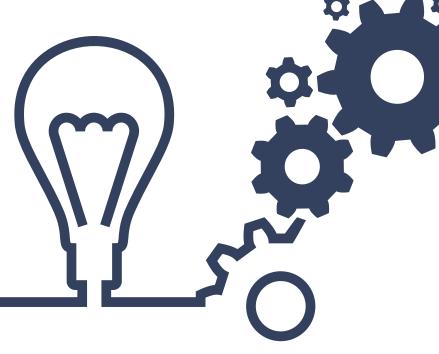
Privcap/ Conversations

THE RISE OF

Operational Due Diligence

Part of the thought leadership series: Unlocking the Power of Private Equity Data



With Expert Commentary From:

Gordon Barnes, Cambridge Associates Steven Alecia, Gen II Fund Services



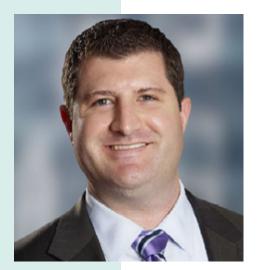
About the Experts



Steven AleciaChief Client Officer
Gen II Fund Services

Steven is a founding member of Gen II Fund Services, LLC. He has spent over twenty-six (26) years in the private equity administration industry. Steven oversees all of the client service team operations at Gen II.

Prior to founding Gen II, Steven was a Managing Director of Citi Private Equity Services, Inc., a Senior Vice President of BISYS Private Equity Fund Services, and a Partner of DML Fund Services, a pioneer in the fund services industry. Steven is a recognized leader in the field of private equity fund administration. Steven is a Certified Public Accountant and holds a BBA in accounting from Hofstra University.



Gordon BarnesHead of Business Risk Management Group
Cambridge Associates

Gordon is the Head of the Business Risk Management Group where he oversees manager operational due diligence. Gordon has been with Cambridge Associates since 2006 and brings more than 20 years of investment due diligence experience to the firm.

Prior to joining Cambridge Associates, Gordon was an alternative investment research analyst in the hedge fund-of-funds group for Kobren Insight Management. In this role, he performed due diligence on back office processes and investment strategies to identify the risks of prospective hedge fund managers. He also evaluated the procedures used by hedge fund service providers and monitored the risks of the fund-of-funds portfolio and underlying fund portfolios. In addition, he managed all operational aspects of the hedge-fund-of-funds product. Prior to this, he was a hedge fund account senior at BISYS Hedge Fund Services (formerly Hemisphere Financial Services and now Citi Fund Services). There, he performed back office accounting and administrative functions for various hedge funds. Gordon is a Chartered Alternative Investment Analyst and received his MBA from the Boston University School of Management and a BS in Business Administration and Concentration in Finance from the University of New Hampshire.

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The Rise of Operational Due Diligence

Institutional investors increasingly are focused not only on the returns generated by private equity managers, but on the soundness of the firm's infrastructure. With each passing day, it seems that the legal, regulatory and competitive environment in which private capital firms do business becomes more complex, thereby elevating the risks faced even by firms that have shown an ability to generate strong returns. This elevated awareness of risk has given rise to operational due diligence (ODD), a painstaking vetting demanded by most LPs that looks into the business integrity of private capital firms. Privcap spoke recently with two ODD experts—one a fund administrator and one the head of ODD for a major investment advisor. This report presents an edited transcript of that conversation:

Privcap: At what point in the fund commitment process does operational due diligence come into play?

Gordon Barnes, Cambridge Associates: Most of the time, it comes after we've identified a top manager who we believe has an edge. It's really about ensuring that there's an appropriate infrastructure behind that investment team. It's everything non-investment related: anything from their management structure, HR, compliance, the operational framework they have, the fund accounting, to the third-party services providers they have. [It's] that total package to understand that there's an appropriate alignment and with the complexity of what they're doing on the investment side. So, a lot of the expectations are really driven by complexity—where they invest in the world, how the fund is structured.

I'll note that a lot of people ask, "Are you guys like auditors?" It's certainly helpful to have an auditor's skillset, but auditors are looking at the

past. ODD is forward-looking. We're looking at the people, the infrastructure, the processes and controls that have been established to essentially keep the train on the track going forward.

We're sitting down with the team and understanding how they manage the business side, technology, team and processes. How do they manage regulatory risks and keep up with regulatory guidance? It's the total package of business infrastructure.

Steven Alecia, Gen II Fund Services: The scope has drastically changed in the past couple of years. Prior to that, we were just confirming to LPs or advisors that we were the administrator. Now, ODD has evolved into a much deeper dive into controls and processes and people. We've been asked to complete 40 or 50-page questionnaires, and we're asked to answer a lot more questions than simply "Are you the administrator?"

