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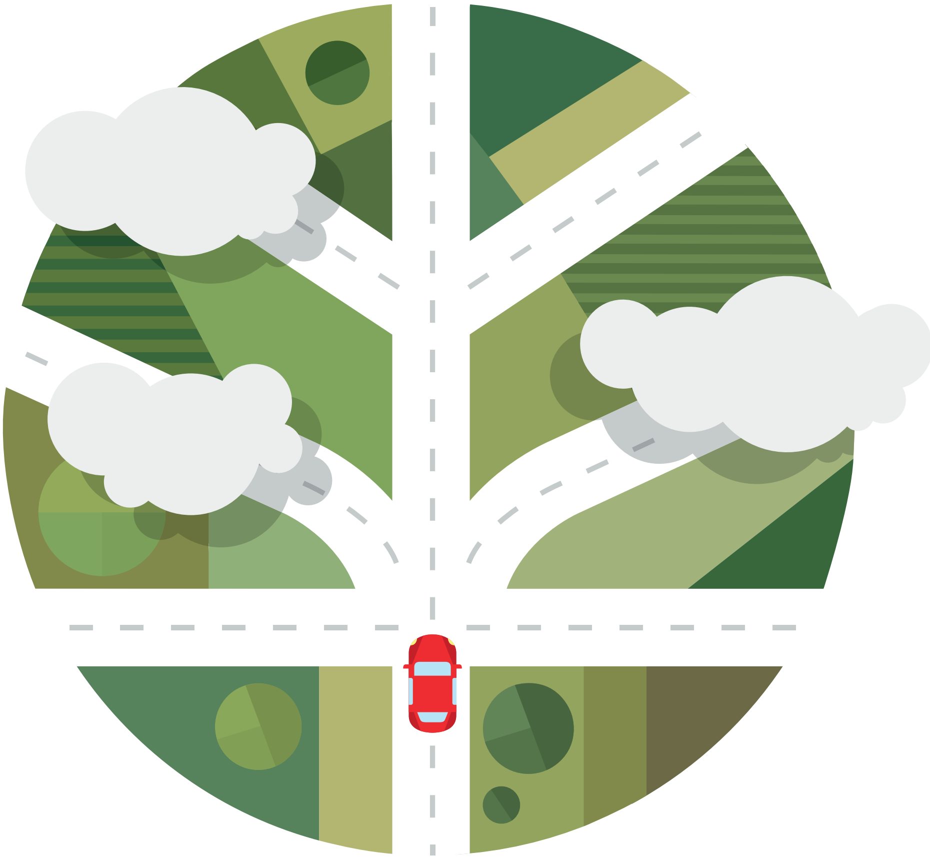

Where to from here? Operational due diligence of outsourced investment management in Australia matures.

In this article Deloitte Assurance and Advisory's **Philip Hope** and **Mark Archer** outline the realities of operational risk, the risks themselves, and the regulator's expectations.

Operational risk is typically defined as a failure of people, processes, and systems.
There are numerous potential opportunities for an operational breakdown within an investment management company, as in any business. Although definitions vary slightly, for us operational due diligence (ODD) refers to an analysis of an investment manager's operational capabilities, and infrastructure's ability to support the investment thesis.

The purpose of the analysis is to identify the levels of operational risk within the investment management company. The ODD process needs to review qualitative aspects of an investment management company — such as organisational structure, personnel, governance, policies and processes, business continuity planning, and service provider monitoring.

ODD considers the risk of loss stemming from issues related to middle and back-office functions. Such losses could be incurred from issues such as an incorrect valuation of a fund's investment portfolio, poor business continuity processes resulting in potential loss of trading capabilities, or poor monitoring of cash movements. ODD also considers the cultural aspects of a firm, including incentivisation structures, as well as risk management and compliance reporting processes, to ensure adequate transparency across the end-to-end operations of the fund manager's organisation.

Historically, investment due diligence has been the main focus when looking at making an investment decision or when reviewing existing investments.

2008 / 2009

A focus on the performance returns drove a large majority of investors throughout the late twentieth century. This attitude changed somewhat due to a number of high profile events in 2008–2009.

2015

In 2015, two industry bodies—the Australian Institute of Superannuation Trustees (AIST), which represents Responsible Superannuation Entities (RSEs), and the Financial Services Council (FSC), which represents fund managers and RSEs in the retail superannuation space — each convened a working group of representatives to develop an ODD guidance note.

These working groups were developed in response to APRA's disclosure of its expectations of RSEs in relation to ODD on investment management companies and, in particular, its article published in 2014.

2016

In 2016, AIST published its first version of the ODD guidance note, with a revised version published in February 2017 following stakeholder feedback.

