

The Third Constituency of Adviser Compliance Programs – Due Diligence Teams

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Overview

The 2004 release of Rule 206(4)-7 by the Securities and Exchange Commission (“SEC”) revolutionized investment adviser compliance programs, requiring: (1) a named Chief Compliance Officer (“CCO”); (2) written compliance policies; and (3) an annual review of the compliance program. Like any new initiative, best practices have evolved related to adviser compliance programs since 2004, and many of these emerging best practices have been communicated via written articles within industry publications. Naturally, many of these articles have focused on the first constituency of adviser compliance programs – the SEC and other regulators. Other articles have focused on a second constituency – the importance of designing a compliance program to work with the adviser’s organization rather than against it (through the use of customized rather than template policies, risk matrices and testing programs, for example). The focus of this article is a third adviser compliance program constituency which is quickly gaining momentum – advisory client due diligence reviews.

Institutional Due Diligence Functions Defined

Most institutions maintain some level of due diligence over its service providers. The core purpose of a due diligence function is to gather and assess information; specifically, to gather information regarding an organization’s practices in an effort to analyze the quality of those practices and to assess the level of risk associated with doing business with the organization.

Potentially any institutional client could have a due diligence function, including:

- Traditional institutions, such as banks, insurance companies and other corporations;
- Mutual funds (generally related to an adviser serving as sub-adviser to a fund);
- Sub-advised programs;
- Wrap investment programs;
- Taft-Hartley plans; and
- Foundations.

Historically, institutions employed the use of a formal due diligence function to focus on investment matters, including style, performance, portfolio management staff and investment process. Some institutions employed staff, while other institutions engaged an outside consultant, to perform initial and ongoing due diligence reviews of an adviser’s investment function. Many institutions have now expanded their focus to include a review of the adviser’s compliance and oversight functions.

The focus on adviser compliance matters by institutional due diligence teams has evolved over time. While periodic questionnaires were once the primary method used to conduct due diligence reviews of an adviser's compliance program, more institutions are supplementing (or replacing) these due diligence efforts with in-person reviews. Given the level of compliance and operational risk generally attributable to advisers, the implementation of a more formal due diligence function is a natural extension of the institution's other due diligence processes. In fact, our experience has been that institutions view reputational risk as a true risk, and an adviser with a great investment management function but a poor compliance program may be viewed as too great of a liability for the institutional client (i.e., no institutional client wants its adviser to be on the front page of *The Wall Street Journal* for regulatory violations). Advisers choosing to target institutions to grow its asset base would be well served to prepare for in-person compliance reviews by the client's due diligence teams.

Due Diligence Team Expectations

Institutional due diligence teams certainly consider compliance with SEC regulations and expectations in reviewing an adviser's compliance program. These teams also often consider whether the program is designed and maintained to work in concert with the adviser's business model. However, these institutional due diligence teams also have their own agenda, and they expect the compliance program to meet the institution's standards as well. Those standards may be higher than either the SEC staff's expectations or the adviser's internal standards. Therefore, an adviser managing its compliance program to meet, rather than exceed, minimum SEC staff expectations may not measure up to the institutional due diligence team's expectations.

While not meeting SEC requirements and/or SEC staff expectations may result in enforcement action (including sanctions and fines), in reality relatively few advisers who actively strive to maintain an adequate compliance program meet this fate. However, an adviser meeting the SEC staff's minimum requirements but not the industry's or institutional client's minimum compliance expectations may result in fewer clients for the adviser and, consequently, lower revenue. In this respect, institutional due diligence teams may at times be more intimidating than SEC examiners. In practice, we have found institutional due diligence teams to be considerate, reasonable and sophisticated. However, they may have a significant voice in determining whether the adviser is engaged and, therefore, should garner a high degree of attention in advance of the due diligence review.

Compliance Challenges...

CCOs working for advisers with an institutional client focus are no longer able to manage a program solely around the SEC's and its own expectations. Such CCOs should be prepared for institutional due diligence teams to play an increasingly important role in the firm's compliance program; however, managing a program to meet institutional clients'

expectations can be challenging. Depending upon the quantity and explicit desires of the adviser's institutional clients, this third constituent may in reality represent the fourth, fifth, tenth or fifteenth constituency – each institutional client's expectations may represent a separate constituency. Managing these expectations as well as the periodic visits by due diligence teams is a challenge for CCOs.

....and Opportunities

Challenges often present opportunities, and working with institutional due diligence teams is no different. Among the opportunities for CCOs are:

1. *Increased Resources*

CCOs struggling to receive an appropriate allocation of resources for the compliance program may be able to leverage the expectations of the adviser's institutional clients in an effort to obtain additional resources. Management will generally be open to adding resources as required by a core client base, and compliance should be no exception.

2. *Independent Reviews*

Periodic examinations by the SEC and reviews by consultants are generally solid tests of an adviser's compliance program. However, the SEC may not visit an adviser over a five to ten year period of time, and not all advisers engage outside consultants to review their compliance program on an annual basis. Routine reviews by a sophisticated due diligence team may represent an additional independent test of the adviser's compliance program. If the due diligence team offers recommendations (not all do), implementation of those recommendations often results in a stronger compliance program.

