



Shadmoor

operational due diligence ● operational risk

Shadmoor Advisors, Inc.: White Paper

A Roadmap for Operational Due Diligence in the Time of a Pandemic

Michael V. Merrigan, Founder, Shadmoor Advisors, Inc.

Email: info@shadmoor.com

Website: Shadmoor.com



On-Site Operational Due Diligence is No Longer an Option for at Least the Near-Term, Maybe Longer

An on-site operational due diligence (“O.D.D.”) meeting, conducted at an investment manager’s office, is universally considered an *elemental* component to a comprehensive operational due diligence process. However, over the last month, as SARS-CoV-2 (the virus) has been spreading across the Earth inflicting COVID-19 (the disease) upon millions, that elemental ritual of meeting on-site became untenable in what felt like the blink of an eye.

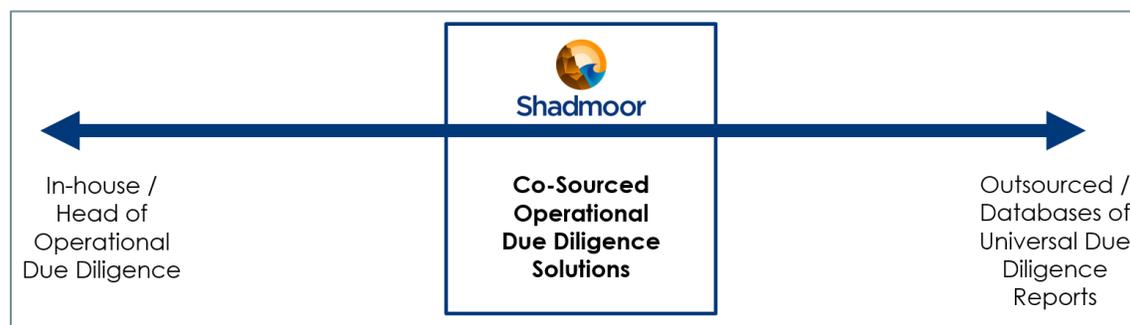
The New “New Normal”

Now that an important component of the total O.D.D. process has effectively been turned on its head, how do O.D.D. practitioners and allocators responsibly proceed with their respective roles related to investment allocation activity? The goal of this white paper is to present Shadmoor’s observations and opinions about how best to adapt operational due diligence best practices in both the near-term and the long-term in the time of a pandemic. Adapting will become especially vital if we assume that neither a vaccine, nor effective therapeutics, nor herd immunity materialize for a year or more. Within that horizon, new allocations to alternative funds will certainly be made. As a starting point, it is important to outline Shadmoor’s principles, which serve as the foundation of our approach to O.D.D.

Shadmoor’s CODE (“Co-Sourced Operational Diligence Expertise”)

Our experience has led us to develop three fundamental principles that guide the operational due diligence solutions we provide to our clients:

- Shadmoor provides co-sourced O.D.D. solutions to sophisticated investors. We believe working closely with our clients and understanding their concerns, sensitivities and risk tolerances helps foster a more constructive dialogue and leads to better investment decisions. Such an approach practically means we aim to be a more tailored and integrated part of an investor’s investment decision making process (as opposed to just a provider of O.D.D. reports available via a database whose audience is any investor).



- We aim to identify, monitor, and remediate operational risks on behalf of our clients and constructively work alongside investment managers with which our clients invest to implement best practices whenever possible.
- We believe every client that engages Shadmoor has a unique operational risk profile. Some of our clients may assign a different value or importance to certain operational risks identified by Shadmoor than other clients of ours. As a result, clients may make different remediation requests of an investment manager or make different investment decisions based on similar or identical sets of facts and circumstances related to operational risk.



Gap Analysis: 'Virtual' O.D.D. vs. 'Traditional' O.D.D.

The last bullet point of our CODE (diagram directly above) is of utmost importance because it highlights that a 'one size fits all approach' to O.D.D. does not align with the reality of Shadmoor's experience. The assumption that an investment manager can 'pass' or 'fail' O.D.D., or be assigned a green-light, yellow-light, or red-light rating assumes all investors assign the same value to a given set of operational risks. We respectfully disagree.

