Jefferies

Jefferies Prime Services

Jack-of-all-Reads

A newsletter for multi-hat-wearing C-suite leaders and their key constituents.

Spotlight on Operational Due Diligence – Insights from the ODD Community

Our newsletter, *Jack-of-all-Reads,* shares the latest and greatest insights in a brief read on a monthly basis. Please let us know of any comments or questions – we welcome and appreciate your continued partnership.

Industry Insights: In recent months, the bank failures at Silicon Valley Bank (SVB) and Signature Bank, the collapse of crypto exchange FTX, and continued liquidity concerns across the banking system has brought heightened attention to operational due diligence across industries. These events have had a ripple effect on our industry, and are prompting managers and investors to re-evaluate current practices. We spoke with ODD teams, clients, and service providers to better understand how firms are responding, and discover what newly raised expectations there may be for managers going forward.

1. **Reassessing the Redundancy, Contingencies, and Quality of Counterparties.** Many of the ODD teams we spoke with cited that the future of cash management will be based on redundancies, contingencies, and higher quality counterparties. Firms are reconsidering their approach to cash management and counterparty selection. Safety of assets and operational efficiency are at the top of the list when assessing and reassessing custodians and banking partners. What does this mean for managers?
    - **Making Sure There's a Plan B… to Z.** There is increased emphasis on diversifying where assets are held. Firms need to ensure that they can sustain operations and fulfill payroll obligations, even if they don't have access to one or more bank accounts. Having a strong contingency plan is becoming essential as a result.
    - **Key Considerations Include**:
        - Where are you holding cash?
        - What kind of sweeps do you have?

> *"This is an opportunity to rethink segregation of assets, diversification of assets, and to pay more attention to underlying balance sheets out there"*
>
> **James Newman, perfORM**

2. **Actionable Manager Responses.** Many fund managers have bank accounts with institutions whose ratings have recently decreased. Although contagion risk appears to have been contained in the near-term, the perception of this risk has remained high. If this had occurred during a subscription/redemption period, it is likely the consequences could have been far more severe. How are managers responding?
    - **Moving Assets.** Several fund managers who have accounts at impacted regional banks are choosing to open new accounts with banks that are considered "Too Big to Fail," when feasible. This is posing a challenge for smaller and mid-sized hedge funds who are struggling to meet the requirements of such large players. However, there are viable alternatives available– *please reach out to our team if you'd like to discuss these options further.*
    - **Diversifying Number of Counterparties.** The concept of diversification and counterparty risk has been critical to the hedge fund industry, but has been historically less emphasized in the private markets. Groups are encouraged to reach out to their vendors and perform continuous due diligence on these relationships to see where risk may be.

> *"This calls for increased diversification of banking relationships"*
>
> **Chris Addy, Castle Hall**

3. **Forward Looking Views from ODD Teams.** While most groups were not concerned about direct fund exposure to SVB or Signature Bank, many inquired about exposure through underlying private investments, if relevant to the strategy. Moving forward, it is likely ODD teams will place heightened importance on manager vendor selection and counterparty relationships. Insights from the conversations existing and prospective LP's are having with their managers on operational focus areas include:
    - **Would you bank somewhere deemed junk?** There have been a diverse range of views –some teams are denying manager requests to transfer money into banks that have been in the headlines, and are asking for alternative accounts. Others are taking a wait and see approach, and increasing communication with their managers in the meantime. In most cases, investors are hesitant to wire money through a low-quality financial institution, but broadly investors plan to conduct more comprehensive research on the vendor relationships and bank accounts being used by their managers, beyond what has been customary in the past.
    - **Whose money are you managing?** This recent situation may serve as a helpful reminder to asset managers of whose assets they are managing. Managers have a fiduciary duty to adhere to institutional standards if they intend to retain and attract new institutional capital.

> *"Asset managers / GPs need to be more conscious of whose money it is – it belongs to the investors"*
>
> **Chris Addy, Castle Hall**

4. **SEC Regulations Still Top of Mind.** Regardless of headline news, the SEC is still actively regulating the alternatives industry. Both managers and investors have been concentrating on the following proposals while navigating increased counterparty diligence:
    - **Off-Channel Communications.** Managers, notably at some of the larger funds, are becoming more proactive in finding best practices for personal device usage and business messaging.
        - **Potential Solutions?** Firms have begun implementing new workflow solutions, such as switching to two phones, enabling Zoom chat archiving capabilities, and applying Global Relay to Whatsapp.
    - **Custody Rule.** Amid bank account transfers and new account relationships, managers are reminded to adhere to the SEC Custody Rule if switching counterparties.
    - **The New Marketing Rule.** This is still an area of concern for most groups since the rule went into place in November of last year. Managers are encouraged to remain conscious of their marketing materials and the regulations as some additional guidance is brought to light.

Please reach out to your Jefferies contact for more information on any of the topics above.

Client Corner:
Why your competitors are raising capital faster than you are. The path to raising and retaining assets can be challenging during a period of transition and competitive environment, but not impossible. We examined the strategic considerations necessary to build more enduring asset bases and LP pipelines, and compiled this work into our latest piece, **Capital Raising in a Transition**. *Contact your Jefferies salesperson for access to this piece and to learn more about latest capital raising trends.*

Interesting Service Provider Reads: Highlighting Topical Content From Industry Leaders

Seward and Kissel – Off-Channel Communications: Action Items for Advisers
Agio – 5 Best Practices to Prepare Your Firm for New Cybersecurity & Compliance Regulations in 2023
Sidley – Implications of Silicon Valley Bank Closure
EisnerAmper - How Leaders Can Diversify Lending/Banking Relationships
Haynes & Boone – Silicon Valley Bank and Signature Bank: Dealing with the FDIC Powers in Receivership and Bridge Bank Scenarios

Jefferies Prime Services Contacts:

Mark Aldoroty
Head of Jefferies Prime Services
maldoroty@jefferies.com
Erin Shea
Head of Business Consulting
eshea@jefferies.com
Barsam Lakani
Head of Sales for Prime Services
blakani@jefferies.com

Leor Shapiro
Head of Capital Intelligence
lshapiro@jefferies.com
Shannon Murphy
Head of Strategic Content
shannon.murphy@jefferies.com
Paul Covello
Global Head of Outsourced Trading
pcovello@jefferies.com