BNY Mellon Investor Solutions

Importance of Operational Due Diligence During a Pandemic

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Financial crises have historically exposed or heightened risk in certain non-investment areas for investment managers, and the current global pandemic is no exception. COVID-19 and the remote work environment have introduced heightened risks and challenges to managers' operational controls. Smaller firms with limited resources are particularly vulnerable compared to larger firms with dedicated functional groups and top tier service providers supporting the control environment. This warrants more frequent monitoring by operational due diligence teams to assess a manager's ability to address disruptions and volatility.

Key Risks to Investment Managers

Since March 2020, the Operational Due Diligence (ODD) team at BNY Mellon Investor Solutions has conducted multiple surveys of all investment managers under coverage to monitor the impact of the pandemic on their financial stability, resources, operational processes and compliance program. Based on these surveys, we have highlighted the operational risks heightened during the pandemic below.

Business Continuity

COVID-19 required nearly all investment managers to convert to a remote working environment for an extended period. Very few managers, if any, had previously tested their business continuity plans to withstand a pandemic, creating uncertainty as to how well such plans would perform. There is a direct correlation between a manager's ability to ensure employees have the proper technology to quickly adapt procedures for remote collaboration and the manager's capacity to conduct "business as usual" to minimize disruption and the potential for operational errors. Firms had to ensure that their remote workforce was able to communicate internally, with each other, and externally, with third parties and investors. This required many firms to invest in technology and communication and provide additional hardware and software, such as monitors, cameras and other collaboration tools. IT infrastructure was needed to support a fully remote environment with the appropriate redundancies in place for mission-critical systems and data.

Managers also had to increase preventative training, use secure data rooms and perform heightened monitoring of service provider relationships during this time. Fortunately, the transition to work-from-home has not materially impacted many managers, primarily due to the technological advances of cloud-based solutions and other software-as-a-service providers. Suffice it to say that a decade ago, many managers would not be in a position to handle a remote workforce on the scale and manner that is required during a pandemic.

Financial Stability

Severe market volatility during the pandemic led to capital outflows and negative performance for many managers. Material decreases to assets under management impacts a firm's fee revenue, which can lead to cost reduction measures and employee turnover.

Consideration also needs to be given to the stability of the manager's investor base and breakeven point, which can be indicative of the firm's long-term viability. Whether an investment manager received loans through traditional banking channels or via the Paycheck Protection Program created by the U.S. Treasury and Small Business Administration in response to the pandemic also raises questions about the manager's stability. It has been reported that in excess of 1,400 registered investment advisors applied for and accepted loans via the program.[1] For those firms that received loans, it is necessary to (i) understand the rationale for obtaining the loan, (ii) confirm that the investment manager made the appropriate disclosures to investors by reviewing Form ADV filings and (iii) review the management company's budget and ownership structure to assess whether the pandemic represents a short-term financial disruption or could have an on-going impact on the ability to continue operations in the future.

Valuation

Significant market volatility stressed the valuation policies of investment managers, particularly for alternative strategies holding illiquid assets that rely on public market comparables for fair valuation. The closure of Chinese financial markets in early 2020 and the effect of circuit breakers in U.S. markets made it difficult to obtain accurate prices, and required fair valuation of marketable securities in certain instances. Managers should ensure any challenges or changes to the pricing methodology are appropriately documented and that valuation committees continue to meet regularly. Proper segregation of duties between the front and back office can reduce conflicts of interest with respect to valuation, and engaging valuation consultants and auditors to provide an external opinion represents best practice controls during periods of volatility.

Operations

Investment managers work with multiple service providers —prime brokers, administrators, custodians and others — on a daily basis. Any disruption to trading arrangements and back office operations could affect pricing, reconciliation and settlement, or trigger issues with lending counterparties, margin calls or other obligations. COVID-19 has also forced some firms to adopt new technology, such as e-signature solutions for agreements, security protocols and cash movements. Whether a firm has an in-house back office or an outsourced model, all parties involved need to ensure that any new procedures are adhered to. Independent confirmation of third-party service provider relationships has always been a critical step in the ODD diligence process. Supplementing traditional confirmations with conference calls can help to further understand the service providers' business models and any latency issues, both domestically and abroad, which can lead to operational delays or errors.