The AIST guidance note covers nine distinct aspects of an investment management company to be considered by an ODD review.
It reinforces APRA's view that 'appropriate attention must be given to operational risk policies and processes, but also to the risk culture within an investment management organisation.'

The AIST guidance note promotes the 'manager-engaged' model, with the obligation for the cost burden of ODD reviews to be carried by the fund manager as a prerequisite for a superannuation fund to allocate, continue, or renew a mandate with that fund manager.

The manager-engaged model was chosen by AIST in order to achieve some degree of scale in the industry with fund managers able to provide copies of outsourced ODD reviews to multiple superannuation RSEs, rather than having each RSE undertake its own ODD review.

The AIST guidance note observes that 'the ODD review process must be conducted by an appropriately qualified, reputable, competent firm that is independent of the investment manager/ product', and notes that 'APRA expects that any RSE relying on the ODD conducted will need to be satisfied of the skill and independence of the firm conducting the ODD.'

Emphasising that the ODD review process is 'not a 'tick the box' exercise,' AIST notes that it expects the ODD provider will express 'an independent validation of the investment manager's attestation regarding its policies and practices, and that the ODD review process will include a mix of desktop policy reviews, questionnaires and detailed on-site due diligence.'

AIST Guidance: Operational Due Diligence review needs to consider the criteria in the following nine key principles

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1 **Organisation Structure**
The opinion should be whether the organisation's structure is fit for purpose and whether any risks have been identified leading to concern that the structure cannot support the investment management process. Specifically focus on the risk culture to ensure that this message is set from the top and permeates the organisation appropriately.

2 **Personnel**
The opinion should be based on the appropriateness of capability of all relevant staff, the number of staff involved in various functions, the level of responsibility held, and the quality of and adherence to the policies that support the personnel.

3 **Governance (including risk management, compliance and related party issues)**
The opinion should be based on the appropriateness of the risk management framework and ensuring that all associated compliance practices are adequate with the right risks being captured, monitored and reported, and that there is an appropriate, proactive risk culture.

4 **Trading Processes and Operational Functions (including the ability to identify individual assets, settlement and confirmations, trade allocation processes, reconciliations, segregation of duties and registration of assets)**
The opinion should also be based on the appropriateness of the operating model employed, specifically assessing transparency, robustness and effectiveness.

5 **Valuations**
The opinion should be based on the appropriateness of the valuation process, specifically assessing transparency, robustness and effectiveness at mitigating or removing the risk of errors in the valuation process.

6 **IT Systems and Security**
The opinion should be based on the appropriateness of the IT systems and security within the organisation, specifically assessing whether they are robust, sufficient and fit for purpose for the investment management strategies offered by the investment manager.

7 **Business Continuity and Disaster Recovery**
The opinion should be based on whether the ODD provider believes that the investment manager has an adequate BCP that is appropriately tested and maintained to ameliorate any concern for an RSE.

8 **Service Provider Oversight**
The opinion should be based on whether the ODD provider believes the investment manager has appropriately outsourced any material services and the extent to which these are documented and managed. The ODD provider should identify any key issues of relevance for an RSE in any agreements and key service terms between the investment manager and any relevant outsourced service provider.

9 **Reporting**
The opinion should be based on whether the ODD provider believes the investment manager can provide accurate and adequate reporting to an RSE in a timely manner, such that inter alia the RSE can meet its reporting obligations to APRA and any other regulator as well as meeting its own reporting requirements.

The expectation is that the investment manager will provide the ODD report to the RSEs for assessment and align to its their own risk appetite.
The publication of the ODD guidance note raises the bar for the Australian investment market, with a maturing ODD model a positive step toward more thorough due diligence and alignment with the regulatory developments of our global peers. AIST will have a continuing role to play in the space with future iterations of the guidance note predicted to capture changes to expectations, perspectives, and analysis in the market.

It is possible that the current framework will evolve into a two-model system: manager-engaged versus RSE-engaged ODD reviews. Some of the larger Australian RSEs will continue to undertake their own ODD analysis and will use the information provided by the manager-engaged ODD reviews to supplement their assessment process.

The ODD Australian framework has potential regional and international reach
Where there are less developed Asian markets, the ODD approach adopted in Australia may drive due diligence or investment expectations across Asia, particularly given Asia Region Funds Passport (an initiative to facilitate the cross-border marketing of managed funds across participating economies in the Asia region).

For global fund managers, the introduction of Australian market ODD obligations will bring us closer to the market standards and expectations currently in place in the US and UK.

Where a super fund RSE may have mandates with internationally-based fund managers, the ODD expectations will remain in place but will likely be at least partially met by existing regulatory obligations in their local market, in particular in the US and UK.

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