WRITTEN BY PAUL BANNIER

GUERNSEY APPROACH TO INCREASING OPERATIONAL DUE DILIGENCE HELPS MANAGERS STAND OUT

24 JANUARY 2018

Competition among managers for capital in the alternative investment sector has never been greater. Similarly, as fund service providers vie for business in a crowded market place, it is important for firms to stand out from the crowd, writes Paul Bannier of Icorserv, on behalf of the Guernsey Investment Fund Association.

One way in which they can do that is to consider their responses to the ever-increasing number of due diligence requests.

In the case of fund managers, the primary focus is often on investment due diligence and demonstrating to potential investors that the firm has the resources, expertise and track record to deliver positive returns to investors in a variety of market conditions. However, an essential part of the process for attracting more business, whether it be investment capital or, in the case of fund service providers, securing new administration or custody mandates, is operational due diligence (ODD). In its broadest sense in the context of alternative investments, ODD can be considered to be an investigation by the purchaser of a service into the operational factors or aspects of a company.

There is agreement that investors and fund managers seeking to appoint new or replacement service providers are carrying out more ODD than ever before, and that, in many cases, the level of due diligence is deeper than at any time in the past.

Is there a benefit to be gained by standardising the approach?

In-depth ODD can be an expensive and time-consuming process both from the perspective of firms responding to due diligence requests and those initiating the requests. In the alternatives space, some investors such as small family offices simply cannot afford, or are not resourced to carry out, ODD to the level of larger LPs such as pension funds.

Historically, many investors have used due diligence questionnaires such as those which the Alternative Investment Management Association (AIMA) makes available to its members. Jennifer Wood, Managing Director of AIMA, said that there is a benefit in increasing the standardisation, as responses with limited narrative make analysis faster and more straightforward.

From a service providers' perspective, it is time consuming to complete multiple variations of ODD. Adam Moorshead, from fund services provider JTC, says completing ODD questionnaires (and pre-ODD visit data requests) has become an everyday part of doing business as a service provider.

"So much so, that we have specialist resources committed to the task that have developed significant expertise in best practice and understanding of our counterparties requests," he said. "We have used the experience to build a library of material in order to complete questionnaires speedily and to the right standard. Much of the information requested is also used to fulfil RFPs."

However, on the flipside, there are a number of drawbacks to standardised questionnaires, particularly if not supplemented by carefully thought-out questions.

James Penney, Chairman of Guernsey-based investment manager Darwin Property Investment Management, while acknowledging the efficiency of standardised approaches, sees a risk that adopting a tick-box approach will lead to a false sense of security. Mark Simpson, Partner at Baker & McKenzie, agreed that the use of standard form due diligence checklists are simply a starting point which can then be used by the reviewer to drill down or otherwise focus on specific areas of potential weakness.

The trend towards greater standardisation of comparatives in a contrarian industry has led some to note that the opportunity to tell the 'story' behind the offering is being lost.

Clive Snowdon, founder of award-winning consultancy firm Draycliffe, finds that clients are increasingly interested in the creation of a “Company Manual” that fills the gap between the pitch book and the AIMA due diligence questionnaires.

“The Company Manual provides a roadmap to demonstrate that joined-up product, operating and governance models, which encompass all the disparate elements listed in the DDQ, have been developed by the manager,” he says.

Demonstrating the inherent understanding, insight and strength across the investment manager’s operation to ensure that investor deliverables are securely managed is not something that Draycliffe believe a checklist alone can deliver.

This leads to the question – does ODD add real value, or is it simply a ’check-box’ approach designed to give comfort to the recipient?

Undoubtedly in the past, some investors have taken the view that if other ’big-name’ investors are invested with a particular manager, or are using a particular service provider, then it must be okay for them to do the same.

However, this of course overlooks the fact that the purchaser of the service in question may have different needs and will almost certainly have a different risk tolerance.

Paul Wilkes, Group Partner and head of the Corporate and Commercial department at law firm Collas Crill, is regularly involved in establishing new alternative investment vehicles. In his view, operational matters are often an overlooked aspect in the diligence process.

"Investors will often spend a great deal of time considering track record and investment processes, but less on operational matters – it shouldn’t be missed,” he says. “All theory and no practicality is a recipe for disappointment.”

Mr Moorshead views the topics of standardisation and value from a slightly different perspective.

He suggests: “Delivering a completed ODD questionnaire to a high standard of quality with all of the appropriate backup documentation can clearly demonstrate a competitive advantage and differentiate those businesses that are well governed and take risk management seriously.”

A one-off up-front exercise or an ongoing process?

Increasingly, a pattern appears to be developing whereby due diligence is conducted not just at the selection stage of the potential relationship but on a regular basis thereafter. Such subsequent checks supplement the more usual routine oversight of the service provider and are, perhaps, understandable given the pace of technological developments within firms, as well as the mobility of skilled personnel within the industry.

Wilkes views the trend towards increased diligence as one that is not going away any time soon.

“This trend is one that, perhaps counter-intuitively, favours jurisdictions like Guernsey,” he says. “The island has a well-developed funds sector with substance on the ground to respond to requests promptly, with the depth of knowledge to meet the nuances that can often otherwise be missed with standardisation.”

This view is reiterated by Nick Hofgren of GFG Ltd, a fund manager operating out of Guernsey and London. Hofgren comments that a thorough ODD review is a good way of establishing not just which processes and controls are in place at the target firm, but also understanding the true substance and the location of that substance within it. He sees this as particularly important in a sector where outsourcing is sometimes the case on an intra-group basis within the service provider.

Hofgren further observes that different approaches can be found in the context of the due diligence undertaken by fund managers on target investments.

“In certain locations such as Cayman, the expectation is that the manager is likely to be solely responsible for the ODD and unlikely to have the administrative support of service providers with direct experience to augment the ODD processes,” he says. “Guernsey by contrast provides a services community that can augment or enhance the ODD generated by the fund manager making direct investments.”

The above is, of course, only a small part of the broader picture when considering current trends.

Of particular interest at the moment are security controls around IT platforms and an assessment of the target firm’s readiness for the General Data Protection Regulation.

Moorshead reports that he is seeing close scrutiny of the business’s arrangements, besides the obvious penetration testing and vulnerability scanning.

“We are frequently asked in-depth questions on our management of third party suppliers, incident management training and network data loss prevention controls," he says. "As a firm we must stay at the leading edge in managing our IT platform risks in order to maintain our competitive position."

As a process, ODD is relatively time-consuming and largely manual and thus expensive, particularly from the point of view of the party conducting the ODD. Notwithstanding the value that a heavily-customised ODD approach can add, it is anticipated that standardised approaches will continue to be used for some time to come. In this respect AIMA's updated due diligence questionnaire is considered by many to be the industry standard.

However, as the number of areas potentially within scope of ODD increases, those responding to ODD requests are likely to find that they have to allocate greater resources to respond appropriately to such requests, with a number of firms already undertaking internal "defensive" due diligence evaluations, not dissimilar to mock regulatory examinations. The aim of these evaluations is to identify and remediate any shortcomings before potential clients submit formal ODD requests.

It is clear that service providers based in Guernsey are well prepared to not only respond to both standard and non-standard ODD reviews, but also to support fund managers in conducting due diligence reviews on target investments – which ultimately allows fund managers to focus on their core competence of managing investors' money.

An original version of this article was first published by Hedgeweek, January 2018.

PO Box 655, St Peter Port,
Guernsey, GY1 3PN
+44 (0)1481 720071
INFO@WEAREGUERNSEY.COM