ESTABLISHING YOUR CDP – COVID-19 DILIGENCE PLAN

DILIGENCEEXCHANGE

CASTLEHALL

The Due Diligence Company

MEETING AN UNPRECEDENTED CHALLENGE

To state the obvious, the Covid-19 novel coronavirus has rapidly become the most serious global public health crisis since the Spanish Flu epidemic of 1918, more than a century ago.

What should investors and asset managers do in such a rapidly changing crisis situation? Clearly, due diligence as usual is not on the agenda. Equally, investors are typically fiduciaries and are often regulated. Putting all diligence on hold is, therefore, not an option – clients, plan members and beneficiaries expect investing entities to manage risks and protect their interests, especially at a time of crisis.

Castle Hall recommends that investors create a Covid-19 Diligence Plan – a "CDP". A CDP creates a framework for a logical, consistent and evidenced process to monitor capital allocated to third party asset managers. We recommend a five step process:

1. Establish the framework for your CDP
2. Level 1 Due Diligence: Covid-19 Status Report
3. Level 2 Due Diligence: Covid-19 Review
4. Establish a Covid-19 manager monitoring program
5. Expand your CDP to consider next level risks

Castle Hall has moved quickly to provide new sources of information on Covid, and build new diligence solutions – including a free DiligenceExchange Covid-19 Status Report.

Above all, we're all in this together: this is a time when everyone in the asset management community can collaborate to share ideas and best practices. Working together, we can help protect our colleagues and their families, and support our businesses across the industry.

The Castle Hall Team.

DILIGENCEEXCHANGE

For **investors**, operational due diligence is now a structured and consistent discipline, applied to all external managers and all asset classes.

For **investment managers**, more investors conducting more due diligence more frequently means higher costs - and an inherently duplicative process.

Before we had all heard of Coronavirus and Covid-19, Castle Hall had already been working to solve this problem and create a win-win for both investors and managers. For investors, our online portal, DiligenceHub, provides consistent, validated due diligence, available for every manager and fund in a portfolio. For investment managers, Castle Hall saves time by enabling the manager to work with our diligence team on behalf of multiple investors, reducing the costs of duplicative due diligence.

At this time of industry need, Castle Hall has elected to make our DiligenceExchange Covid-19 Status Report available free of charge.

Castle Hall's standardized Covid-19 Status Report is designed to be practical and informative. Castle Hall clients will reach out to managers in their portfolios and request responses to be provided through an online portal.

Managers are also free to complete the questionnaire and distribute the responses to their own investors – again free of charge. Importantly, any distribution of information is controlled by you as the investment manager – Castle Hall will not share confidential information with investors without your permission (Castle Hall does not operate an "open access" database).

It is our expectation that the scope of DiligenceExchange data will increase over the coming weeks: once more, both investors and managers will be able to complete, review and distribute industry standard information free of charge.

Please contact Castle Hall at solutions@castlehalldiligence.com to learn more.