Barnes: ODD was always a big topic on the hedge

fund side. More attention is now being paid on the private equity side. There's a lot of overlap in the way you do it, but there are differences that you need to understand.

Alecia: To that point, private equity has probably lagged a bit behind hedge funds in terms of operational due diligence. We still see questionnaires that likely have been written for a hedge fund and have not been updated to reflect operations from a private equity fund perspective. We have some challenges answering hedge focused questions in a private equity context, and in some cases we simply say "N/A." However, the ODD process is definitely evolving. Recently, I am taking two or three calls a week related to private equity operational due diligence from our client and prospect base. I now devote significant time speaking to LPs and their advisors on operational due diligence. This is healthy for our industry, because it means GPs are raising capital and that LPs are ensuring that the operational side of the business meets their requirements.

Barnes: Private equity ODD has had a slower evolution than hedge funds because with hedge funds, you had the Madoff scenario. This was a large event that made a lot of people rethink their process. There hasn't been that type of event in private equity.

Privcap: Briefly, what are some of the aspects of a firm that you look into for ODD?

Barnes: Initially, we request that the manager fill out an operation to due diligence questionnaire and we have an online platform. Basically, we want to understand who the manager is, what the team structure looks like, what the entity structure looks

"We've seen CFOs who don'tunderstand fund accounting."

-Gordon Barnes, Cambridge Associates

like, what their policies are, and the strategies they have. A lot of it is about qualifying the team, the COO, the CFO, the compliance officer.

If there's a fund administrator, what exactly does the fund administrator do? We're also looking at technology. How do they send confidential information? Do they encrypt it, or do they have a portal that they release it on?

Then, understanding how they oversee their service providers. For example, on the compliance side, they may use an external compliance group. We need to understand what exactly is the role and how the back and forth works.

We don't want to waste a manager's time by asking questions that we could have read, so we try to be as prepared as possible and have a specific agenda and say, "We want to talk about X, Y and Z. We don't understand this, can you tell us more about it?"

Privcap: About how many managers are you performing ODD on per year?

Barnes: In total, it's close to about 300. A lot of those managers are ones we know and we've done work on in the past, so it's very efficient.

Privcap: How has Gen II acted to make the ODD process more efficient for its clients?

Alecia: We have taken several important steps to help our clients and the investor community become more efficient in the ODD process. We have created standard ODD packages for LPs and advisors to review, and foster regular dialogue with the

LP community. We encourage our clients to share these packages with their investors. Then, when further due diligence takes place, and understanding our clients' specific needs, we will customize these packages for their conversations with LPs. We regularly participate with them in investor calls and meetings related to ODD. For emerging manager clients, we will conduct learning sessions to educate and expertise members of the GP that many be new to private equity operations. For existing GPs, we will provide them with updates on how we are managing new and evolving LP requirements, such as producing ILPA compliant documents or the latest steps we have taken at Gen II with respect to strengthening cybersecurity and data protection. Frequently, we will receive ODD questionnaires well in advance of a closing and we work closely with our clients to answer the questions and expertise them in operational processes and procedures. We help LPs drill down on mission critical items, whether that be our SSAE 18 (SOC 1), a GP's cash controls, the separation of roles and responsibilities or business continuity.

Privcap: Gordon, where have you detected weaknesses as you've done ODDs?

Barnes: The weaknesses can be put into a few categories. The first is just a general lack of investment in the non-investment business infrastructure. Maybe they're understaffed or there are inadequate systems or compliance policies. Another one is inappropriate people for their roles. We've certainly

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come across CFOs and COOs who don't necessarily have the appropriate experience. We've seen CFOs who don't understand fund accounting. Some of these managers might have no third-party fund administrator and this person is overseeing functions like the waterfall calculation, and that's not in their wheelhouse.

Another issue may arise from complacency. There are a lot of managers that have been around for a long time and they have the attitude of, "We've always done it this way and we've never had a problem." We might

provide feedback and say, "Maybe you should engage a third party to help you out with this."

Privcap: How much can GPs do ahead of time to shorten the ODD process?

Alecia: The GP can be prepared and armed with knowledge that helps the investor understand that the private equity firm will operate at the highest standards within our industry. Knowing the LP's primary concerns around a GP's compliance structure, processes, controls, risk mitigation, protection of

investor data, and having pertinent responses will allow the GP to enable the LP to meet their fiduciary requirements more efficiently. And importantly, a GP should work closely with their compliance consultant, their fund administrator, their legal counsel and also placement agent to construct an appropriate operational due diligence package that is reviewed regularly. As our industry continues to mature and operational requirements evolve, this preparation will be vital for GPs and LPs.