeably the key terms of the fund. Investors will evaluate the technical knowledge of the directors but more importantly often wish to evaluate a director's understanding of his or her discretion and responsibilities to the fund's investors.

A further area of focus has been the number of boards on which any one director sits. It is important to maintain the balance between having sufficient directorship experience, while still ensuring each director has enough time to dedicate to all their roles.

The mechanics of board governance are also often reviewed as part of the due diligence process. Investors have a preference for active boards with an appropriate schedule of meetings and well developed procedures for the establishment of agendas and prompt resolution of issues as well as the recording and retention of minutes. The mechanics of voting and quorum requirements are also often included in due diligence analysis.

There are differences of opinion across the industry as to the preferred number of directors and on the presence of related parties sitting on the board. The industry standard appears to be three independent directors with a range of experience. It is normal for investors to seek legal experience, accounting experience as well as experience of the alternative investment industry.

The UK FSA now requests fund directors resumes as part of an investment manager's authorisation process, thus demonstrating the increased interest in Corporate Governance.

## **TECHNOLOGY**

The security and reliability of an investment manager's technology infrastructure has come under increased scrutiny. Security is of paramount importance in the light of recent hacking scandals and viral attacks. Sensitive information needs to be effectively safeguarded and access to systems must be appropriately structured to support the investment strategy. It is important to ensure that business continuity and disaster recovery plans meet investors' expectations. The balance between accessibility and security can be a challenge to get right.

Current investor focus includes the hosting and connectivity of investment data feeds, the security around proprietary information and security issues around the total technology infrastructure. Investors have shown a recent interest in wireless networks, mobile phones and the physical security of onsite servers. This can be an extremely costly area so it is important to balance the risks with the business viability to build an appropriate infrastructure.

## **REGULATORY RISK**

Regulation continues to develop across the global markets. Dodd Frank in the US and the AIFMD in Europe have headlined the sweeping changes currently being made in this area. Investors require managers to comply with all relevant regulation. Investors wish to be assured that managers have a sufficient expertise in place to identify applicable regulatory changes and to ensure compliance with the various applicable regimes.

Investors wish to see appropriate advisors in place to provide the necessary technical support to enable a manager to effectively respond to the changing regulatory landscape.

Interestingly we note that in the last year particular focus has been placed on compliance training.

## **LEGAL TERMS**

Over time, there has been a marked change in exactly what investors consider acceptable in a fund's offering memorandum. Many of the previously uniform protections have been modified to prevent misuse and terms have been removed where not appropriate for the strategy. There is investor unease with the use of gating provisions and redemption fees where a strategy has good underlying liquidity.

Potential investors have been undertaking a forensic analysis of fund documentation to check the consistency of offering memorandums with a fund's underlying constitutional documents. Investors check carefully to ensure that powers which should be exercised by the directors are not granted to the manager. Some investors perform diligence on service provider liability clauses and related insurance policies.

## **SUMMARY**

The above is by no means an exhaustive list of recent developments in operational due diligence. Development is continuous and covers most aspects of the due diligence process. There are no uniform rules for operational due diligence as the process can be very different depending on the investor, size of the fund and strategy of the fund.

It is important for managers to maintain regular contact with their existing investor base to ensure they keep up-to-date with investor requirements. If an existing investor has a requirement, it is likely that potential investors will too. Service providers have extensive knowledge of the pressures experienced by other fund managers as they attempt to satisfy investor needs, making them another valuable source of information.

It seems unlikely that the current trend of increasingly stringent operational due diligence development will slow down or that the opaqueness of the process will disappear. It is critical for managers to be aware of investors' growing requirements. If not they will struggle to raise new capital.

***Any comments or queries relating to the above issues please contact [phillip.chapple@kbassociates.co.uk](mailto:phillip.chapple@kbassociates.co.uk)***



***Phillip Chapple, Executive Director with KB Associates UK***