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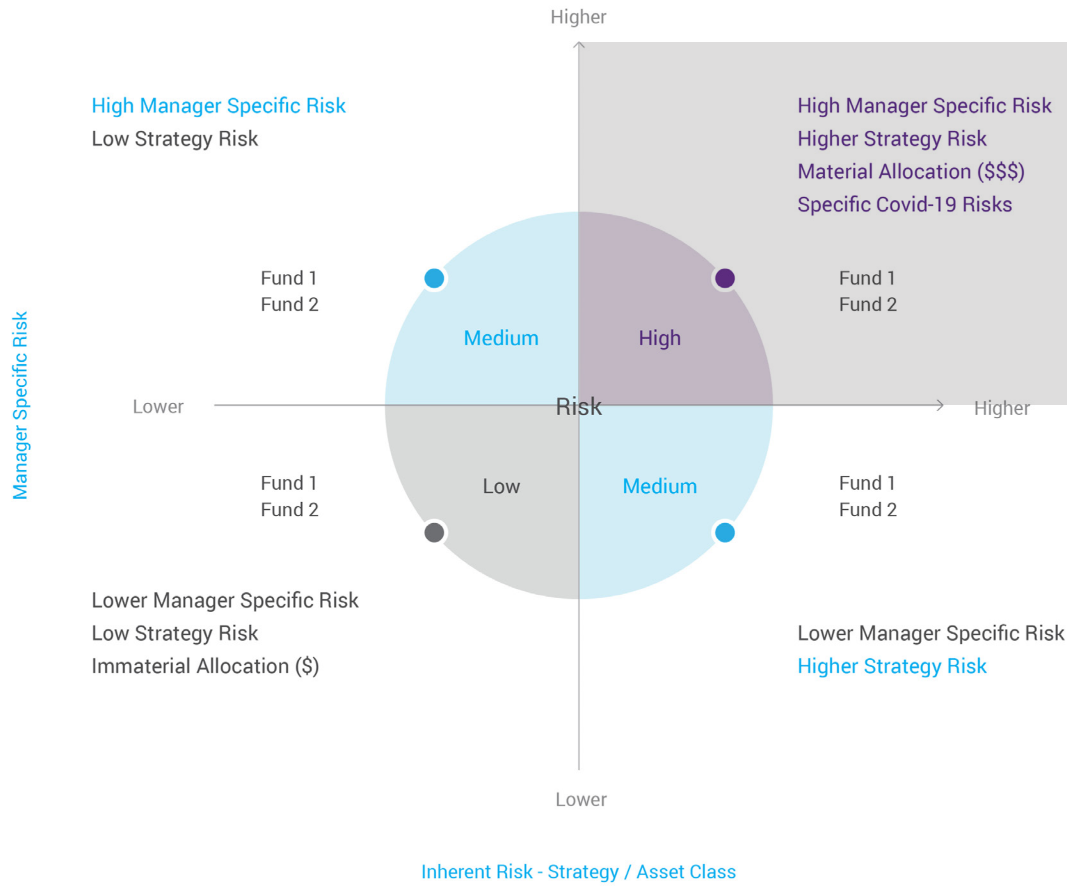
ESTABLISH THE FRAMEWORK FOR YOUR COVID-19 DILIGENCE PLAN (“CDP”)

In normal times, many investors have established a Due Diligence Policy to guide the work of their due diligence teams. Castle Hall’s 2018 white paper on developing a DD policy stated: ***“Internal and external stakeholders now see a DD Policy as best practice to establish a consistent, evidenced and auditable diligence process across all external manager relationships. When drafted effectively, a policy document guides daily activities, and equally provides a longer-term, strategic framework to oversee the inherent risks of a third-party manager investment program.”***

These are, however, not normal times. Clearly, due diligence needs to be redirected to gathering actionable information to monitor external asset managers and underlying assets in the context of the Covid-19 crisis. But, the core principles of the DD policy – that the process be consistent, evidenced and auditable – remain valid, especially for fiduciaries and regulated entities. We recommend the following steps:

- Review your regulatory obligations, if any.
- Review your obligations as a fiduciary to your clients, if applicable.
- Do you have potential liquidity needs? If so, you may wish to prioritize those funds and accounts which could be available to provide liquidity. Equally, any restrictions around fund liquidity such as gates, side pockets or suspension of redemptions may be a key risk area.
- Establish the baseline diligence information needed around all asset managers. (Level 1)
- Adopt a risk based framework for deeper dive and follow up due diligence: (Level 2)
    - Consider the amount allocated to external managers – clearly, deeper dive diligence will likely be required to prioritize managers with higher allocations.
    - Consider the size of the manager – larger managers are likely to have more resources to respond to Covid-19, but larger teams may be more likely to have colleagues impacted by the virus.
    - Consider the strategy: certain strategies may be more exposed to interruptions at the asset manager level or across markets as a whole. Highly levered strategies dependent on PB financing may be exposed to drawdowns falling through NAV triggers. Strategies such as private lending may be exposed to challenging valuation questions.
    - Respond to manager specific information (eg. operational problems at that firm identified during Level 1 diligence).

