

## DUE DILIGENCE MATTERS - MAY 2022

Our flexible **Allocator On-Demand ODD**, **Investment Manager ODD Therapy**, and **Service Provider ODD** work continues cross asset class, from long only, hedge, crypto, private equity and credit. We are delighted to be welcoming two ODD practitioners to the team in the coming weeks ahead.

We are now considered a **leader in the field of crypto ODD**, with a large and very fast-growing coverage of Investment Managers and Funds, plus Virtual Asset Service Providers (Exchanges, Custodians, Lenders). Our clients include Investment Managers, Family Offices, Multi Family Offices, Private Banks, Wealth Managers, Fund of Funds and Sports Teams. Please contact [us](#) to discuss our wide asset class coverage and accessing our ODD Reports.

Please click [here](#) to register for the Thalès Capital Agora crypto strategies institutional investor conference (virtual) on 17th May where perFORM, Co-Head, James Newman will speaking on a panel covering institutionalising crypto assets.

### DeFi

2022 has seen a significant increase in interest in the digital asset world of decentralised finance ("DeFi"), with perFORM carrying out several fund and service provider reviews to date. DeFi is a fascinating concept, enabling the provision of financial products and services for digital assets, without the need to rely on intermediaries. DeFi is based on "smart contracts", which are programs stored on a blockchain that run when predetermined conditions are met. Common examples of DeFi strategies employed by digital asset hedge fund include 'yield farming', where a fund generates interest income and rewards through borrowing and lending activities, or 'liquidity provision' where a fund can deposit digital assets to a decentralised exchange (DEX) liquidity pool and earn a share of the generated fees and rewards.

DeFi is an emerging technology with a unique and developing risk profile. One of the most significant risks in our view is smart contract risk, which arises when there are errors or

bugs in the smart contract code. These can be exploited by hackers to inflict large unrecoverable losses to investors, or have unintended consequences, such as inadvertently not allowing withdrawals. Another significant concern is financial crime risk, which arises from the fact that DeFi projects are permissionless meaning there are few, if any, AML/KYC checks carried on participants. As a result, it is possible for a fund's 'KYC'd' assets to interact with the proceeds of criminal activity. Whilst this is technically also the case for centralised digital asset exchanges, many of these have invested in AML/KYC compliance processes to be in line with FATF standards. The reputational risk for hedge fund managers of allocating to DeFi programs found to be associated with illicit activity could be significant.

In carrying out its reviews perFORM is working closely with industry participants to encourage mitigation of these risks, through implementation of robust processes and controls.



## INSIGHTS, THOUGHTS AND OBSERVATIONS

### ODD Blog: #2

Nearly twenty years ago, two US journalists, Arvielund and Ocrant, published separate articles questioning the legitimacy of Madoff Securities, an investment business run by Bernard L. Madoff. The articles suggested the returns apparently being generated via US options trading were far too good to be true.

Seven years later Madoff was arrested and charged with running the largest Ponzi scheme in American history. Nine years later still, the 24,000 private and institutional investors in the scheme started getting (some of) their money back.

When Madoff was asked why a 2006 US Securities and Exchange Commission investigation had not then uncovered the \$12bn-\$20bn fraud, he replied that the SEC had not asked the right questions: "I was astonished. They never even looked at my stock records."

### Investor Protection

Asking the right questions, and in a timely manner, is key to perFORM's ODD process, particularly when it comes to investor protection, where we normally think about safeguarding assets from malpractices and mitigating the likelihood of reputational damage.

It is not just the investment manager and its fund(s) that are subject to extensive investigation, but also their service providers: custodians, administrators, and in the case of crypto, the digital asset exchanges, custodians and lenders.

Prior to investing, allocators are looking to confirm that what they see is what they get. In other words, that the investment manager is not saying one thing and doing another.

This is increasingly important now that ESG considerations and the associated reputational risks, have come to the fore. No investor wants to trumpet green credentials only to find that the portfolio in which they are invested contains skeletons in the closet, for example, old-style industrial polluters or firms with questionable business practices.

*"Morningstar has removed more than 1,200 'sustainable' funds with a combined \$1.4trn in assets from its European sustainable investment list after closely examining disclosures provided to investors such as prospectuses and annual reports."* Financial Times - 14 February 2022.

ESG due diligence can be broadly categorised at the highest level in two ways:

1. ESG / impact investment considerations
2. ESG at an operating business level

Typically, perFORM looks at the latter, and this very broadly encompasses the environmental practices of the firm (such as sustainability and energy use), the social practices (such as pay, diversity, gender, whistleblowing policies, board and ownership diversity) and governance (employee related litigation, complaints record, policies, tone from the top, staff turnover).

The cost of carrying out ODD is very low compared with the potential risks and financial implications of not doing it. ODD has become a key component of the investment process and the value of the assurance derived from detailed research cannot be understated. Unlike regulatory investigation (as in the case of Madoff), ODD reviews take place in advance of committing capital, typically followed by an annual monitoring programme.

As the US financial journalist, Jane Bryant Quinn, who focuses on investor protection, pointed out: *"Hindsight is not a strategy."*

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# perFORM

## DUE DILIGENCE SERVICES

perFORM Due Diligence Services Limited is an award-winning provider of operational due diligence services for a diverse base of UK and international Allocators and Investment Managers.

Launched in 2019 as the only London-based and technology-led ODD service of its kind, perFORM is a growing team of highly experienced ODD practitioners

with a laser-like focus on client service which ensures high levels of client satisfaction, trust and partnership. In October 2021, perFORM announced it had been formed as a subsidiary company of [JTC Group PLC](#), an award-winning provider of fund, corporate and private client services.