

# SPARK - Preparing for ODD



## 1. Introduction

Operational Due Diligence (“ODD”) is an important part of the investor allocation process. Typically, an ODD team will have the right to “veto” an investment into an external manager. The ODD process will involve a desktop review of documents collected in advance, onsite visit(s)<sup>1</sup>, and follow up verifications. ODD professionals from institutional investors will expect a robust control environment even in small and emerging managers; although there will be recognition that controls may look different in small versus large managers.

This SPARK<sup>2</sup> memo outlines how managers can best prepare for institutional investor ODD and includes:

- **Before the Meeting:** Documentation requests and the level of detail required.
- **During the Meeting:** Time required, who should attend, system and process walkthroughs and office tours.
- **After the Meeting:** Background checks, service provider verification and additional follow ups.

ODD teams at different institutional investors may have different priorities and as such may ask for differing levels of documentation or ask different questions; however, this memo should help provide the basis for preparation for most due diligence meetings.

There may be some instances where a small or emerging manager is not able to provide some of the required documentation or information. Some of these instances are detailed below along with advice on how to provide the investor with comfort that controls are still in place.

### New Fund Launches or SMAs

For a new fund launch or a separately managed account (SMA), some of the documentation required (such as audited financial statements) or historical information (such as AUM or investor concentration over time) may not be available, and as such cannot be provided to the investor. In these cases, asset managers may be able to:

- Provide information from another fund structure that has a similar strategy – this will likely be the case where an SMA is being constructed mirroring a commingled fund strategy,
- Where an offering memorandum has not yet been finalised for a new launch, be prepared to share a draft version with the investor (this may result in receiving useful feedback or identifying any issues that could cause roadblocks at an early stage),
- Provide dates for the expected release of any outstanding documents and commit to providing these to the investor as soon as they are available, or

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<sup>1</sup> During Covid-19 onsite visits have been replaced with video conference meetings but the same principles apply.

<sup>2</sup> SPARK is the SBAI's Programme for small and emerging managers.

- For independent verification items such as ATRs<sup>3</sup> or audited financial statements, allow investors to verify the engagement of reputable providers directly or through review of engagement letters or contracts.

#### Data a Manager Cannot or Does Not Disclose:

Managers must be as transparent as possible with institutional investors during the due diligence process. Any information that will not be disclosed during this process should be for a valid reason. There may be information that a manager cannot legally disclose or is unwilling to disclose. Examples of this may be things such as employee diversity data or price sensitive data where the manager is linked to a listed company. In these cases, the manager should do the following things rather than simply state the information is not disclosed.

- Clearly explain the reason this cannot be disclosed. Note that if this is information that many managers are willing to share, investors will expect a strong reason why it cannot be shared in this case, for example a legal prohibition on collecting the data, and
- Provide other information that will help the investor gain comfort on the controls that are in place. For example, if you cannot disclose employee diversity data (perhaps due to regulatory restrictions) you can talk about any diversity initiatives that are in place, or if you cannot disclose other information, talk about how it is collected or monitored and the control procedures in place.

## 2. Before the Meeting

#### Documentation:

ODD teams will ask for documents to be made available in advance of the meeting. Where this is not possible, the investor should be made aware of the reason why and the document should be made available for review onsite<sup>4</sup>. Documents requested will include but not be limited to:

- DDQs for the Investment Manager, Strategy and Fund,
- Organisational Diagrams,
- Fund Governing Documents - Offering Memorandums, Articles of Association, Investment Management Agreement, Limited Partnership Agreements etc.,
- Marketing Presentations,
- Compliance Manual and Policy Documents including Valuation, Trade Allocation, AML, Best Execution, Soft Dollars (US), Research (Europe), Personal Account Dealing, Gifts & Entertainment, Expense Allocation, and Responsible Investment amongst others,
- SOC 1 or SOC 2 reporting, or equivalent (if available), and
- Other materials relating to the fund and firm including operational documentation and trade flow diagrams.

