



What is Operational Due Diligence

Identifying and assessing non-investment risks for asset managers

Aon | Retirement & Investment

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Four Key Areas of Non-Investment Risk

Fraud

- Purposeful misappropriation
- Collusion
- Employee theft

Blow-Up

- Counterparty risk
- Asset – Liability mis-match
- Inappropriate or poor understanding of leverage
- Potential for style drift

Reputational

- Headline risk
- Costs or losses associated with business deterioration

Alpha Degeneration

- Lower level risks that contribute to slippage
- Trade errors
- Sub-optimal implementation of core or ancillary processes

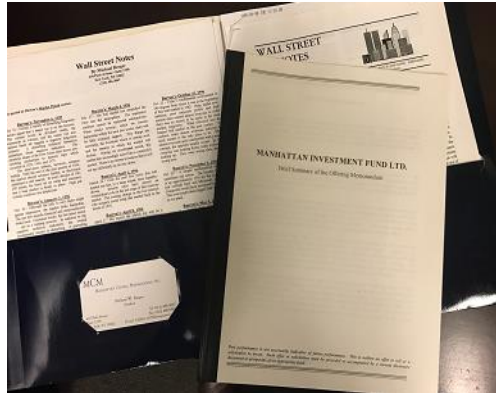


How Operations and Operational Due Diligence are evolving

Evolution of Operations... and Operational Due Diligence

2005

Half of all hedge fund failures are related to operational failures



2017

Are half of all hedge fund failures are related to operational failures any longer?

Evolution of Operations... and Operational Due Diligence

2005

2017

Pre – Madoff

Operations

- Limited regulation
- Nascent technology
- Internal administration

ODD

- **Best practice:** Comprehensive ODD
- Focus on hedge funds

Post - Madoff

Operations

- Increasing regulation
- Developing technology
- External administration

ODD

- **Market practice:** Comprehensive ODD on hedge funds
- **Best practice:** Attention to other asset classes

Current Environment

Operations

- Material increase in regulation
- Straight through processing
- External administration

ODD

- **Best practice:** Comprehensive ODD on all asset classes



What is Operational Due Diligence

Audience Question:

What are the biggest non-investment risks faced by asset managers today?

What is Operational Due Diligence?

Topics we cover



What is Operational Due Diligence?

Topics we cover: Key Areas



Corporate and Organizational Structure

- Corporate Structure – control, decision making, and oversight
- Organizational Structure – segregation of duties and staffing adequacy/competency
- Key person exposure and succession planning
- Employee Retention and Turnover
- Background checks

What is Operational Due Diligence?

Topics we cover: Getting in the Weeds



Corporate and Organizational Structure

1. Compliance can trade and actively does
2. Complete absence of background checking (in most scenarios)
3. Historical/pending regulatory or litigation issues that are material
4. Senior non-investment functional heads that are clearly not skilled, experienced, or empowered
5. Going concern risks sufficient to cause involuntary liquidation (profitability, contingent liabilities, litigation, regulation issues)
6. Under resourced control or support functions; inadequate compliance or finance functions as exhibited by minimal staff
7. Gut or similar cues whether onsite (empty desks, noticeable disarray, nervousness, etc.) or desk-side/pre onsite (lack of transparency)
8. Significant turnover among firm Board of Directors members (if applicable)
9. Absentee controlling shareholder with limited expertise, conflicting business activities, etc.
10. Manager / fund(s) set up in a jurisdiction that is not highly regulated or unusual location without reasonable business support (eg, UK manager running a fund in Brazil)
11. Segregation of duties issues that are less severe (CFO is CCO, trading is segregated by employee but reports through operations, CCO reports to COO rather than CEO, CEO has investment responsibilities)
12. Individual has multiple roles that challenge ability to conduct each/all of them effectively (COO is also CCO and head of HR) or with appropriate level of skill/competence.
13. Lack of appropriate representation on the committees (cross functional for example)
14. Lack of committee meeting consistency
15. Material firm level/firm-wide initiatives (changes in ownership, senior leadership changes, re-locations, systems, etc.)
16. Other org chart deviations or inhibitive reporting lines or backgrounds (say, IT reports through investment team or head of ops/risk is a former investment professional)
17. Limitations in background checking (not all personnel, no recurring checks, etc.)
18. Concentrated decision making (lack of committee structure; majority owner/controller of firm)
19. Limitations in firm external oversight or governance (lack of independent oversight, particularly in a firm that is not private)
20. Overly complex legal structure- jurisdictional mismatch
21. Key Person risk, particularly when combined with lack of succession planning (functional or control)
22. Limited employee turnover (less senior level)
23. Client concentration
24. Other Employee turnover issues or lack of tracking/spikes in turnover
25. Inappropriate levels/lack of insurance (currently Yes/No)
26. Rapid growth or decline in assets, product extensions, etc., (even if well supported) but especially if not well supported.
27. Inconsistent employee compensation or review process
28. Trading occurs in offices or at times when operations/compliance/risk management personnel or guidelines are not present/available
29. Recent inception date; no operating history
30. Isolation of staff / multiple locations (i.e. compliance and ops team in a diff building to the IM team)

Audience Question:

How do we determine what is
“riskier”?

