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Investor Solutions
Operational Due Diligence

FOR PROFESSIONAL CLIENTS AND, IN SWITZERLAND, FOR QUALIFIED INVESTORS ONLY

Frequently Asked Questions

The Operational Due Diligence Team at BNY Mellon Investor Solutions, LLC is dedicated to evaluating the business, operational, compliance and fund structure risks of prospective and current managers for client accounts. The Operational Due Diligence process is independent, yet complementary, to the Manager Research process, which examines investment risks.

1. What is Operational Due Diligence?

It is an evaluation of non-investment risks that can materially impact an investment manager's ability to conduct its daily functions. These risks are broadly categorized in four areas: business, compliance, operational and fund structure. ODD takes an in-depth look at these risks beyond the investment proposition to seek to identify any issues that could merit further investigation.

ODD reviews are not designed to be full scale audits or replace regulatory examinations. The team recognizes the potential strategic, reputational, financial, legal, regulatory, and fund structure risks associated with investment management activities and is committed to an evaluation, monitoring and oversight program designed to identify operational deficiencies.

2. Why is Operational Due Diligence important?

The need for operational due diligence has evolved since the financial crisis, especially with the increased number of investment manager frauds, counterparty failures, operational risk lapses, and cybersecurity threats and data breaches. The following events resulted in enhanced operational due diligence in key areas:

- Madoff exposed the need for transparency and independent verification of service providers.
- Lehman Brothers' failure exposed the need for enhanced counterparty risk management, including dual brokerage and asset segregation.
- Insider trading at The Galleon Group and SAC Capital Advisors and others exposed the need for additional forensic testing around MNPI and the use of expert networks.

Each one of these failures or crises reveals foundational gaps in key areas of a manager's operations, and the depth and sophistication of operational due diligence reviews has increased substantially as a result.

Operational due diligence provides a heightened level of review and oversight focused on factors such as valuation, compliance, trading, operations, management company and technology risks. This is integrated into the overall assessment of a manager to ensure it is not directly impacted by operational lapses, regulatory matters or reputational concerns.

3. What does the Operational Due Diligence team do?

The team takes a risk-based approach based on the operational risk profile of an advisor, structure and investment strategy. The team seeks to identify and opine on potential business and operational deficiencies that may otherwise imperil the objectives of clients across BNY Mellon Investor Solutions and BNY Mellon Wealth Management. This is achieved through an evaluation of controls, observation of certain business practices, discussions with personnel at the advisor and services provides and an evaluation of various documentation and representations provided by the Firm.

4. What is the philosophy of the team?

The ODD program is built on four pillars: transparency, consistency, infrastructure, and manager reputation. We evaluate how the four pillars are applied to the operational risks and seek evidence of their implementation. For example, a manager's compliance program should provide transparency into its key policies and procedures, have sufficient resources and infrastructure to perform its oversight and monitoring functions, have consistency across governing documents and demonstrate there are adequate processes in place to prevent reputational harm to the firm.

5. How are reviews conducted?

The team take a consistent approach to analyzing managers. While the operational risk profile for each manager may differ depending on structure, size, strategy and regulatory status, the operational standard for the internal control environment, compliance robustness and transparency remains consistent with industry best practices. Whether an investment advisor is a traditional long-only, a hedge fund or a private equity manager, the process starts with a review of the firm and fund documents. This is followed by an introductory conference call, an on-site meeting to verify the controls and systems, and finally, independent verification of service providers, assets under management and background checks. The introductory conference call is typically held prior to the on-site meeting, where the team seeks to gain an understanding of the firm's governance structure, ownership, product offerings, key personnel, service provider relationships, insurance coverage and significant changes have either occurred or are expected to occur in the near term.

At a firm level, the document review includes policies and procedures for valuations, expenses and cash controls, trade operations, compliance policies and business continuity, cybersecurity and disaster recovery plans. This assessment may be supported with background research of the firm, media searches and documentation provided by regulators. At a fund level, this includes reviewing offering memorandums, limited partnership agreements, audited financial statements, fund governance and fund structure charts.

6. Why are on-site meetings valuable?

In normal market environments, all managers must be initially reviewed on-site to obtain a rating. Among the main reasons the team conducts on-site reviews is to gauge the interaction of teams, evaluate the firm's culture, observe inconsistencies between the firm's practices and documentation, and review specific documentation and systems only available in person. The team verifies the key controls in place and assess the level of risk present in the control environment and surrounding the management firm. The team seeks distinct segregation of duties between portfolio management, asset management, trading, deal execution, operations and compliance, supported by documented operational policies and procedures. In these meetings, the team meets with the firm's principals, including, but not limited to, the Chief Operating Officer, Chief Financial Officer, General Counsel and/or Chief Compliance Officer, Head of IT, Head of Trading and their supporting teams. The team discusses the firm's control environment and seek to review those controls in practice as well as nuances with the fund's structure, terms, liquidity, expense and fee allocations, advisory boards, governance and third-party relationships. The team also discusses the firm's business model and risks associated with the future growth plans of the business, while also discussing risks associated with recent changes at the firm.

