PRISM INSIGHTS

TRENDS IN OPERATIONAL DUE DILIGENCE

Operational due diligence is changing quickly, and for the better.

Given COVID-19 and the global stay at home orders, institutional investors around the world have been amending their approach to conducting due diligence. While this is happening, investors are finding that it's time to change and update the industry's old approaches that were less efficient, and sometimes less effective.

To re-cap, there are multiple aspects to operational due diligence. There is the "operations risk assessment" which covers pre and post trade processes, regulatory compliance, and technology. This is a similar agenda to a SOC 1 Type 1 review. Then, there is the qualitative business assessment, which measures the quality of the operations and the firm's business. Finally, there is the personnel assessment, which takes into account not just credentials of investment manager personnel, but know-how, understanding of their own business, responsiveness, ethics, and professionalism. In summary, overall you can have what appears to be sound "processes" and industry standard "internal controls", but the personnel could be over worked, distracted, ineffective, or the worst case scenario they display ethical isues. The latter is the fundamental reason investors conduct ODD to begin with.

On the other side, investment managers should receive an efficient and professional ODD process from their prospective investors. Investment managers are busy with their day to day responsibilities, and yet they are honoring their time to conduct, often hundreds of ODD reviews per year to their various investors. Why the world has not yet moved to a fund pay model for an annual ODD review for the investor base, is due to a few reasons. The main driver is that there is currently a large pool of professionals who moved into the ODD space post 2008, and these people value their roles. Two, many ODD professionals say that they believe that they are the only ones who can accurately assess the "personnel" and they don't want to outsource this function. They insist that their personal opinion of a CFO or CCO is paramount to the ODD review. Another reason is that there is currently no generally acceptable ODD standards that ODD consultants can follow in conducting a fund pay ODD review. All of these factors give value to the allocator pay model.

A fund pay model would however significantly reduce operating costs of both investors and managers. With that said, Australia and Europe are leading the way on this new ODD model, and as we see the fruits of this model, the rest of the world will likely follow. During COVID-19 and until such a transition is completed, PRISM believes that we shouldn't underestimate the value of desk reviews, video meetings, data rooms, screen shares, detailed service provider confirmations, formal background checks, and numerous reference checks. Further, managers can reduce their meeting time if their FAQ/DDQ is up to date and specifically addresses industry standard due diligence queries.

> "The laws of innovation and efficiency tell us that the industry would benefit from a fund wide operational risk assessment model. The financial services industry has long depended on consultants to advise them on different risks (private equity, investment banking, fundamental research). In 2020, we should be prepared to do the same for Operational Due Diligence.

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