It is key for investors to be able to fully understand processes as described in policies, documents such as operating procedures or workflow diagrams will be useful to assist with this.

#### Level of Detail:

There are many data points that an ODD team will need to collate to form a view of the manager's business and operations. Providing information in advance of the meeting allows for a more meaningful

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<sup>3</sup> Administrator Transparency Reports: <https://www.sbai.org/toolbox/atr/>

<sup>4</sup> Onsite review should be a last resort and documents should be provided in advance of the meeting wherever possible

conversation during onsite visits and allows the ODD team to gain a better understanding of the firm and the fund before the meeting.

The information may be requested in investor DDQs, questions in meetings or general requests for information. The key point is to ensure that the data:

- Is provided in as granular a form as possible,
- Where possible, is provided alongside the prior year's information for comparison purposes, and
- Is provided in advance of the meeting unless there is a valid reason not to do so.

Appendix A provides an overview of the types of data that may be requested, and the level of detail required in the response.

### 3. During the Meeting

Each institutional investor may have their own style of ODD meetings; however, there are some common themes that managers should be prepared for:

- **Time Required:** ODD teams may want to spend a significant amount of time in onsite meetings, this may be over the course of one day or split into several shorter meetings. Managers should be prepared to allow investors to spend this time getting comfortable with the firm and its operations.
- **Personnel:** Senior individuals responsible for functions such as operations, compliance and technology will need to be made available. ODD teams may also speak with other individuals to discuss processes in detail with the people who complete them on a day-to-day basis.
- **Walkthroughs:** Investors will typically want to see system and process walkthroughs. These may include trade lifecycle, reconciliations, NAV packs and cash control processes. Where possible viewing the live system and recent activities in walkthroughs will always be preferable. Since the onset of the Covid-19 pandemic, virtual meetings and walkthroughs have become common and some element of this will likely remain once employees begin to return to offices. The same walkthroughs that would be provided onsite will be expected virtually.
- **Office Tours:** ODD teams will want to complete office tours. This aids with confirming items such as the number of staff, where teams sit in relation to each other, and that any parts of the business that should be behind information barriers<sup>5</sup> are appropriately segregated.

### 4. After the Meeting

The ODD process does not finish with the meeting. There will be several other verifications that may take place post the meeting.

- **Background Checks:** In some cases, this may occur before the meeting, but these are typically completed by all institutional investors on key individuals such as significant risk takers in the portfolio and those with ultimate responsibility for cash transfers and operational processes. Refusing permission for a background check could be a serious red flag for investors. Background checks are typically detailed and include verification of education and employment history, searches of legal and regulatory filings, and reviews of media references to the firm and individuals. Managers should ensure to disclose to investors, in advance, any items they expect to show up in a background check.

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<sup>5</sup> This may include teams that receive non-public information (e.g., deal teams), affiliated broker dealers or portfolio management teams that are not subject to a firm wide restricted trading list.

- **Service Provider Verification:** ODD professionals will typically want to speak to service providers such as the fund's administrator or directors to independently verify information provided by the manager. Being denied access to service providers will be a significant red flag.
- **Additional Follow Up:** There will likely be follow up questions post the meeting; managers should respond to these requests in a prompt and detailed manner.

### Ongoing Monitoring

Once an investment has been approved the due diligence process does not end. ODD teams generally wish to keep up to date with any material changes that the manager has made to its operational frameworks. Some ODD teams may require regular reporting of certain information or annual questionnaires, but all will complete ongoing monitoring meetings at intervals determined by each investor. Ongoing monitoring will require most of the same information and documents that are detailed above.

## Appendix A – Level of Detail for Requested Information

The information below may be requested through investor DDQs, email requests or during the due diligence meetings (or some combination of all three). The below provides a guide on the level of detail that will be expected when responding to these requests. The information below is split into two sections: Firm Information and Fund Information.

