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Due Diligence of Funds, Subadvisors, Counterparties and Vendors
For Investment Advisers, Investment Companies and Private Funds

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Agenda

- What are the Regulatory Considerations for Due Diligence?
- What are the Components of a Due Diligence Program?
- What are the elements of the initial due diligence program and the ongoing compliance review?
- How does the status of the entity change the due diligence program?
- Cases
- Q&A



What are the Regulatory Considerations for Due Diligence?

- For registered funds, Rule 38a-1 of the Company Act requires fund boards to adopt written policies and procedures reasonably designed to prevent the fund from violating federal securities laws. Policies and Procedures must provide for the oversight of compliance by the fund's investment adviser, principal underwriter, administrator and transfer agent. Policies and procedures of these key service providers are considered part of the compliance program and must be approved by the fund board.

What are the Regulatory Considerations for Due Diligence?

- For investment advisers, members of the SEC's staff have also provided insight into their views on the role of the fiduciary responsibilities of the Adviser when certain activities/duties usually performed by the Adviser are outsourced to a third party.
- During the SEC's 2009 CCO Outreach Regional Seminars directed to the compliance staff of advisory and broker-dealer firms, the staff devoted its April session to "The Evolving Compliance Environment: Examination Focus Areas." During this session, the staff stated that "when a service provider is utilized, the adviser still retains its fiduciary responsibilities for the delegated services."
- See Section 206 (e)(6) of Investment Advisers Act.



What are the Regulatory Considerations for Due Diligence?

- For broker Dealers and/or dual registrants, FINRA Notice 05-48 lays out guidance from the regulator regarding their expectations for their members with respect to responsibilities when outsourcing activities to third-party service providers.
- In 2011, FINRA issued Notice 11-14, in which it proposed a specific rule (3190) to clarify the scope of a member firm's obligations and supervisory responsibilities for functions or activities outsourced to a third-party service provider. This proposed rule has not yet been approved/finalized.



What are the Components of a Due Diligence Program?

- Adoption and implementation of written policies and procedures that have been reasonably designed to detect any violation of securities laws and to demonstrate that the due diligence process have been consistently applied.
- Demonstration that internal due diligence policies and procedures have been followed.
- Evidence that the initial due diligence and ongoing oversight is being conducted as described in the policies and procedures.
- Periodic tests of the key compliance controls and procedures and, reporting these test results as part of the annual review.
- Periodic on-site visits.
- Discussions and interviews with key members of service provider.
- Walk-throughs of key processes and related controls.
- Retention of appropriate books and records.
- Escalation process in place.



Initial Due Diligence Review Counterparties

- The RFP
- Proposed contract /agreement (if any)
- The Counterparties written:
 - compliance policies and procedures
 - business continuity/disaster recovery plans
 - anti-money laundering policy
 - Information security policies, procedures, standards and guidelines
 - policies specific to the proposed activities
- Financial statements
- Reputation and history, references, clients
- Regulatory, internal audit or other internal review report
- Financial stability (creditworthiness)
 - Sector Exposure
 - Ability to provide margin loans
 - Ability to change relationship easily
 - FOCUS Report certification report by accountants on financial condition
- Finra BrokerCheck report (focusing on any specific items related the services to be provided)
- Other publically available information
- Fee Structure
- Reporting quality
- Quality of their customer service staff
- Google search on principals of the firm
- Custodian



Ongoing Due Diligence of Counterparties

- Periodic Due Diligence Questionnaire
- Information about unexplained gaps in time related to service history, complaints by supervised persons on service delivery and other Red Flags
- Information security policies, procedures, standards and guidelines
- Financial statements, Creditworthiness
 - FOCUS Report (certification report by Accountants)
- Safety of Client Assets
- Customer Service issues or concerns



Ongoing Due Diligence of Counterparties (cont)

- Reporting
- Conflicts of interest between the counterparty and the firm or clients
- Regulatory issues, internal audit or other internal review reports; (periodic review of BrokerCheck)
- Changes since the time of the last review affecting the provider or the services under consideration
- Any anticipated changes that will affect the provider or the services under consideration
- Any other applicable considerations.