Yes, we do agree that O.D.D. should be comprehensive. Yes, an investment manager can exhibit a range of practices in a particular operations area and we aim to follow and implement best practices whenever possible. However, a practical approach to O.D.D. is required as one frequently works within imperfect circumstances and / or imperfect information when conducting O.D.D. A key to all good investment management decision making is understanding what operational constraints and operational risks are being assumed. Shadmoor's clients expect us to identify operational risks, within reason, by working within the constraints that each O.D.D. review presents. These constraints may include, but are not limited to: a short timeframe to complete our diligence, limited expenses for travel, the size of the client's investment, the availability of investment manager staff members, working within varying ranges of transparency provided by an investment manager and their service providers, and most recently, the inability to complete an in-person, on-site meeting related to an operational due diligence review due to a pandemic.

One may define virtual O.D.D. as the process of substituting the on-site component of the O.D.D. process and replacing it with either a telephonic conference or video conference. It is important to note that the on-site component of the O.D.D. process is important. However, from a time duration perspective, an on-site does not take up anywhere near the majority of the time it takes to complete an entire O.D.D. review from start to finish. Nor do we believe on-sites are the *most* important component of the O.D.D. process. The bulk of the time spent and work involved in the O.D.D. process should generally be focused on the *preparation* for the meetings one has with an investment manager, whether they be on-site or virtual. Managers generally provide a significant amount of documentation and O.D.D. professionals must thoroughly review such documentation prior to any manager meeting. Doing so will enable O.D.D. professionals to be prepared to discuss the most important due diligence topics with an investment manager and not just address surface level information in the limited time O.D.D. professionals may have with an investment manager. In our discussions with managers, when we asked about their experience with operational due diligence processes in general, they routinely point to a lack of "desk work" preparation as their number one complaint regarding operational due diligence professionals.

Another essential part of the operational due diligence process, which remains continuous despite the pandemic, is independent confirmation provided by an investment manager's non-affiliated, third party service providers. Depending on the structure of an investment manager's organization, confirmations can be received via written or verbal correspondence from groups, such as a fund administrator, an information technology firm (managed services provider), a cybersecurity consultant, a law firm, an auditor of a fund, a fund's counterparties, a fund's board of

