How to Conduct Effective Due Diligence:

A Best Practices Guide

CENTRL

DUE DILIGENCE PLATFORM

CENTRL is a leading third party risk and diligence platform for financial institutions worldwide. CENTRL's DD360 delivers significant efficiency improvements and enhanced risk oversight to asset owners, consultants and investment groups.

The CENTRL platform is used by the largest allocators, banks and investors across the Americas, Europe and APAC. For more information, please visit oncentrl.com/due-diligence or visit us at oncentrl.com/demo-request/ to schedule a demo.

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INTRODUCTION

In May 2021, a private equity manager at JES Global Capital in Florida was indicted on fraud and identity theft charges. According to court papers, the manager made false claims about his investors to obtain a $95 million bank loan for the $500 million fund. He also submitted a forged audit letter and fabricated bank records for a wire transfer.

Unfortunately, such fraud cases are not uncommon in the institutional investment landscape. This fact, combined with increasing financial risks and rising regulatory pressures, underscores the importance of conducting effective due diligence.

Before pursuing alternative investments, institutional investors must conduct thorough operational due diligence (ODD). ODD is also crucial for investors planning to invest in private equity or hedge funds.

This article looks at how you can conduct operational due diligence before finalizing an investment. We also provide a checklist of essential items, so you can tick all the right boxes and ensure a successful due diligence outcome.

WHAT IS OPERATIONAL DUE DILIGENCE AND WHY IS IT IMPORTANT?

Operational due diligence is an investor-initiated process for assessing the operational infrastructure of investment managers and funds to both detect and mitigate potential operational risks associated with the investment.

By conducting ODD, investors can identify any “red flags,” i.e., inadequate internal processes or controls that may indicate potentially fraudulent behaviors. They can also detect and mitigate potential operational risks associated with the potential investment before actually signing on the dotted line.

ODD is forward-looking, unlike financial due diligence that looks back over several years of past performance. So, when you perform ODD, you can assess the operations of a target investment and consider whether they will be sustainable in the future.

You can also evaluate inherent risks and opportunities and assess how value will be generated and sustained over the coming years.

Critical Elements of an Efficient and Effective Operational Due Diligence Process

ODD is an investor-initiated "buy-side" process, but it encompasses the workflows of both investors and sell-side managers.

For investors, the assessment process consists of multiple steps, including:

- Developing due diligence questionnaires (DDQs)
- Reviewing supporting documents and content
- Interviewing managers
- Managing and mitigating issues or risks
- Conducting onsite reviews

On the other side of the table, investment managers must answer multiple questionnaires that are critical components of the ODD process. They must also participate in lengthy meetings with investors conducting the ODD on the investment manager.

It's impossible to efficiently carry out the ODD at both the investor's and investment manager's end without a few key elements. These are explained below:

#1. Relevant Documents

For an efficient due diligence process, several documents and policies are required. These detailed assets should outline all the crucial information, so the investor can better understand components such as the investment manager's:

- Operational infrastructure
- Valuation policy
- Trade lifecycle
- IT infrastructure
- Compliance posture
- Firm & governance structure

It's essential to review DDQs and other documents such as marketing presentations, operational policies, standard procedures, regulatory filings (SEC ADV), and audited financial statements. These inputs help you assess whether the potential investment is viable and if it meets your company's investment criteria.

#2. Meetings

After reviewing the documents and getting an early look into the investment manager's operational infrastructure, your ODD team should conduct meetings with key personnel, including – but not limited to – the:

- Chief Financial Officer (CFO)
- Chief Operating Officer (COO)
- Chief Compliance Officer (CCO)
- Head of IT
- Other key operational staff

The objective is to understand the institutional quality of operations and operational controls, as well as the company's work environment, culture, and levels of IT security.

The COVID-19 pandemic has materially impacted onsite and face-to-face meetings. However, they remain critical to:

- Understand if staff members are qualified for their roles
- Confirm if documented operational procedures mirror actual practice
- Check if a culture of compliance exists
- Verify if written policies are correctly implemented
- Validate the adequacy of internal controls and proper segregation of duties

That's why your ODD staff must find other alternative ways (telephone, video calls) to conduct such meetings without fail.

#3. Detailed reviews and checks

In addition to studying documentation and conducting meetings, you should also review other aspects that could impact the investment decision, including:

- Ownership structure
- Key personnel and compensation structures
- Key hires and departures
- Regulatory and legal matters
- Material changes in assets under management (AUM)
- Strategic plans and objectives

Conduct detailed background checks on the investment manager and its key principals and stakeholders. Check their educational and professional backgrounds, potential conflicts of interest, any litigation, and search for negative media reports. Meetings with investment managers may not yield these insights, so it's critical to do these reviews independently.