While developed to help investors design their ongoing monitoring program, Castle Hall's Risk Quadrant remains relevant to help stratify the portfolio when creating the CDP:



- Establish an ongoing monitoring program:
  - Core monitoring should continue, including review of Form ADV (Castle Hall's free DiligenceExpress service supports investors in this key task).
  - Media monitoring, as discussed further below, is critical.
  - Review of audited financial statements will be key: do the accounts, when issued, have new Covid-19 disclosures, are they qualified – or are even issued on a timely basis?
  - There may be opportunities to deploy capital for hedging strategies or to allocate to managers who bring forward opportunities to buy distressed assets. As such, full scope diligence will be required, even if diligence will now be conducted remotely via conference call and screenshare inspection of key documents.
- What "new" diligence should be adopted? Read on....

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LEVEL 1 DUE DILIGENCE: COVID-19 STATUS REPORT

An effective CDP will enable investors to gather sufficient, timely Covid-19 information on all external managers in a portfolio, across all asset classes. Completeness of diligence is critical – especially if acting as a fiduciary, investors should gather baseline information on ALL managers to whom capital is deployed.

A careful balance is required: in this time of crisis, it is not reasonable to ask an intrusive and extensively detailed list of questions. Managers will likely not have time to complete exhaustive and endless DDQs at this time and, in any case, detailed questions could be superseded by events very quickly. In early March, investors may have asked whether a manager's BCP includes any content around what would happen if staff were asked to work for home. Now, virtually all asset manager staff are working from home - irrespective of whether the legacy BCP document covered the topic or not.

COVID-19 STATUS REPORT

To help with risk assessment and initial data gathering, Castle Hall has developed a free DiligenceExchange Covid-19 Status Report. The aim is to create a rapid turnaround document which can be quickly gathered across all managers. This quick response data can then be combined to create a risk heatmap.

Initial topics are listed to the right; we expect, however, that questions will rapidly evolve as new issues emerge across the industry. Updated Status Report information can also support ongoing monitoring as discussed in Section 4 below, either by updating all information, or targeting managers (and service providers) with specific, thematic questions.

1. What percentage of manager staff are working from home?

2. To what extent have manager operational procedures been impacted since March 15, 2020?
    a. Trading
    b. Confirmation / Middle Office
    c. Portfolio reconciliation / Back Office
    d. Cash payments
    e. Portfolio valuation procedures

3. Has the manager contacted service providers to determine their current status of Covid-19 preparation and exposure?
    a. Prime Broker
    b. Custodian
    c. Fund Administrator
    d. Auditor
    e. Technology Consultant
    f. Compliance Consultant
    g. Fund Directors

4. Could the manager continue to trade in the event that the fund administrator was unable to provide daily accounting, reconciliation and related services?

5. Does the manager expect any delay in the issuance of the March 31, 2020 NAV?

6. Has the manager had a cyber security incident since March 15, 2020?

7. How long does the manager expect to be impacted by the Covid-19 pandemic?

8. Open question: Provide any further information relevant to Covid-19 and the manager's response to the pandemic.

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LEVEL 2 DUE DILIGENCE: COVID-19 REVIEW

As noted in Section 1, an effective CDP will prioritize additional due diligence efforts to higher risk managers. As identified by Castle Hall's Risk Quadrant, these will be managers with higher dollar allocations, who are smaller firms with fewer resources, or who operate with strategies which are more exposed to the market impacts of Covid-19. More detailed due diligence will also be necessary as an escalation following the Level 1 Status Report – which managers, if any, have reported significant difficulties in the roll out of their BCP plan in response to Covid-19?

We have set out below a range of questions which can form the basis of a more detailed Covid-19 Review.