Much of this data will be required to not only understand the current situation, but also to be able to compare it to prior years. Wherever possible data should be provided for the current period and the same data for the prior year. Where there is less than a year's worth of data the prior reference point can be different but should still be provided.

### A1: Firm Level Information

In addition to the data shown in the tables below, DDQs and investor questions will also touch on other areas and investors will expect to be provided with full transparency. This list is not exhaustive and the SBAI recommends that managers maintain a list of questions asked during due diligence meetings to be able to answer them effectively in future meetings.

- Any legal matters (new and pending) with a summary explanation. This should also highlight any reputational issues such as sexual harassment claims and the like,
- Whether the firm has any affiliates that may pose a potential conflict of interest (for example an affiliated broker dealer),
- Details on any use of soft dollars (US) or research budgets (Europe),
- Details of insurance coverage such as errors and omissions and cyber insurance,
- Details on any MNPI<sup>6</sup> controls in place for use of expert networks, company meetings, research consultants, alternative data, or equivalents,
- Information on cyber security such as controls, training, and phishing campaigns.

#### Corporate Entities:

Entity Name	Domicile	Purpose	Ownership
<i>XYZ Holding Company Ltd</i>	<i>Cayman</i>	<i>Management Company</i>	<i>85% Jane Doe (CIO) 15% Joe Bloggs (COO)</i>

<sup>6</sup> Material Non Public Information or "Inside Information"

XYZ Capital Ltd	UK	Investment Manager	100% XYZ Holding Company Ltd
XYZ Fund A GP LP	Delaware	General Partner to XYZ Fund A	100% XYZ Holding Company Ltd

Offices:

Location	Headcount (Current)	Headcount (Prior Year)	Functions
London	12	10	Head Office, Investment Management, Operations, Compliance
Paris	2	2	Investor Relations
New York	8	7	Investment Management, Operations, Compliance

Employees:

Function	Headcount (Current)	Headcount (Prior Year)	Responsible Senior Executive
Portfolio Management	5	9	CIO – Jane Doe
Trading	2	2	Head of Trading – Sarah Jones
Research	2	1	CIO – Jane Doe
Risk	2	2	CRO – Dwayne Jones
Operations	3	2	COO – Joe Bloggs (COO in prior year was Jim Smith)
Middle Office	2	2	COO – Joe Bloggs (COO in prior year was Jim Smith)
Compliance	3	2	CCO – Sarah Green
IT	2	2	CTO – Bob Smith and CISO – Lucy Taylor
Investor Relations	4	3	CIO – Jane Doe
Administration	1	1	COO – Joe Bloggs (COO in prior year was Jim Smith)
<b>Total</b>	<b>24</b>	<b>24</b>	

Investors should also be provided with details of staff turnover that may not be obvious from the net figures above, and more detailed information should be provided on senior departures. For initial due diligence, the details should cover the last five years at a minimum (or since launch if the firm has been operating for less than five years).

Committees:

In a smaller firm these functions may all be considered in one committee (for example a management committee), in this case the manager should make clear which functions are formally governed via this committee.

Committee	Formal?*	Frequency	Members
Management	Yes	Quarterly	CIO, CRO, COO and CCO
Valuation	Yes	Monthly	COO, Head of Operations, CCO
Risk	Yes	Monthly	CRO, CIO, CCO
Operations	No	Monthly	COO, CCO, Head of Operations
Investment	No	Weekly	CIO, CRO, CCO

Best Execution	Yes	Quarterly	As part of Management Committee
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\*Formal means the meetings have minutes been kept.