To conduct background checks, look at sources like:

- Dow Jones Risk & Compliance system
- Regulatory websites
- Specialist investigative agency
- Industry networks
- Social media platforms

In addition, investment managers may have outsourced several operational functions, such as compliance, IT, and cybersecurity. You should assess these third-party providers and all critical vendor relationships to ensure they're qualified and performing their functions adequately and appropriately.

#4. Digitization

According to one poll, 47% of institutional investors use multiple disparate systems to process ODD activities and investments, as well as email, offline spreadsheets, and tedious manual processes. These legacy systems create a lot of chaos and confusion, add to ODD complexity, and adversely impact efficiency and effectiveness.

Manual ODD processes are not scalable, which can be problematic as your investments increase in size and frequency. They also make it harder to understand investment risks, thus increasing the chances of overlooking a critical risk that can impact your investment decision and ROI.

To eliminate all these issues, it's crucial to automate ODD processes. Here's where a solution like DD360 comes in. This modern ODD software can reduce ODD complexity with automation, analytics, centralized repositories, visual dashboards, and many other capabilities.

ODD has changed a lot since the 2008 financial crisis and more so after the 2020 COVID-19 crisis. To streamline your workflows – and ultimately make the best possible investment decisions – the automation of ODD processes is crucial.

#5. Ongoing Reviews

For a new investment, the timeframe of the ODD process depends on the number of stakeholders involved and the timeliness with which they provide the necessary information. But in general, it could take anywhere between two and three months.

It's crucial to analyze the gathered information in detail and forecast potential implications on your investment. If your investigation raises any red flags – even if the DDQ is "clean" – probe them thoroughly before making any decisions. This is essential to identify potentially nefarious behaviors, pinpoint material issues that could impact your investment, and mitigate potential risks.

The ODD should not stop after the initial diligence process is completed. You should conduct an annual review (or any time there are material changes) and investigation of:

- Updated documents
- Regulatory filings
- Audited financial statements

Now that you understand these key elements, it's helpful to understand the ODD process itself. Let's explore this next.

THE OPERATIONAL DUE DILIGENCE PROCESS AND CHECKLIST

An effective ODD process consists of these critical steps:

1. Initial Assessment of the Investment Manager's Operations

- [ ] If the investment manager's operations meet your company's standards and are appropriate for the strategy
- [ ] If there are any conflicts of interest that need to be addressed
- [ ] If any upfront capital investments are required to bring operations up to a desired level or to match a desired benchmark
- [ ] If the investment manager is appropriately staffed for their AUM and complexity
- [ ] If the organization is not using the appropriate technology and systems to support its business

The last three steps are essential to assess if operations are sustainable for the long term.

2. Document reviews to understand the operational infrastructure

- [ ] Internal procedures, controls
- [ ] Compliance posture
- [ ] Regulatory filings
- [ ] IT infrastructure
- [ ] Legal documents to understand investment terms

3. Background checks to verify references and backgrounds of key personnel

- [ ] Personnel references
- [ ] Regulatory websites
- [ ] Criminal records
- [ ] Media searches
- [ ] Legal filings

4. Service provider reviews to avoid secondary risk

- [ ] External controls reports, e.g., SSAE
- [ ] Service providers used are appropriate for the investment manager's business
- [ ] Services described by the investment manager are what's being performed in practice by the service provider

5. Onsite visits to verify internal systems and controls

- [ ] Operations and key processes
- [ ] Technology infrastructure
- [ ] Systems used to facilitate operations
- [ ] Culture

ODD approval and investment decisions both hinge on successfully completing all these activities. Based on the information gathered in Steps 1-5, you can make assessments to ensure that there are no material operational risks that could have a negative impact on your investment.