During on-site reviews, the information assessed is validated via discussions with employees, an examination of the office structure, and a review of the firm's systems and reports. The on-site validation step is critical in determining a complete assessment of the firm. Validation steps may include trade and transaction-related functions such as valuation, deal execution, best execution, trade allocations, liquidity risk, soft dollars, and trade errors; and non-trade related items such as firm risk assessments, compliance monitoring and reporting practices, code of ethics training, personal trading oversight, and disaster recovery and cybersecurity policies.

On-site meetings often reveal gaps with the manager's controls and the ODD Team will use this opportunity to recommend best practices. Simply relying on statements made by managers is not sufficient; transparency from managers and service providers, and validation of assertions, both verbal and documented, is critical for making investment decisions.

During the COVID-19 pandemic, the team has adapted to being unable to conduct on-site reviews while maintaining the same standards for the process. The four pillars of the ODD philosophy – transparency, consistency, infrastructure and manager reputation – remain unchanged and the process continues to be documented. Additional verification, sharing of documents (covered by Non-Disclosure Agreements) typically only provided on-site, targeted questions, and screen shares facilitate the review. Technology has proven to bridge the gap while keeping our high standards. While it is ideal to be on-site, as long as the ODD plan is properly conveyed and agreed upon between the parties, the rating can be effectively obtained. On-site reviews will be scheduled as soon as reasonably possible.

7. What are some red flags that are uncovered during a review?

A robust ODD process may reveal red flags signifying a potential risk to investors. The team evaluates the seriousness of identified red flags and evaluates whether there are mitigating factors. Common red flags include, but are not limited to: lack of independent oversight, poor segregation of duties between front and back-office functions, inadequate cash controls, insufficient operational and technology infrastructure to support the strategy, weak execution of compliance policies, issues in the valuation process, a history of regulatory failings, outstanding legal matters, unsatisfactory service provider engagements, material conflicts of interest, and limited cybersecurity policies.

8. What level of independent verification is performed?

Verification steps differ for traditional long-only managers and alternative investment managers. For traditional managers, the team seeks to verify assets under management and service provider relationships through publicly available information. For alternative investment managers, the team seeks direct confirmation with service providers, including prime/clearing brokers, fund administrators, custodians, depositaries, auditors, legal counsels, appraisers, valuation agents, outsourced compliance teams and outsourced back office teams. These service providers are contacted to independently verify a fund's assets under management, cash controls, extent of their business relationship with the manager, and previously cited materials and any past issues.

For private funds with less than daily liquidity, the team utilizes a third-party firm to conduct background checks on key principals upon receipt of a signed release form. The background check may include the following areas of focus: employment verification, educational degree verification, regulatory checks, bankruptcy filings, civil cases, criminal cases, and media and internet searches.

9. How are managers rated?

After undergoing a thorough internal peer review, the team rates each manager on scale of 1-4, with 4 as the highest rating indicating low risk. The ratings are determined subjectively by the team but are based on objective standards, best practices, as well as insights and perspectives related to risk factors reviewed. If a management firm receives a 1 – Deficient rating, BNY Mellon Investor Solutions will not invest with the management firm until it makes improvements that justify a higher rating. The team regularly makes best practice recommendations to managers and in some cases, requests that the manager make adjustments before an allocation is made. The team reserves the right to veto any manager.

This rating system provides BNY Mellon Investor Solutions with additional non-investment factors to consider as they complete their own manager assessments and portfolio construction.

10. How is the ODD process documented?

The ODD team has developed a proprietary report that details the risks identified during the review process. The report is shared internally with select investment, manager research, portfolio construction, legal and compliance professionals at BNY Mellon Investor Solutions.
All recommendations documented in the report are shared directly with the manager, and a response is requested from the manager on each item to see if they would consider implementing the suggested changes. An action plan is established for each manager indicating the timing for follow-ups on specific recommendations or key risks. Many of these recommendations are originally discussed with the manager on-site to explain our findings in detail, and a follow-up conference call with the manager may also occur if appropriate.

11. How frequently are managers reviewed?

Depending on the manager's risk rating, reviews are conducted within 12-24 months of the prior review date. Low risk managers will generally be reviewed within two years, while higher risk managers are reviewed annually. A significant change in operations, ownership or portfolio management may trigger an off-cycle review. The ODD review process is not a single assessment in time. It is an ongoing process, constantly evolving to address new risks and regulatory requirements. Ongoing monitoring is equally important to assess any changes that may impact the initial rating.

Conclusion

With the expansion of global regulations, more sophisticated investment processes including the use of alternative data, and, most recently, pandemics, it is critical to have a comprehensive process to ensure an investment manager is operationally sound. While operational due diligence does not prevent fraud, it can reveal potential operational failures that may put clients at risk. Operational due diligence demonstrates an adviser's fiduciary duty to its clients in conducting proper due diligence.

Having experienced professionals who can conduct such due diligence across all asset classes and evaluate the integrity and validity of a manager's operations so that the Manager Research and Portfolio Construction teams can make informed investment decisions is a distinguishing service of BNY Mellon Investor Solutions.

The value of investments can fall. Investors may not get back the amount invested.

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