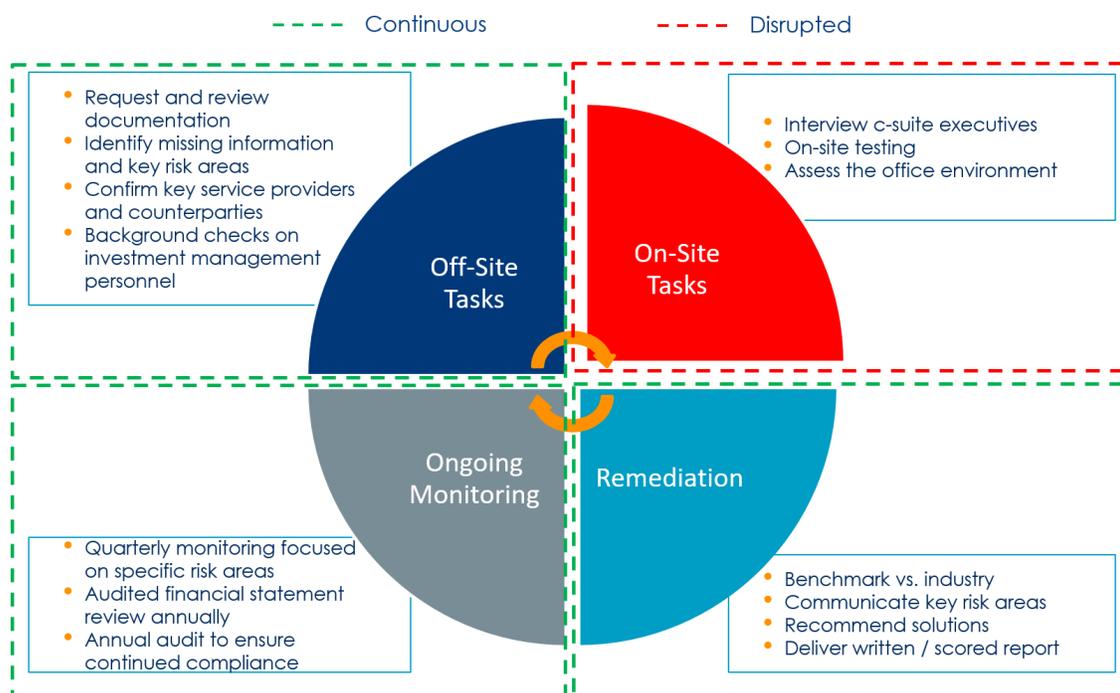


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directors, or a compliance consultant. Third-party confirmations are perhaps the most important step in a comprehensive operational due diligence process and the lack of such confirmations, especially with respect to a high-profile fraud like Madoff, may arguably be the biggest contributor to Madoff's deception and its ability to continue for so many years.

However, the above does not diminish the fact that on-site meetings have historically been an important part of the operational due diligence process (and at some point, will hopefully continue again). For now, we must adapt to the greatest extent possible and remediate as much as possible the inability to visit an investment manager on-site. In the diagram below, we have simplified the overall O.D.D. process. We have also highlighted (both directly below in writing as well as in the upper right-hand corner of the diagram) what we believe are the three most important objectives O.D.D. practitioners aim to accomplish during an O.D.D. on-site at an investment manager:

1. The ability to interview and assess the knowledge, abilities, and qualifications of key business executives that manage the 'business' or 'non-investment' side of the investment manager on a day-to-day basis.
2. The ability to complete 'testing' on-site of materials, procedures, and systems that are not readily available in a distributable electronic format and/or the manager considers to be proprietary or confidential. The amount of testing that can be completed during an on-site is dependent on an investment manager's proclivity toward transparency and their levels of concern that such data could be easily distributed outside of the firm as a result of such 'testing'.
3. The ability to assess the physical office environment via an office tour. A tour allows the O.D.D. practitioner to assess a variety of factors, including, but not limited to: how physically secure the office is, how are various employees grouped within the office, are there non-related businesses sharing office space with the investment manager, is confidential information conspicuously displayed on employees' workspaces, and is the décor of the office elaborate or frugal.





Bridging the Gap

Above we defined the gaps between virtual O.D.D. and traditional O.D.D. How have allocators / investors / consultants on one side of the table and investment managers on the other side of the table been adapting to bridge the gap that has been created due to the pandemic? We have already noticed a welcome anecdotal shift which evidences that some investment managers are willing to go further than they have previously to bridge the gap with respect to greater transparency. For example, investment managers have willingly made themselves available via telephonic conference and video conference for longer periods of time. Availability of investment manager personnel in general seems more open and flexible as most of them are working from home and their days (although likely busier than ever) may be less rigidly scheduled as in-person meetings have been eliminated.

In terms of documentation, our most recent experience is that investment managers have been increasingly open to sharing documentation remotely and electronically (such as compliance manuals) that were previously only shared in-person during an on-site meeting. Investment managers have adopted technology to help with transparency, utilizing tools such as a computer's shared screen functionality or utilizing the added security of an online data portal with strong access controls related to the virtual viewing of electronic files. Separately, managers may begin to increase the use of or expand the comprehensiveness of non-disclosure agreements in exchange for providing an extraordinary level of transparency compared to what was typical in the pre-pandemic environment.

Finally, we have yet to see any meaningful example of a proxy for how to assess an investment manager's office environment virtually. There could be value in conducting a virtual tour of the investment manager's office via video, similar to residential real estate web sites. Such a practice, in conjunction with receiving diagrams of the investment manager's office layout, could help provide operational due diligence professionals and investors with a visual understanding of the manager's physical space.

We have provided a few of our predictions (both realistic and perhaps unrealistic) in the Appendix section at the end of this document.

Rise of the Virtual Investment Manager

While it may seem that virtual O.D.D. snuck up on us, it's important to note that the evolution of the investment management industry due to the impact of technology has been evolving for quite some time. Now, more than ever, especially on the emerging manager front, O.D.D. teams are reviewing emerging managers with a smaller physical footprint, geographically dispersed personnel /offices, fewer staff members, less IT infrastructure on-site, and alternative workspaces such as shared space accommodations. In addition, many emerging managers have outsourced their operations functions to third-party service providers. Separately, well-established managers with a global presence can also pose challenges, as operations staff and processes can be spread across multiple offices globally and visits to every 'operations-related' office by operational due diligence professionals would be financially burdensome and not feasible.