AUM as at [DATE]:

	AUM (USD) - Current	AUM (USD) – Prior Year
Firm	5 bn	5 bn
Strategy 1	1.5 bn	1.5 bn
- Fund 1	- 1 bn	- 1 bn
o Offshore	o 750 m	o 750 m
o Onshore	o 250 m	o 250 m
- Fund 2	- 300 m	- 300 m
- SMAs (2)	- 200 m	- 200 m
Strategy 2	3.5 bn	3.5 bn
- Fund 1	- 3 bn	- 3 bn
- Fund 2	- 400 m	- 400 m
- SMAs (1)	- 100 m	- 100 m

Breakdown Target strategy to granular detail (i.e., individual entities including feeders)

Investors:

Concentration:

	% of Firm AUM Current	% of Fund AUM* Current	% of Firm AUM Prior Year	% of Fund AUM* Prior Year
Largest Investor	3%	10%	3%	10%
Top 3 Investors	19%	33%	19%	33%
Top 5 Investors	26%	45%	26%	45%
Top 10 Investors	65%	70%	65%	70%
Total Number of Investors	35	20	35	20

\*Complete for Target Fund

Type:

	% of Firm AUM Current	% of Fund AUM* Current	% of Firm AUM Prior Year	% of Fund AUM* Prior Year
Public Pension	5%	5%	5%	5%
Corporate Pension	10%	10%	10%	10%
Fund of Funds	5%	5%	5%	5%
Sovereign Wealth Fund	15%	15%	15%	15%
Family Office	35%	35%	35%	35%
Employees/Partners	30%	30%	30%	30%

\*Complete for Target Fund

**Geography:**

	<b>% of Firm AUM Current</b>	<b>% of Fund AUM* Current</b>	<b>% of Firm AUM Prior Year</b>	<b>% of Fund AUM* Prior Year</b>
<i>North America</i>	<i>60%</i>	<i>60%</i>	<i>60%</i>	<i>60%</i>
<i>Europe</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>
<i>Asia</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>	<i>15%</i>
<i>Middle East</i>	<i>10%</i>	<i>10%</i>	<i>10%</i>	<i>10%</i>

*\*Complete for Target Fund*

**Regulators:**

<b>Entity Name</b>	<b>Regulator</b>	<b>Licence/Registration Type</b>	<b>Date Registered</b>
<i>XYZ Capital Ltd</i>	<i>FCA</i>	<i>Authorised</i>	<i>DD MMM YY</i>
<i>XYZ Capital Ltd</i>	<i>SEC</i>	<i>RIA/ERA/Exempt (include reason for exemption)</i>	<i>DD MMM YY</i>
<i>XYZ Capital Ltd</i>	<i>NFA/CFTC</i>	<i>Exempt Commodity Pool Operator (exemption 4.13)</i>	<i>DD MMM YY</i>

Investors will also look for details of regulatory examinations<sup>7</sup>

**Firm Level Service Providers:**

<b>Type</b>	<b>Firm</b>	<b>Functions engaged for</b>	<b>Date Engaged</b>
<i>IT Consultant</i>	<i>XXXXX</i>	<i>Hardware, helpdesk, network monitoring</i>	<i>MMM YY</i>
<i>Compliance Consultant</i>	<i>XXXX</i>	<i>Ad hoc Reviews and SEC Mock Audits</i>	<i>MMM YY</i>
<i>Accountant</i>	<i>XXXX</i>	<i>Management Company Accounts</i>	<i>MMM YY</i>
<i>Auditor</i>	<i>XXXX</i>	<i>Management Company Audit</i>	<i>MMM YY</i>
<i>Cyber Security Consultant</i>	<i>XXXX</i>	<i>Incident response, penetration testing, network monitoring</i>	<i>MMM YY</i>

**Systems and Functions:**

With the information below ensure to include details of whether the system is a proprietary or vendor system.

