TRENDS IN OPERATIONAL DUE DILIGENCE

ODD BRIEF #120

Following the Path of Misleading Information in ODD

Due diligence is defined as is an investigation or audit of a potential investment or product to confirm all facts, that might include the review of financial records. Due diligence refers to the research done before entering into an agreement or a financial transaction with another party. (Investopedia)

Due diligence is the investigation or exercise of care that a reasonable business or person is expected to take before entering into an agreement or contract with another party, or an act with a certain standard of care. It can be a legal obligation, but the term will more commonly apply to voluntary investigations. A common example of due diligence in various industries is the process through which a potential acquirer evaluates a target company or its assets for an acquisition. The theory behind due diligence holds that performing this type of investigation contributes significantly to informed decision making by enhancing the amount and quality of information available to decision makers and by ensuring that this information is systematically used to deliberate on the decision at hand and all its costs, benefits, and risks. (Wikipedia)

Due diligence: law : the care that a reasonable person exercises to avoid harm to other persons or their property failed to exercise due diligence in trying to prevent the accident, business : research and analysis of a company or organization done in preparation for a business transaction (such as a corporate merger or purchase of securities). (Merriam-Webster)

Following the path to fraud and finding nothing is the first goal of conducting operational due diligence ("ODD") on any type of business. Fraud comes in various forms, ranging from outright theft, to providing inaccurate or misleading descriptions of your business and/or client base, during or even after a funding process. The second goal of ODD is identifying operational and business weaknesses. Both goals make up the PRISM ODD Program, the evidence of which is fully documented in the 50 page PRISM Green Book. The PRISM ODD Green Book is an assurance report on each hedge fund or private equity fund, providing PRISM's client with a professional and independent operational risk opinion.

In conducting investment manager operational due diligence, it is paramount to have a deep long tenured understanding of the hedge fund and/or private equity fund industries. This tailored clarity provides invaluable background that facilitates working with investment managers and their counterparties, as well as identifying and benchmarking each fund's operations. Without this understanding of the industry's evolution and culture, it can be much more difficult to make an accurate fraud or operational risk assessment. Without executive experience in general, it can be very challenging to effectively interview other executives and obtain the necessary information by interacting in a constructive board room dialogue.

Misleading information is a key trigger or flag that not a lot of people talk about. Providing even minor misleading information can lead an ODD reviewer to a negative opinion. Without proper leadership or sometimes adequate legal counsel, some managers in history have inflated their AUM, their headcount, or their projected pipeline of new client mandates in an effort to close a new client investment. Other managers have not clearly disclosed the roles of the service providers, or not adequately described the segregation of duties of back office staff, all in an effort to close new AUM. In summary, forthcoming transparency during the ODD process is a key to a lasting and productive LP/GP partnership.

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