1. BUSINESS

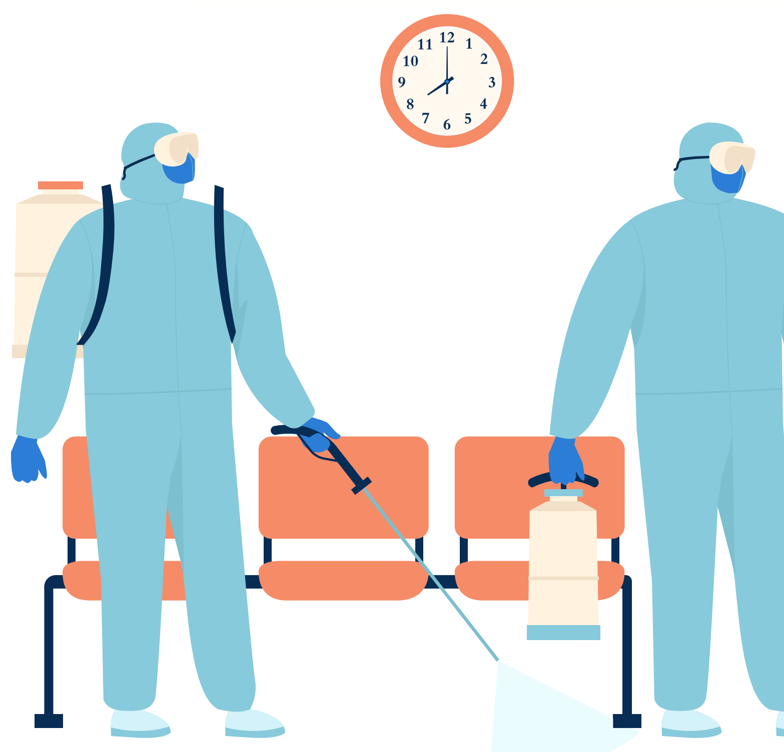
- Overview: How is the asset manager directing its response to Covid-19?
- Has the firm formed a taskforce / working group to address the situation?
- Has Covid-19 led to any changes to internal committees and firmwide governance?
- What is the manager's estimate of current break even assets under management?
- What has been the impact on firm assets under management due to market movements since March 1?
- What has been the impact on firm assets under management due to capital movements (subscriptions / redemptions) since March 1?
- Has the manager reduced headcount (staff layoffs, redundancies) since March 1?
- Has the manager taken other actions to reduce expenses since March 1?

2. KEY PERSONNEL

- Who would the manager designate as a key professional, without whom the business would be materially impeded in its ability to continue its operations?
- Does the manager have a succession plan?

3. BUSINESS CONTINUITY

- What are the key measures the manager has taken as it has enacted its BCP plan in response to Covid-19?
- How does the manager expect to respond in the event that the BCP period extends beyond 1 month, and beyond 3 months?
- Has the manager encountered any challenges with respect to implementation of a widespread work from home policy to date (e.g. problems with connectivity etc.)



4. CYBERSECURITY

- Has the manager made any changes to cybersecurity policies since March 1, 2020?
- Has the manager completed updated cyber security training since March 1, 2020, or does it plan to do so before April 15, 2020?
- Has the manager prohibited use of personal employee computers? (i.e. do all staff work exclusively from employer owned computers)?
- Has the manager made any changes to phishing testing since March 1, 2020 or does it plan to do so before April 15, 2020?
- Does the manager apply two factor authentication to all technology platforms?