<b>Function</b>	<b>System</b>
<i>Trade Execution</i>	<i>Name</i>
<i>Trade Capture</i>	<i>Name</i>
<i>Trade Affirmation</i>	<i>Name</i>
<i>Reconciliations</i>	<i>Name</i>

<sup>7</sup> There may be some jurisdictions where disclosure of details is not possible. Please refer to the SBAI's Alternative Investment Standards for guidance on this disclosure: <https://www.sbai.org/standards/> (Standard 1.6)

<i>Collateral Management</i>	<i>Name</i>
<i>Shadow NAV Accounting</i>	<i>Name</i>
<i>Fund Expense Payments</i>	<i>Name</i>
<i>Pre-Trade Compliance Restrictions</i>	<i>Name</i>
<i>Post-Trade Compliance Restrictions</i>	<i>Name</i>
<i>Risk Management</i>	<i>Name</i>
<i>Compliance monitoring and reporting</i>	<i>Name</i>

## A2: Fund/Strategy Level Information

In addition to the information in the tables below, there will be other areas discussed during ODD. The below list is an example of some topics and as per above, managers may want to keep record of questions asked during due diligence meetings to better prepare for future meetings:

- Any legal matters matter related to the fund (new and pending) including a summary.
- Information on the Fund's Governing Body including biographies, dates of engagement and whether they are fully independent from the manager and its service providers. This should also include detail on the frequency of board meetings and whether they are held in person or not.
- Details on any NAV restatements for the Fund and whether there have been any qualified opinions in the audited financial statements.

Fund Terms from Fund Governing Documents:

	<b>Fund Terms</b>
<b>Fund Legal Name</b>	<i>XYZ Fund A LP</i>
<b>Domicile</b>	<i>Delaware</i>
<b>Date of Documents</b>	<i>DD MMM YYYY</i>
<b>Liquidity Terms</b>	<i>Subscriptions – 1<sup>st</sup> of Month (3 Business Days' Notice) Redemptions – Quarterly (90 Business Days' Notice)</i>
<b>Management Fee</b>	<i>Class A – 1.5% pa Class B – 2.0% pa Accrued and crystallised monthly</i>
<b>Performance/Incentive Fee</b>	<i>Class A – 15% Class B – 20% Crystallises Annually (31 Dec) Series of Shares</i>
<b>Gate</b>	<i>Yes At Directors discretion for redemptions over 25% Four dealing period Sunset (max one year to get full capital returned) No priority to prior redeemers</i>
<b>Side Pockets</b>	<i>Allowed at Director's Discretion Standard fees charged</i>
<b>Payment in Kind/In Specie Redemptions</b>	<i>Allowed at Director's Discretion</i>
<b>Costs allowed</b>	<i>Admin, Audit, Custody, Trading, Research, Data, Trading, Legal, Directors, Technology</i>

Side Letters:

	Number of Side Letters
<b>Total</b>	9
<b>Offering Preferential Fees</b>	3
<b>Offering Preferential Liquidity</b>	0
<b>Offering Enhanced Transparency</b>	0

Total Expense Ratio as at [DATE]:<sup>8</sup>

This table should be provided for both the current year and the prior year to allow for comparison.

Expense Category	Expense Type	Bps
<i>Management Fee</i>		150bps
<i>Operating Expenses</i>		18bps
	<i>Admin Fees</i>	9bps
	<i>Custody Fees</i>	3bps
	<i>Directors Fees</i>	2bps
	<i>Audit Fees</i>	1bp
	<i>Legal Costs</i>	3bps
<i>Compensation Passthrough</i>		0bps
<b>Non-Trading Costs</b>		<b>168bps</b>
<i>Direct Research Costs</i>		9bps
<i>Soft Dollar Research Costs</i>		0bps
<i>Data Charges</i>		3bps
<i>Trading Costs</i>		150bps
<b>Total TER</b>		<b>330bps</b>

Counterparty Exposure:

Provider Type	Name	Exposure as % of NAV Current	Exposure as % of NAV Prior Year
<i>Custodian</i>	<i>Name</i>	40%	30%
<i>Prime Broker 1</i>	<i>Name</i>	30%	40%
<i>Prime Broker 2</i>	<i>Name</i>	30%	30%
<i>FCM</i>	<i>Name</i>	0%	0%

