THE ONGOING EVOLUTION OF OPERATIONAL DUE DILIGENCE

An interview with Peter Sanchez, chief executive officer of Northern Trust Hedge Fund Services

As competition for capital grows fiercer in the hedge fund industry, every small choice a manager makes can mean the difference between winning a mandate or losing it to another manager. One area investors are scrutinizing more closely is a firm's operational side.

Peter Sanchez, chief executive officer of Northern Trust Hedge Fund Services, discusses what investors are looking for when they conduct operational due diligence on a fund. He also discusses recent legislation and how it is putting pressure on firms to comply with a host of new regulations.

What are the biggest changes to operational due diligence in the last decade? Are there particular areas of operations that investors care about more than others?

Operational due diligence has evolved considerably in the last 10 years. Thematically, we've seen changes grouped into a few broad categories:

First, operational due diligence is a lot more formal – it's no longer a "tick the box" item. Hedge fund investors now bring the same intensive, hands-on approach that large institutional investors have been employing for years with traditional managers. Ten years ago operational due diligence for a hedge fund involved a questionnaire and perhaps a phone call. Today on-site visits with both the manager and the administrator are quite common. Also, descriptions of controls are no longer enough – investors want to see controls in action through demonstrations.

Second, investors focus heavily on the issues that affect them most, particularly controls around who can move cash and the independence of valuation practices. For cash, they want to see controls that will help prevent errors and fraudulent behavior. For example, Northern Trust uses online tools, input/approval procedures that require two separate individuals to authorize a wire and a third-level review by our cash team before the wire is released. Other administrators may handle it differently, but whatever the specifics, investors want to confirm there are protections in place against operational errors or fraudulent activity.

Valuation follows a similar theme – investors want to understand the administrator's role in valuation. Is the administrator sourcing prices from vendors or using models? How much of the portfolio uses manager marks or broker quotes? What checks/controls are in place to substantiate manager marks? All these lead to the overarching question: "How do I know my investment is actually worth what my manager tells me it's worth?"

Are there any recent regulatory changes that have affected the way asset management firms must run their funds (in terms of operations and best practices)?

The litany of new regulations – FATCA, Form PF, AIFMD, EMIR and others – all place demands on managers who are otherwise seeking to reduce costs. This inherent conflict manifests itself in a few different ways.

First, managers are being forced to change their perspective of what are "acceptable" fund expenses. In the beginning, managers would attempt to support regulations in-house because they felt the pricing set by administrators was too high. Over time, they came to realize that the level of resources required to support regulatory demands – particularly the costs of attracting and retaining talent with the necessary expertise – actually make in-house support more expensive.

The fact is, regulation is adding to the baseline costs required to support a hedge fund. It raises the threshold for market entry for new fund launches, and it changes the outlook of established firms when contemplating operating budgets. At the end of the day, regulation presents a new reality, and managers who adjust their financial management/budgeting process to account for that reality are better positioned to succeed.

Second, managers are discovering that outsourcing doesn't completely eliminate the burdens of regulation. New regulations are often broadly worded, subject to interpretation and changing frequently. Moreover, a manager can outsource the work, but accountability for the accuracy of regulatory reporting remains with the manager. The result is that regulatory compliance is *always* a collaborative process, with the manager and administrator working together: What has changed? Do we need to modify our reporting methodology? Are we prepared for new regulations? How do we monitor compliance on an ongoing basis?

Finally, managers are realizing that it's all about the data. The common thread among all these new regulations is they dramatically increase the amount of data managers must produce and maintain. However, some of the most forward-thinking managers are recognizing that the value of "big data" capabilities extends far beyond meeting regulatory demands. These firms understand that those same principles – data aggregation, historical analysis, custom tagging functionality, on-demand or real-time data retrieval – can have a positive impact on their investment strategy and their operations: what we call Operational Alpha™. So managers are now starting with the question, "How do I manage my obligations?" This leads to a fundamental rethinking of operational and data needs, not only for regulatory purposes, but for how the firm uses and accesses data as part of its investment strategy.

What areas of operational due diligence don't get enough attention?

These days, I think the most savvy investors have an expansive definition of operational due diligence, and they are increasingly thorough. That said, I think there are several items addressed by best-practice investors, but overlooked more often than they should be.

The first is considering a manager's maturity level and assessing a manager's controls within that context. A firm's size and age shape the definition of "best practice" in terms of outsourcing and its operational controls. This takes an arc-like form:

- Launches and new funds under $500 million are focused on strategy, attracting capital and building a track record. They tend to have a single fund and focus on a particular strategy. Given the expense of in-house operations, they look to outsource as much of the middle and back office as they can.
- As firms grow – let's say to between $500 million and $2 billion – they add new funds and new strategies, and they find they're outgrowing the administrator they launched with. In response, they start to build internal operational capacity and in-source key functions that are close to alpha-generating decision making: collateral management, treasury optimization, regulatory reporting and the like.
- As firms grow into multi-billion "mega funds," the pendulum swings back. Now, they have multiple funds with different structures in different jurisdictions, varied regulatory requirements, multiple administrators, and dozens of broker and counterparty relationships. It's way too complex to manage effectively in-house, so we are back to the "outsource everything" concept, **except** now it's very different. The manager has built up all this expertise, and should have robust oversight and governance mechanisms in place to keep track of the administrators' activity. It's a form of co-sourcing – the administrator does the work, but the manager has oversight, transparency, governance and, ultimately, control over operations.

Sharp investors recognize this concept frames their perceptions of operational controls correspondingly: "Do the controls make sense *based on who the manager is*?"

The second overlooked aspect in due diligence is personnel. All financial firms will talk about people, process and technology, but I think due diligence is more focused on the last two items while lacking focus on the quality of the people. Process and controls are the core of operational due diligence, and technology is vital for good controls, but at the end of the day, it's people who dictate the quality of both the processes and the technology.

Increasingly, we're seeing investors who want to engage with the specific individuals who service their assets. They want to get a sense of expertise, skill levels and industry knowledge. And they're not just interested in senior management – they want to take the measure of the analysts and associates doing the day-to-day work. As a result, managers are increasingly recognizing the value of hiring administrators with high-quality people.

Finally, we have the issue of security. Press coverage of the recent Heartbleed virus reminded us of the importance of IT security. But while your standard due diligence agenda focuses heavily on operational controls, often little time is dedicated to issues like confidentiality policies, IT security, information loss prevention and business resiliency. These are key areas every investor should consider as part of operational due diligence. While we've seen a bit more attention paid to these issues than before, we're still surprised at how often we'll go through a full-day due diligence review with only minimal focus on security issues.

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