6. Ongoing monitoring

To improve the effectiveness of ODD, regularly check for, monitor, and analyze all of the following:

- [ ] Organizational structure and internal/external governance oversight
- [ ] Staff turnover
- [ ] Reputational risk
- [ ] AUM changes, capacity, and stability
- [ ] Legal and compliance processes
- [ ] Risk management processes
- [ ] Independent pricing and liquidity mismatches, if any
- [ ] Trade and reconciliation processes
- [ ] Cash management and controls
- [ ] Counterparty risk

7. Other checks

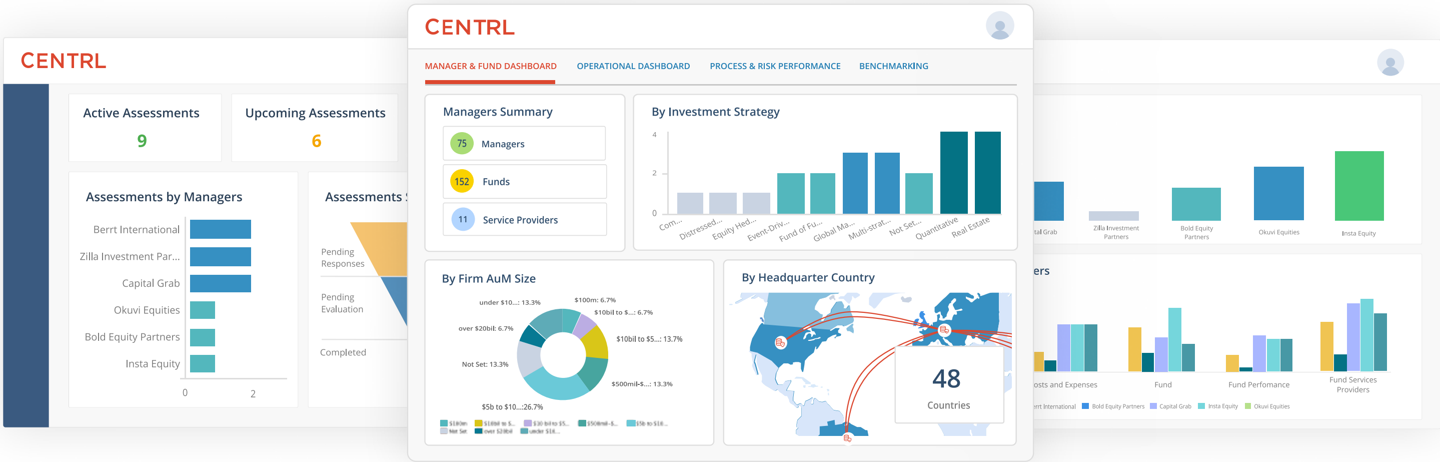
Your ODD process should also include confirming that there is an appropriate third-party administrator in place. Self-administration is no longer considered acceptable, so make sure you review the services being provided by the administrator, including reviewing their SSAE internal controls report.

Review the IT infrastructure and business continuity plan (BCP) to confirm operations run smoothly. Evaluate financial statements for at least two fiscal years. Analyze overall exposure, risk, liquidity, and critical financial ratios.

Finally, assess the level of transparency in the firm. Ask managers for a monthly risk report to better understand risk exposure. A lack of transparency usually raises red flags, which affects investor confidence. To ensure better investment decisions, it’s critical to assess if the firm is open and can sufficiently meet your reporting requirements.

Keep in mind that there’s no “typical” ODD process, so consider the steps outlined above as guideposts rather than a set of rules. You can efficiently conduct due diligence to meet your investment needs by following these steps.

EFFICIENT AND EFFECTIVE DUE DILIGENCE WITH DD360



[DD360](#) from CENTRL is a multi-party due diligence platform that simplifies due diligence for investors, fund managers, and consultants. Offering deep automation and analytics, DD360 enables you to manage all your investments and strategies from one single place.

The platform completely automates DDQ and RFI (request for information) workflows, simplifies issue generation, and auto-generates insightful reports. It brings dramatic efficiency improvements to current manual due diligence processes.

By automating due diligence, DD360 delivers benefits like:

- Access all required workflows, schedules, assignments, and clarifications from one platform
- Eliminate the need for multiple documents in non-standard formats
- Replace inefficient email-based communication with centralized communication and seamless collaboration
- Remove the possibility of human error in reporting and data entry
- Provides standard DDQs as well as proprietary templates

Leverage DD360 to configure and customize your due diligence processes for your specific needs and approvals workflows. You can automate scoring to auto-evaluate a majority of submissions and save time. The software will even help you improve audit readiness with audit trails and a centralized repository of documents, assessments, and issues.

With DD360, allocators and managers have:

- Increased efficiency by 50%+
- Enhance risk management and due diligence effectiveness
- Achieved savings of 40-90% over previous due diligence approaches

To try DD360 for yourself, request a free, no-obligation demo.

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