The concept of an increasingly 'virtual' investment manager is here, and as a group, their growth is likely to continue as pressure on investment manager-related fees continues. This could lead to more outsourcing to third parties of many operations-related services which have historically been performed by an investment manager's own employees (e.g., fund administrator, middle office, treasury, back office, IT, cybersecurity), with an appropriate level of oversight continuing at the investment manager.

While we have entered a new global environment due to the pandemic, some of these virtual O.D.D. conundrums that we feel we are facing for the first time more recently have actually been growing in quantity and frequency for



years. The difference is that now is the first time these virtual O.D.D. issues have presented across all O.D.D. reviews, regardless of a specific investment manager's profile.

Less than Ideal, more than Sufficient, Can Equal Acceptable

Even when an on-site O.D.D. was considered the ideal option, information transparency from one investment manager to another investment manager was never perfect and never identical. The on-site experiences themselves were never perfect either and what could be extracted from those visits could vary significantly based on size of the investment manager, size of the potential investment, capacity of the strategy, the subject fund being open or closed to additional capital, availability of key investment management personnel on the day of the on-site visit, etc. We live in an imperfect world where we must work within less than ideal circumstances to complete our objectives. During this time of pandemic, others inside and outside of our industry have made compromises in order to adapt. In many cases, but not all, it will make sense for O.D.D. practitioners to do the same. For example, within the investment industry, in March 2020, the SEC's Office of Compliance Inspections and Examinations (OCIE) stated, "In light of health and safety concerns and other circumstances, OCIE has moved to conducting examinations off-site through correspondence, unless it is absolutely necessary to be on-site." In the healthcare industry, we've witnessed tremendous growth in the use of 'telemedicine'. Something that really was entirely uncommon, and certainly not preferred, as recently as a month ago.

Is Virtual O.D.D. Appropriate for Your Next O.D.D. Review?

We advise our clients to take a risk-based approach, guided by their unique operational risk profile, and the totality of the facts and circumstances related to a specific investment opportunity's many attributes when considering their O.D.D. process. Within the context of Shadmoor's CODE philosophy, Shadmoor is confident that in many cases (but not all), virtual O.D.D. can serve a consequential and vital role as one of the many inputs of the mosaic that determine an investment decision.

Appendix: Back to the Future or a Brave New World?

Whenever our lives are severely disrupted by (largely or entirely) unexpected circumstances, we have the freedom, more than ever, to ponder what shifts may occur temporarily, and which shifts may be permanent going forward. In the spirit of that sentiment, we present below our predictions (from the obvious to the outrageous) as to how O.D.D. may change during a pandemic that exists longer than our current expected time frame of one to one and half years (which is the widely reported estimated period of time for a safe and effective vaccine to be developed).

[Please see the following page.]

Pandemic Duration	Due Diligence Prediction
<p style="text-align: center;">Near Term</p> 	Manager's openness to longer calls and videoconferences
	Manager's increased transparency through screen sharing with respect to systems and documentation testing
	Manager's focus on cyber security due to remote work force
	End of the handshake (I'm advocating for a salute)
	Face masks worn in the office
	Temperature checks before entering the office
	Rotating shifts of employees in the office to maintain appropriate social distancing within the office environment
	Employees that are identified as more vulnerable to Coronavirus (COVID-19) will be less inclined to work on-site
	Wrist watches that warn when employees are less than six feet apart from each other and can track who they came in close contact with on a historical basis
	More detailed and frequent non-disclosure agreements in exchange for greater transparency virtually
	Manager office layout diagrams, virtual office tours, to help experience the physical layout of an office if an on-site is not permissible
	Increased use of O.D.D. reference checks, as opposed to I.D.D. related reference checks
	Less on-sites related to ongoing monitoring (i.e., existing investments) for O.D.D.
	<p style="text-align: center;">Long Term</p>
	Increased frequency and broadening of 'bad actor clauses' in fund terms to provide more assurance to investors that they can redeem under extraordinary circumstances beyond traditional 'key person' clauses

Thanks for your time and interest. We are wishing you, your loved ones, and colleagues health and safety as we navigate these uncertain times. We look forward to hearing from you.



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