Initial Due Diligence Review of a Vendor

- The RFP
- Proposed contract and any proposed service level agreements
- The third parties written:
 - compliance policies and procedures
 - business continuity/disaster recovery plans/cybersecurity plans and infrastructure
 - anti-money laundering policies
 - policies and procedures regarding personal trading and security around your proprietary information
 - Privacy Policy
- Financial statements
- SSAE-16 or SOCS reports, if applicable
- Regulatory, internal and external audit and other internal review reports
- Vendor's reputation and history
- Number and competence of staff and managers (especially those who will be servicing your firm)
- Financial stability and commercial record
- Fee Structure
- Conflicts of interest between the service provider and the Firm or Clients
- Systems used and compatibility with your firm's systems
- Retention rates of employees servicing the contract
- Quality assurance
- On-site visit (interviews, process walk-throughs, system demos, etc.)



Initial Due Diligence Review of a Vendor

- Where the Vendor will be handling information classified as NPPI or Sensitive/proprietary the firm shall conduct a reasonable amount of diligence on the Vendor's information security protections prior to contract execution. Such diligence may include evaluation of:
 - Information security policies, procedures, standards and guidelines
 - Background checks on employees or contractors servicing the Firm
 - Intellectual property protection
 - Specification, design, development, testing, implementation, configuration, management, maintenance, support and use of security controls within or associated with IT systems
 - Anti-malware, anti-spam or similar controls
 - Information technology change management processes
 - Contractual warranties
 - Access control monitoring, audit reporting, and/or engagement of independent technology risk assessment and/or
 - Business continuity



Ongoing Compliance Review of Vendors

On an annual basis, or as defined in the policies and procedures, here are some examples of information to be reviewed

- Review any material changes in the compliance policies and procedures
- Certifications - Monthly, quarterly, annual questionnaires, other certifications, for example, Business Continuity Policy
- Audits SSAE 16, Internal Control Report
- Google search on Management team
- Service level agreements
- Periodic Onsite Visits – Risk basis
- The service provider's satisfaction of contractual obligations
- The cost of the service
- The service provider's responsiveness to the Firm
- Whether technology used by the service provider enhances or impedes the services being provided
- The service provider's organizational structure
- The service provider's institutional resources
- The service provider's business continuity plans
- Potential Conflicts of interest between the service provider and the Firm or Clients



Initial Due Diligence Review of a Subadvisor

- The RFP key sections:
 - Organization structure
 - Organization chart
 - Disciplinary history and litigation
 - Insurance coverage
 - Investment strategy and process
 - Resume or bio of the Chief Compliance Officer
 - Operations and Compliance
- SEC, FINRA proceedings recent enforcements, investigations, relevant lawsuits
- Form ADV Part 1 and 2A
- Rule 206(4)-7 Compliance Policies and Procedures
- Code of Ethics
- Most recent Annual Review and summary of the process
- Business Continuity Plan
- Privacy Information Security Plan
- Finra BrokerCheck report for affiliated broker-dealers
- Overview of critical systems used (OMS, portfolio accounting, etc.)
- Cybersecurity
- Onsite visit
- Google search for criminal activity
- Background checks for key personnel



Initial Due Diligence Review of a Subadvisor (cont.)

Examples of Areas to Review

- Compliance Program and function
- Policies
 - Allocation
 - Aggregation/Bunching Policy
 - Best Execution Policy
 - Valuation Policy
 - Side-By-Side Management
 - Trading Error Policy
 - Privacy Policy
 - Electronic Communications Policy
 - Regulatory Reporting
- Complaints
- Employee Compliance Training
- Code of Ethics – Insider trading/Gifts/Political Contributions
- Portfolio Management and Trading
- Proxy Voting
- Business Continuity Plan
- Cybersecurity
- Performance Related Records



Ongoing Due Diligence of Subadvisors

Reviews may include interviews with key subadvisor personnel, collection of data and information, and/or the construction of any analysis, including forensic analysis, that the CCO (or other members of senior management) deems relevant at any given time. Supplementing publicly available data, using questionnaires and document requests will provide a basis for evaluating whether to maintain a relationship with a subadvisor.

