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Risk Management Update
August 2012

THE IMPORTANCE OF PERFORMING DUE DILIGENCE

The painful lessons that the financial industry has learned from the Madoff and Stanford Ponzi scheme scandals are numerous, but maybe none as important as the necessity of performing ongoing due diligence. Importantly, the responsibility to perform due diligence rests with many, including banks, trust companies, broker-dealers, investment advisers, and investors. However, since 2008 the Securities and Exchange Commission ("SEC") has brought over forty five (45) enforcement actions against individuals and firms for running Ponzi schemes, many of which were private funds and their managers,[1] so it has become a very high priority with regulators that investment advisers have a strong due diligence program in place covering their recommended investments and the service providers they use.

This Risk Management Update outlines regulatory requirements that investment advisory firms must adhere to when implementing such a program and also provides information on steps that can be taken to ensure the process is reasonably designed to detect issues and help prevent violations of the federal securities laws.

Overview of Requirements

As a fiduciary, investment advisers are required to ensure that the services they provide and investments they make on behalf of their clients are, and continue to be, in the client's best interest. This fiduciary duty includes the performance of due diligence.

The types of due diligence that should be performed depends on a firm's business practices. For example, an adviser that invests clients' assets in unaffiliated private funds should perform initial and ongoing due diligence on those private funds and its service providers, including the general partner, investment manager, prime broker, fund administrator, accounting firm, legal counsel, and third party marketer(s). This would include, but not be limited to:

1. Performing a detailed initial review of the private fund's offering memorandum, partnership and subscription agreements, along with additional reviews of any amendments to such documents;
2. Performing onsite visits to the fund's principal place of business to view operational processes and compliance controls (including technology used), and to meet with senior management and the investment management team (if applicable);
3. Obtaining initial and annual completed questionnaires from the general partner and investment manager (if different firms) to determine, among other things, if any changes have taken place to the fund's practices and/or service providers, and whether any, potential or actual compliance or legal issues have arisen;

[1] http://www.sec.gov/spotlight/enf-actions-ponzi.shtml

4. Reviewing qualifications and affiliations of the service providers and performing initial and periodic on-line research (including Google searches);
5. Having periodic teleconferences with the general partner and investment manager to obtain investment and valuations updates; and
6. Evaluating information provided in reports, including sample testing of performance and statistical numbers and processes used for valuation.

Investment advisory firms also are expected to perform due diligence on certain contracted service providers, such as sub-advisors, pricing services, back office operation firms, fund administrators and custodians (just to name a few). In 2009, the SEC issued a summary of their exam focus areas, which states:

> "*Advisers should perform adequate initial and on-going due diligence of each service provider to confirm that the contracted services and the implementation processes are appropriate for the firm and its clients. Such due diligence is important when reviewing the services provided by both affiliated and third-party service providers*."[2]

In that summary, the SEC provided sampling lists by category of certain due diligence controls observed by examiners that had been implemented by investment advisers. For example, under "Valuation of Client Assets" it reflects that an adviser having manually priced securities periodically obtains prices from an outside source, which is independent of the usual source, to check the accuracy of the price being provided by the primary source.

When performing due diligence, investment advisory firms should ensure that the process is fully documented, with supporting documentation maintained. Any outlier information resulting from the due diligence process should be documented and investigated promptly to determine if any action is needed. Often such backup is instrumental when responding to regulatory examinations and inquires, as it demonstrates the protocols the firm used to evaluation the soundness of a particular product or service.

Compliance Steps

Due diligence takes time and a concentrated effort from various firm personnel, including portfolio management, operations, and compliance. To help ensure employees understand their responsibilities and that your firm maintains a robust due diligence program, the following steps should be considered:

1. Implement written policies and procedures that clearly outline the types of due diligence conducted and related processes.

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[2] 2009 CCOutreach Regional Seminars – "The Evolving Compliance Environment – Examination Focus Areas" (April 2009) http://www.sec.gov/info/iaiccco/iaiccco-focusareas.pdf

2. Identify all investment products and service providers requiring due diligence reviews on a periodic basis and send out due diligence questionnaires accordingly.
3. Create a due diligence calendar that reflects the timing of reviews and the firm personnel responsible for such reviews.
4. Train appropriate employees on firm requirements and the process for performing reviews.
5. Document the process, analysis, and findings of each review performed and maintain all in an appropriately designated file, along with copies of documents provided, questionnaires completed and any red flags identified with corresponding action steps.
6. Provide a report to senior management on findings and recommendations.
7. Evaluate the firm's due diligence program on an annual basis to determine if any changes, or additional training or steps require implementation.

Conclusion

In addition to the SEC and states looking very closely at investment adviser due diligence processes, clients are demanding more transparency regarding investments and asking more questions pertaining to investment firm's internal controls, including due diligence and risk monitoring. Implementing solid policies, procedures and controls regarding due diligence can provide firms with the tools necessary to ensure adherence to their fiduciary duty and help prevent fraudulent activities perpetrated against investors and the financial industry.

For more information, or to learn about how CCLS may be of assistance, please do not hesitate to contact us at (619) 278-0020.

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