These due diligence teams also typically review a number of advisers, and therefore have knowledge of industry best practices. While SEC examiners may have knowledge of industry best practices as well, in practice there is little incentive for them to provide advice specifically designed to improve upon an adviser's program. Depending upon the nature of the review, institutional due diligence teams may have such an incentive and, as a result, at times may provide meaningful best practice advice in an effort to improve the adviser's compliance program.

3. *Enhanced Profile*

The requirements of Rule 206(4)-7 combined with several high profile cases brought against advisers for regulatory violations have enhanced the profile of adviser CCOs within their respective organizations. This profile could be raised further in organizations where the adviser's core client base views the adviser's compliance program as important, if not critical. CCOs may find themselves in a key client contact role, and may be viewed as an integral component of the overall client relationship.

Advice for the CCO

CCOs working for advisers with an institutional client focus must be prepared for institutional due diligence reviews. CCOs may consider the following in preparing for these due diligence reviews.

1. Focus on the First Two Constituencies

Adviser compliance programs which are not designed to meet SEC expectations nor designed to work in concert with the adviser's business model have not met the two key hurdles required to be crossed before addressing the institutional due diligence team's expectations. Advisers should focus their attention first on implementing and maintaining a compliance program which considers these two constituencies.

In considering regulatory expectations, advisers should strive to exceed the minimum requirements – to comply with the spirit of the regulator's expectations rather than simply the letter of the rule. A sophisticated due diligence team is able to sense when an adviser is striving to comply with the minimum SEC requirements, and may consider this approach to be unacceptable.

In designing and managing a compliance program to work in concert with an adviser's business model, a CCO may consider:

- a. Creating a thoughtful compliance program (including the use of customized rather than template policies, risk matrices, testing procedures and compliance calendars). Sophisticated due diligence teams will easily be able to identify a compliance program which is not customized around the firm's actual business practices; and
- b. The adviser's tone at the top. An adviser's culture of compliance is critical to an institutional due diligence teams' review. While a CCO requires management's full support to effectively manage a compliance program for regulatory purposes, this support is equally as critical related to diligence reviews. A due diligence team is focused on risk, and tone at the top is a critical component of the due diligence team's assessment of risk. Further, these teams can sense non-committed management. Therefore, management which "turns on" its commitment to compliance solely for outside interview purposes will likely not pass the test of a sophisticated due diligence team.

2. Prepare for Visits

CCOs should take the time necessary to adequately prepare for visits by due diligence teams. These visits typically do not require the time necessary to adequately prepare for an SEC examination, but should be viewed with a similar level of importance, as the successful completion of the due diligence review

could have a revenue impact to the firm. Matters to consider in preparing for a compliance-focused due diligence review include:

- a. Requesting a document list with sufficient time to gather all documents requested;
- b. Reaching out to the due diligence team to develop an understanding of the purpose of the visit – attempt to identify what the due diligence team wishes to accomplish in connection with the visit;
- c. Coaching compliance staff on how to interview with due diligence teams. While standard advice related to SEC interviews is to answer only the question asked, this advice does not translate to interviews with due diligence teams. In fact, advisers should strive to provide a sufficient level of information to the due diligence team in an effort to leave the team with a full picture of the firm's compliance program and a strong impression that the firm regards its compliance program seriously; and
- d. Coaching staff not specifically involved in the due diligence interviews. Staff not involved should be viewed by the due diligence team as professional, courteous, organized and busy. A good idea in preparation of the due diligence visit is to ensure workstations and copy/file rooms are neat and orderly.

3. *Consider Engaging an Independent Compliance Consulting Firm*

Due diligence teams often rate advisers higher when they involve an experienced, independent consulting firm to either build or review the compliance program. A one-time review is good, but an ongoing review by an independent party is better. The involvement of a third party consultant, particularly in the case of a smaller adviser, is often viewed as an important component in helping the due diligence team gain an acceptable level of comfort with the adviser.

4. *Proactively Communicate*

Do not view the due diligence team as an adversary. Rather, strive to maintain an open line of communication with the team on an ongoing basis, not simply related to the team's on-site due diligence review. If the team identified a deficiency in the compliance program or communicated a recommendation, proactively communicate with the team how the firm has addressed the matter. Likewise, proactively communicate positive developments in the program between due diligence reviews, to the extent the due diligence team is comfortable with this level of communication.

Conclusion

Institutional due diligence functions are here to stay, and will likely play a larger role in adviser compliance programs going forward. Advisers with an institutional client focus should embrace an institutional due diligence team's efforts. Doing so will result in

improved client relations, a more robust compliance program and the potential for more assets managed by the adviser.

Jeff Squires is a founding principal of Vista360, LLC, a consulting firm focused on providing advisers and funds with compliance and strategic advice. In addition to building and reviewing compliance programs, Vista360 routinely performs due diligence reviews of mutual fund service providers and advisers. For more information, please see www.vista360llc.com.