Unencumbered/Excess Cash:

Counterparty	Cash Held as	% of NAV Current	% of NAV Prior Year
<i>Counterparty A</i>	<i>US T-Bills</i>	25%	25%
<i>Counterparty B</i>	<i>Cash</i>	5%	5%
<i>Counterparty C</i>	<i>Cash</i>	2%	2%
<b>Definition of Excess/Unencumbered Cash</b>	<i>Cash held above margin requirements.</i>		

<sup>8</sup> See separate [SBAI Toolbox Memo on Standardised TERs](#)

	<i>Cash held above margin requirements plus available borrowing</i>		
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Fund Service Providers:

<b>Provider Type</b>	<b>Name</b>	<b>Services Engaged</b>	<b>Engaged since inception?</b>
<i>Administrator</i>	<i>Name</i>	<i>NAV Production, Valuation Agent, Middle &amp; Back Office Services</i>	<i>Yes</i>
<i>Auditor</i>	<i>Name</i>	<i>Interim and Year End Financial Statements</i>	<i>No – since Jun 2017</i>
<i>Third Party Pricing Agent</i>	<i>Name</i>	<i>Quarterly valuations of illiquid assets (range of values)</i>	<i>Yes</i>
<i>Depository</i>	<i>Name</i>		<i>Yes</i>

Asset Classes Traded:

<b>Asset Classes</b>	<b>Pricing Source</b>	<b>Added in past 12 months?</b>
<i>Equities</i>	<i>Bloomberg and Reuters</i>	<i>No</i>
<i>CFDs</i>	<i>Bloomberg and Reuters</i>	<i>No</i>
<i>OTC Options</i>	<i>Broker Quotes</i>	<i>No</i>
<i>Listed Options</i>	<i>Bloomberg and Reuters</i>	<i>No</i>
<i>CLOs</i>	<i>IHS Markit</i>	<i>Yes – added MMMM YY</i>

Level 3 Assets in Fund as at [DATE]:

This table should be provided for both the current period and the prior year.

<b>Security Type</b>	<b>% of Portfolio</b>	<b>USD Value</b>	<b>Pricing Basis</b>
<i>Private Placement</i>	<i>1%</i>	<i>USD 750,000</i>	<i>Cost</i>
<i>Private Placement</i>	<i>2%</i>	<i>USD 1,500,000</i>	<i>Cost adjusted for last funding round</i>
<i>Distressed Bond</i>	<i>1%</i>	<i>USD 750,000</i>	<i>Third Party Valuation (Range of Values)</i>

Number of Individual Line Items for prior 4 quarters:

<b>Quarter End</b>	<b>No. of Line Items</b>
<i>Q4 2020</i>	<i>29</i>
<i>Q3 2020</i>	<i>31</i>
<i>Q2 2020</i>	<i>30</i>
<i>Q1 2020</i>	<i>28</i>

Average Trading Volumes:

	<b>Frequency</b>	<b>Trading Volumes Current</b>	<b>Trading Volumes Prior Year</b>
<b>Firm</b>	<i>Weekly</i>	<i>60</i>	<i>60</i>
<b>Fund</b>	<i>Weekly</i>	<i>10</i>	<i>10</i>

Trade Errors in Past 12 Months (Firm):

<b>Date</b>	<b>Incident Type</b>	<b>Gain/Loss</b>
<i>Month Year</i>	<i>Buy instead of Sell</i>	<i>Loss – USD 9,500</i>
<i>Month Year</i>	<i>Incorrect FX Hedge</i>	<i>Gain – USD 500</i>

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The SBAI Toolbox is an additional aid to complement the SBAI's standard-setting activities. While alternative investment fund managers sign up to the Alternative Investment Standards on a comply-or-explain basis, the SBAI Toolbox materials serve as a guide only and are not formally part of the Standards or a prescriptive template.