- Periodic on-site visits as needed
- Reviews of any material changes in the compliance policies and procedures, changes in key personnel (portfolio managers, traders, CEO, CCO, etc.), critical systems, Form ADV etc.
- Review Questionnaires, Certifications on Code of Ethics, best execution and other policies
- Testing and Forensic Reviews
- Annual Reviews – Rule 206(4)-7, Rule 38a-1
- External audit reports, financial statements
- SEC, FINRA proceedings



Initial Due Diligence of Hedge Funds by a Fund of Funds Manager

- Due diligence in the selection and monitoring of underlying hedge funds ranks among the chief responsibilities of a Fund of Funds manager.
- Fulfilling their fiduciary responsibilities to their investors by using a thorough analysis of a broad range of information to decide whether to invest with – or continue investing with – a particular fund.
- Supplementing publicly available data, using questionnaires and document requests provide a basis for evaluating whether to maintain a relationship with an underlying fund.



Initial Due Diligence Review of Hedge Funds by a Fund of Funds Manager (cont.)

- On-site visit
- Offering Memorandum - Offering document review/summary
- Side letters
- Investment Process
- Rule 206 (4)-7 Compliance Policies and Procedures
- Business Continuity Plan
- Cybersecurity
- Information Security Policy
- Valuation Policy
- AML Policy
- Code of Ethics
- Third Party Expert Consultants/Networks
- Auditor/Audit Status
- Fund Administrator
- Custodian
- Prime Broker
- Legal Adviser
- Investment Advisory Agreement
- Information Technology
- Recent Rule 206(4)-7 Annual Review
- SEC filings research (e.g., Form ADV, 13D, 13G, 13F etc.)
- Regulatory filings record research
- Public record research (i.e., civil and criminal records, judgments, liens, etc.)
- SEC or FINRA violations or disciplinary issues
- Educational/employment verifications
- Service providers verifications
- News articles research
- Credit report checks
- References



Ongoing Due Diligence Reviews of Hedge Funds by Fund of Funds Manager

- Periodic On-Site Reviews
- Material changes in the Fund's compliance policies and procedures or compliance program
- Changes in investment process
- SEC, FINRA Examinations, enforcement actions, litigation
- Recent Rule 206(4)-7 Annual Review
- Due Diligence Questionnaire
- Certifications
- Third Party Expert Consultants/Networks
- Cybersecurity
- Valuation Policy
- Auditor/Audit Status
- Fund Administrator
- Information Technology
- Service Provider Due Diligence
- Business Continuity



How Does the Status of the Entity (Private Fund vs Registered Fund) Change the Due Diligence?

- A point of distinction between registered and private funds, generally there is more publically available information and data for registered funds, less so for private funds. A private fund due diligence review may require more information, data and analysis as the information provided by the fund maybe more difficult to validate.



Cases

Resources

- ICI Board of Oversight of Subadvisors Independent Directors Council, Task Force Report January 2010
- Risk Alert: Volume IV, Issue 1 January 28, 2014, Investment Adviser Due Diligence Processes for Selecting Alternative Investments and their Respective Managers.
- “SEC Charges New York-Based Brokerage Firm with Faulty Underwriting of Public Offering by China-Based Company.” SEC Press Release Washington D.C., March 27, 2015

Materials

- Critical Issues Due Diligence Check List – Adviser, Administrator, Accounting, Transfer Agent, Distributor, Custodian.
- Subadvisor Due Diligence Testing Matrix
- Initial Due Diligence Questionnaire – AUM Law
- Annual Due Diligence Questionnaire – IAA/ICI