5. ACCOUNTING & OPERATIONAL CONTROLS

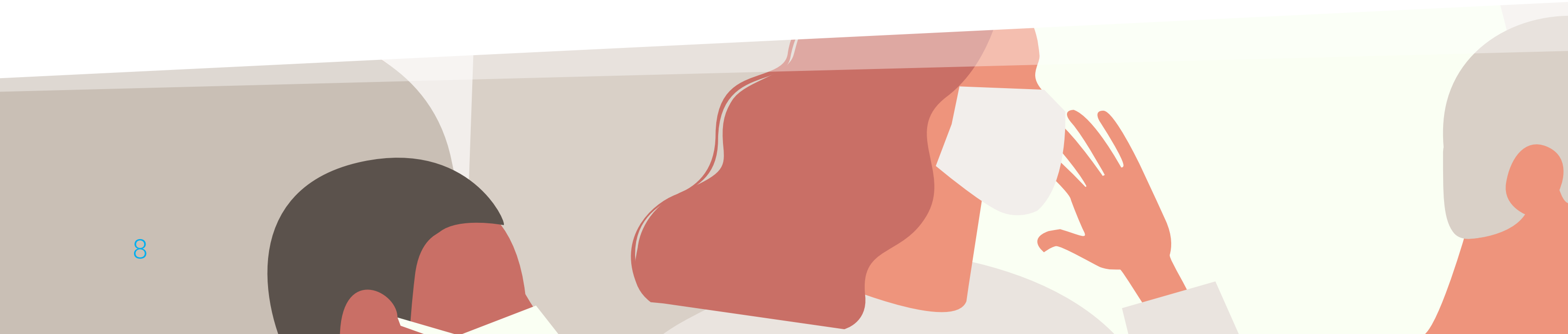
- Trading: Has the manager made any changes to the trading process (e.g. trading outside the office)?
- Middle Office / Confirmation: Has the manager made any changes to the daily middle office process (trade confirmation, booking, daily P&L etc.) following a move to remote working?
- Back Office: Has the manager made any changes to the daily back office process (portfolio reconciliation, fund accounting) following a move to remote working?
- Has the manager made any changes impacting segregation of duties in the trading cycle (from execution to settlement)?
- Has the manager experienced any trade errors, settlement failures, or middle office / back office errors since the implementation of the firm's BCP?
- Has the manager made any changes to cash movement procedures as a result of WFH / Covid procedures?
- Cross training: in the event that one or member of the middle / back office operations team is unable to work due to illness, has the manager cross trained other employees to assume these tasks?
- Liaison with the fund administrator: has the manager changed any procedures with respect to work undertaken by the fund administrator?
- Has the manager identified any service issues with respect to the fund administrator (e.g. timeliness of deliverables, errors etc.)

6. VALUATION CONTROLS

- Does the manager anticipate any changes to valuation procedures at this time?
    1. Valuation policy document
    2. Valuation committee (composition and frequency)
    3. Use of data feeds
    4. Use of broker quotes
    5. Use of pricing models
    6. Use of third party valuation agents
    7. Over-rides of administrator prices / increase in "manager marks"
- Does the manager expect to reclassify any assets from Level 1 to Level 2, or Level 2 to Level 3?

7. FINANCING & CUSTODY

- Has the manager made any changes to its prime brokerage arrangements?
- Has the manager breached any ISDA (or other margin / financing agreement) NAV triggers to date? If yes, were waivers granted?
- What procedures does the manager have in place to monitor the credit risk and business capabilities of its prime brokers and ISDA counterparties?
- Has the manager made any changes to its stock lending program (if applicable)



8. SERVICE PROVIDERS

- Has the manager contacted its service providers to determine their current status of Covid-19 preparation and exposure? What are key findings at this time?
  - i. Prime Broker
  - ii. Custodian
  - iii. Fund Administrator
  - iv. Auditor
  - v. Technology Consultant
  - vi. Compliance Consultant
  - vii. Fund Directors
  - viii. Other(s)

9. HUMAN RESOURCES

- Do you have any staff who have tested positive for Covid-19, or have displayed Covid-19 symptoms for more than 24 hours?
- Do you have any staff members who have members of the same household who have tested positive or have displayed Covid-19 symptoms for more than 24 hours?
- Have you put in place procedures to support your team as they move to a work from home environment?
- Have you made any changes to internal HR policies (e.g. sick leave, medical coverage, support for mental health initiatives etc.)?

4

MONITORING GOING FORWARD

- Review all **communications** from every manager, particularly when aimed at Covid-19 issues. Escalate any material commentary as soon as received.
- Conduct thorough **media monitoring** to determine if a manager is "in the news". Equally, media reporting of an event at another manager may be an early warning sign of events which could ripple across the full portfolio.
- Ensure **rapid follow up** with managers as situations evolve; status report updates can be sent for rapid one question "do you do this?" verifications. Short, thematic surveys can also be used as new issues emerge.
- Implement **structured updates** to formal outreach, matching frequency with the pace of evolving Covid-19 issues. Covid-19 diligence information should be updated systematically, with status report questions adjusted as needed.
- Continue to complete other key procedures, such as **review of all financial statements when released.**
- If the fund is liquid, conduct a detailed **prospectus review** to review terms and conditions around any redemptions.
- Develop **portfolio wide reporting**, so that key stakeholders within an organization (Board, Directors, CEO / CIO etc.) have timely information to support their decision making across the entire firm.

