An ODD perspective into the finance, middle office and compliance of an investment manager

Frank Napolitani of Constellation Advisers highlights the functions which a fund may outsource to realise cost efficiencies

Frank Napolitani
Constellation Advisers

Frank Napolitani is managing director, global head of business development and marketing at Constellation Advisers. Prior to joining Constellation Advisers, from 2015 to 2019, Napolitani was a director, national head of business development for the financial services practice at EisnerAmper LLP in New York. Prior to EisnerAmper, he served as managing director, prime brokerage sales with Concept Capital Markets, LLC, the predecessor company to Cowen Prime Services from 2008 to 2015.

Given the increasing difficulty of raising institutional capital, it is more important than ever to ensure that key, non-investment functions of an investment management firm are being managed in an efficient manner with best practices in mind. Operational Due Diligence (ODD) plays an integral role in the allocation of institutional capital. According to the *2019 JP Morgan Institutional Investor Survey* which collected responses from 227 allocators with a combined $706bn in capital invested across hedge funds globally, 33% of respondents stated that they chose not to allocate to a manager because that manager did not pass ODD. Once an investment manager has been vetoed, the odds of being reconsidered by that institutional investor are extremely low.

For an institutional allocator, ODD is the back-end of the investment process meant to hedge operational risk. The focus of ODD is to gain an understanding of an investment manager's operational infrastructure and to protect investors from potential losses resulting from operational failures in the firm. Generally, it is not just one item that will cause a manager to fail ODD, but rather a handful of violations, that when looked at in aggregate, are too risky for an ODD practitioner to disregard.

There are a number of reasons why an investment manager may be vetoed by an ODD practitioner, which may include, but not be limited to:

- Self-administered funds, self-custodied funds, using unknown or small audit firm
- Poor segregation around cash controls (e.g. at least two signatories for cash movements)
- Unwillingness to provide transparency or uncooperativeness during the ODD process
- Insufficient operational and technological infrastructure to support the fund's investment strategy
- Weak or unclear valuation policies combined with deviations of estimates of NAV, restated NAV and/or audited financial statements.
- Unsatisfactory service provider engagement during the ODD process
- Insufficient personal wealth invested in the fund
- Lack of integrity

The rising cost of operating a business coupled with increased fee pressures is driving investment management firms of all sizes to consider outsourcing or co-sourcing the non-investment functions of the firm. As such, investment managers will often choose to outsource for a combination of reasons including scalability, lack of resources and cost reduction.

Finance and accounting

This area is traditionally managed by the CFO and, depending upon the size of the firm, often staffed with financial controllers that support the finance and accounting functions of the firm and the fund(s). Given the headwinds mentioned earlier, some of these financial functions may only require 20-40 hours of monthly work and thus, not justify hiring a full-time CFO. Conversely, with a larger investment manager in the multi-billions of AuM that has a CFO in place, the firm may look to outsource their controller-level functions to gain scale and reduce costs.

Below are some key functions that a manager may choose to outsource to support the management company and fund entities:

Management company and general partner

- Maintain books and records of the entities
- Provide cash controls including entering expenses into the payment system
- Perform expense processing and bill payment
- Review and process employee expense reports
- Review vendor invoices and process them for payment
- Report quarterly financial positions/reconciliations to management
- Prepare customised quarterly financial statements and a formal financial statement package at year-end to be provided to the tax preparer

Fund accounting oversight and NAV review

- Function in a control capacity over cash movements
- Provide accruals and expense payments to the administrator of the fund
- Review the fund NAV, management fees and performance fees, as calculated by the fund administrator
- Review, prior to filing with the IRS, the fund's tax returns and K-1s as prepared by the tax preparer and/or fund administrator
- Review financial statements and provide assistance with the coordination of the annual audit process

Operations and trade support

This area is traditionally managed by the COO and/or head of operations and, depending upon the size of the firm, often staffed with dedicated middle/back office practitioners that support the fund(s) and separately managed accounts (SMAs).

Below are some key functions that a manager may choose to outsource:

- Maintain a full shadow book and records to reconcile against the fund administrator at month-end
- Maintain all connections between the Portfolio Management System (PMS) and fund administrator
- Nightly import of trades into the PMS and the prime broker(s) from the Order Management System (OMS)
- Generate internal daily portfolio and reconciliation reports (transactions, cash and positions) and compare/reconcile back to the prime broker(s)
- Trade break resolution with prime broker(s), execution broker(s) and outsourced trader(s)
- Monitor and process corporate actions and option expirations

With a larger investment manager in the multi-billions of AuM that has a CFO in place, the firm may look to outsource their controller-level functions to gain scale and reduce costs

Regulatory & compliance

Depending upon the size of an investment manager's assets, the firm may be required to register with a state or federal regulatory agency. If an investment manager is not required to register, it is still considered best practice to operate the organisation with a "culture of compliance".

This operating culture will allow the firm a smoother transition into a regulated environment when they achieve those asset levels and continue to operate their business without creating a tremendous burden on their staff.

If a manager is required to register, they must appoint a designated chief compliance officer (CCO) to oversee all of the firm's regulatory and compliance activities. There are a number of key responsibilities to managing the firm's compliance programme that the CCO is responsible for executing. Having a compliance manual and code of ethics that will accurately reflect the size and structure of the firm are key steps to building and maintaining a compliance programme.

The compliance manual will contain the firm's policies and procedures, specifically tailored to reflect the internal business practices and ongoing regulatory and compliance responsibilities of the firm, including but not limited to the following:

- General employee responsibilities (e.g. gift/business entertainment reporting, disciplinary disclosures, disclosure of outside activities, complaint reporting, etc.)
- Record-keeping requirements
- Custody requirements
- Form ADV disclosure, delivery and updates
- Proxy voting procedures
- Adherence to annual compliance review requirements
- Promotional activities (Regulation D Issues) and use of performance results
- Email retention and reviews
- Trade aggregation/allocation practices
- Insider trading and personal trading issues
- Trade errors
- Brokerage and soft dollar practices (as applicable)
- Solicitation arrangements (if applicable)
- KYC/AML policies and procedures
- Money movement controls
- Social media policies and procedures

Institutional investors have adopted the concept of outsourcing the non-investment functions outlined above, but remain keen to see an internal owner within the firm ultimately responsible for the accuracy, completeness and timeliness of the end-deliverables and the internal controls around the function. Essentially, "you can outsource the function, but you cannot outsource the responsibility".

As the investment management industry continues to evolve, managers who choose to adopt a best practices operational infrastructure will fare far better in the capital raising process than those who do not. Institutional allocators have accepted taking on investment risk, however, they will not accept operational risk, and passing ODD is the key hurdle in this process. HFM