[1]Source: https://www.barrons.com/articles/more-than-1000-wealth-advisors-received-ppp-loans-51594571057

Compliance

Monitoring employees remotely raises concerns about compliance oversight and maintaining a culture of compliance. Controls around material non-public information and trade surveillance as well as procedures on personal trading and confidentiality must continue without interruption. Regulators have continued to perform exams during the pandemic, although exam formats have also been adapted to a remote environment. The U.S. Securities and Exchange Commission (SEC) reported a 71% uptick in enforcement tips, referrals and complaints between March 2020 and September 2020 versus the same time period in 2019.[2] Compliance officers need to ensure all policies and procedures continue to be followed, regulatory requirements are met and documentation is appropriately maintained. Despite the extraordinary nature of the pandemic, exceptions to existing policies could lead to deficiencies and/or enforcement actions from regulators.

Reinforcing the continued regulatory scrutiny of the investment management industry despite the pandemic, the SEC Division of Examinations (formerly the SEC Office of Compliance Inspections and Examinations) released a number of a number of risk alerts in the last several months. One risk alert highlighted the risks associated with dual-hatted chief compliance officers who do not have sufficient experience or time to spend on compliance, and the common compliance deficiencies observed where this is the case. Another risk alert emphasized the need for oversight and consistency in applying policies across a firm's branch offices.

Cybersecurity

The SEC circulated risk alerts in July 2020 warning managers of heightened cyber risks during the pandemic. The SEC's exam focus on cybersecurity will be enforced by a newly created Event and Emerging Risk Examination Team. Some managers have noted an increase in phishing attempts and other cyber incidents, particularly with some well-known service providers. With employees working remotely, many firms may be more vulnerable to attacks. Cybersecurity training and phishing tests should continue and not be delayed until teams return to the office. Investors should pay attention to a manager's information security program, including the controls in place around remote access to the manager's network and the approach to enforcing employee awareness through targeted training and penetration testing.

The increase in cybercrime forced an Australian hedge fund to close following a cyberattack in September 2020.[3] Through a fake invitation to a Zoom meeting, malware accessed the firm's email system, resulting in $8.7 million of invoices being fraudulently generated and approved. Large investor redemptions followed the attack, prompting the firm's closure in November 2020. This incident highlights the need for a strong cybersecurity infrastructure, which includes the safety and ongoing training of employees on the use and security of collaboration tools as well as the need for a robust cash control framework, particularly in a remote working environment.

2. Securities and Exchange Commission Division of Enforcement 2020 Annual Report, available at https://www.sec.gov/files/enforcement-annual-report-2020.pdf
3. "Hacked Sydney hedge fund part of $170m cybercrime spree," Financial Review, November 24, 2020.

Impact on the Operational Due Diligence Process

Pre-pandemic, ODD professionals traveled the globe to review investment managers and strategies to ensure that they were operationally sound. On-site meetings were critical to gauge team interactions and culture, demo systems, review sensitive documents and assess the physical office environment. Frequently, these on-site meetings exposed important vulnerabilities and potential risks. Amid the spread of COVID-19 and government-mandated lockdowns, investment managers across the world implemented their business continuity plans and entire organizations shifted to the unprecedented practice of working remotely. While on-site meetings stopped, investment and allocation processes across the industry continued, as did the need for ODD.

This has led to the development of a virtual ODD process, which entails hosting a series of conference calls and/or video calls with managers, key service providers and strategic relationships. Technology has proven to be critical in bridging some of the gaps created by the pandemic. Virtual ODD enables ODD teams to have more focused calls with professionals across select teams –– e.g., legal, compliance, trading, operations, technology –– rather than conducting a single marathon meeting where time with each professional is limited. Managers are accommodating these circumstances and, subject to non-disclosure agreements, are offering more transparency into documents and aspects of their business that are typically only offered on-site. For example, there may be access to a broader set of people via video conference, virtual demonstrations of proprietary systems and temporary electronic access to sensitive documents than would typically be available on-site.

Looking Ahead to a New Normal

While it's not clear how the traditional office environment will look following the pandemic, it is clear that the practice of ODD is more important than ever and will continue to evolve. Virtual ODD has introduced a new way to engage managers and increase access and productivity while dramatically reducing travel costs. Virtual ODD can also serve as an effective way to conduct recurring ODD reviews after an initial on-site meeting is conducted through screen sharing and online demonstrations of systems. However, most ODD practitioners agree that virtual ODD is no substitute for on-site meetings. These meetings are critical for reviewing sensitive documents, reviewing systems and gauging team interactions, which is especially important for new manager relationships as well as boutique and emerging managers. Once travel resumes, initial ODD should still be conducted on-site, particularly for new allocations to alternative investment managers where redemptions are limited. As business resumes in the workplace and circumstances change, we expect that COVID-19 will confirm the value in various operational protocols only previously considered and not implemented, and may ultimately reduce operational risks across the industry as a result of lessons learned.

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