5

EXPAND YOUR CDP TO CONSIDER NEXT LEVEL RISKS

Castle Hall frequently makes the comment that the first rule of effective due diligence is "not to be surprised". As such, the CDP must proactively plan for contingencies and consider potential scenarios which could impact the business and the portfolio. Our view is to "hope for the best, but plan for the worst."

EXPECT SOME FUNDS TO BE GATED

This is the most significant financial drawdown since 2008, and it is quite likely that at least some funds will trigger gates and / or suspend redemptions due to redemption requests. What is different in 2020 is that offering documents are typically "tighter" than pre 2008.

Over the last 10 years, fund lawyers have written in extensive provisions such that a typical fund has full flexibility to suspend redemptions, gate the fund, or withhold payment of redemption proceeds (which can often include use of vehicles such as liquidating trusts - which are just side pockets with a different name). Detailed pre-emptive review of offering documents may be warranted.

EXPECT LIQUIDITY MISMATCH ISSUES - ESPECIALLY FOR RETAIL FUNDS

Woodford has, of course, shown what happens when a retail fund with a portion of illiquid assets is required to suspend redemptions. Last year, Mark Carney, the former Governor of the Bank of England, said that *"these funds are built on a lie, which is that you can have daily liquidity for assets that fundamentally aren't liquid. And that leads to an expectation of individuals that it's not that different to having money in a bank."*

This obvious failure in structuring funds has not stopped investment products with apparent mismatches of liquidity being very popular, especially in Europe; a particular example is the open-ended real estate fund industry. Europe is also exposed to its large UCITS industry where at least some funds have explored the boundaries of regulatory rules around portfolio composition and fund structuring, relying on the "don't worry, it's a UCITS fund" mantra. Also interesting is AIFMD, including the role of the depositary and the other changes introduced by the creation of AIFM and AIF structures. Covid-19 will be the first test of the EU rules to see if the regulations have any real world impact to protect investors.

EXPECT VALUATION DIFFICULTIES

What is "fair value"? Castle Hall's answer is that something is worth what someone will pay for it, at the time that the seller wishes to sell - which merely highlights the subjectivity of valuation of Level 2 and Level 3 assets, especially in a period of significant market dislocation.

As a particular issue, we highlight that administrators have, since 2008, largely removed themselves from any responsibility around valuation. Most fund administrators are now entitled to rely on marks provided by managers without incurring any liability to independently verify those prices. For strategies with a challenging valuation profile, such as direct lending, valuation issues could become material over the coming weeks.

EXPECT SOME FRAUDS

As Warren Buffet so famously said, it's when the tide goes out, you see who's swimming naked.

EVALUATE SERVICE PROVIDERS

A key risk in the asset management industry is dependence on third party service providers, notably administrators and banks, who have often offshored significant functions to lower cost locations in India and Asia. Many cities in these regions have very large populations and a lower level of funding for healthcare systems. As such, preparedness of the administration industry, as well as banks and other service providers reliant on offshored locations, will be key. Inability of a major administrator to provide uninterrupted servicing could have significant ripple effects across the industry. This is particularly the case when hedge funds rely on administrators not just for NAV processing, but also for day to day outsourced back office (settlement, reconciliation etc.)

We expect due diligence on service providers across the industry to become a key issue over coming weeks.

CONSIDER UNDERLYING PORTFOLIO COMPANIES

As an extension of our comments with respect to service providers, the CDP will likely extend due diligence scope beyond asset managers themselves.

Castle Hall has seen some investors "look through" their PE portfolios to independently gather information on underlying portfolio companies. Reputational Due Diligence – covering corporate data, KYC information, and adverse media monitoring – can be a key tool to ensure that the investor has information on a timely basis as to events in underlying portfolio assets, whether public or private.

AND... THE UNEXPECTED

Our final comment is to highlight the inherent fluidity of this crisis situation. Issues will likely arise over coming weeks which have not yet been considered or foreseen. As such, the CDP needs to be reviewed as a living document, with investors and managers both ready to react to new implications of the virus as quickly as possible.

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