What is Operational Due Diligence ... Not?



The 3 “A’s” of operational risk gaps



Things we've heard in ODD reviews

“Cyber security is not a big threat for us”

“We're not an enterprise”

“We don't like to meddle”



“Our data has not backed up in months”

“Don't want to slow down our decision-making”

“We're too small”



Aon Hewitt's Operational Due Diligence Program

Overview of Aon Hewitt's Operational Due Diligence Team



Our Operational Due Diligence (ODD) process is a multi-faceted review of

- ✓ Written responses to DDQs
- ✓ Supporting documentation
- ✓ Interviews
- ✓ Service providers
- ✓ Process demonstrations



Team of specialists responsible for ODD

- Team of 10
- Experienced, senior professionals
- Supported by data gathering and processing team



Global Operational Due Diligence Team Capabilities

- All new managers and/or products reviewed
- Authority to veto based on operational risk concerns



Examples of Failing ODD Grades

Failing Rating: Material operational concerns that introduce the potential for economic or reputational exposure; we recommend that investors do not invest and/or divest current holdings.

Fixed Income Manager – Fail Rating

Manager profile

- Small, 20-person firm running several billion in traditional equity and fixed income strategies
- Majority owned by employees; Private equity firm maintains a minority stake
- Low trade volume

Risks Identified

Organizational Structure

- Chief Operating Officer ('COO') also PM
- Trading and operations report to the COO
- COO married to another PM
- CFO also reports to the COO

Manual Processes

- Traders utilize physical (paper) trade tickets
- Handwritten allocations
- Trade information entered by operations personnel
- Portfolio manager codes mandate restrictions

Technology Infrastructure

- 4 – 6 week recovery of electronic trading capabilities

Hedge Fund Manager – Fail Rating

Manager profile

- Small, 20-person firm running several hundred million in traditional equity and long-short equity strategies
- Recent regional expansion to Asian market
- Privately owned

Risks Identified

Organizational Structure

- Back up trader does settlement and investor reporting
- Traders report through operations
- PM for Asian office is also the local compliance officer

Technology and Cyber Security

- “Pre-trade” compliance is implemented post execution.
- No password changes or complexity requirements
- Remote access without secondary authentication
- No penetration test of network.

Fund Governance and Administration

- No independent governance
- No external review of cash movements



Examples of Conditional Pass ODD Grades

Conditional Pass Rating: Specific operational concerns that the firm has agreed to address in a reasonable timeframe; upon resolution, AH will review the firm's rating.

Real Estate Manager – Conditional Pass Rating

Manager profile

- Small, 20-person firm running several hundred million private real estate, managed in closed-end funds with multi-year lock-ups
- Privately owned, equally by employees and a large external corporate parent company

Strengths

- Appropriately leverages corporate parent, including governance structures and internal audit
- Highly diversified decision making structure
- Outsources fund administration

Risks Identified

- No use of LPAC for funds
- All commingled investment funds should have some level of independent oversight

Fixed Income Strategy – Conditional Pass Rating

Manager profile

- Large, multi-national investment firm of nearly 3000 employees.
- Managing several hundred billion, primarily in traditional strategies
- Publicly traded company
- Low trade volume strategy

Strengths

- Large, global financial services firm with operations and controls infrastructure that generally supports a firm of its profile.

Risks Identified

- Specialty strategy not subject to the same levels of control and oversight (as well as operational expertise) of firm's core business:
 - Operations analyst is also an authorized trader
 - Ability to trade with new dealers and to authorize new trading relationships without review by others.
 - Manual monitoring of guideline compliance

Some current challenges

ODD as Audit Support



- ODD has gotten broader in scope, but has it gotten better?
- Resource commitments to core versus non-core risks

Lagging Asset Classes



- Private markets standards lag
 - Internal administration
 - Limited regulation
 - Seller's market mentality

Relative Risk Assessment



- What is riskier?
 - Example: Internal administration vs. password changes
- Risk tolerance differences
 - Client or asset class

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