JACKO LAW GROUP, PC
SECURITIES & CORPORATE COUNSEL

Legal Risk Management Tip
April 2010

BEST PRACTICES FOR THE DUE DILIGENCE PROCESS

Investment advisers are required to do due diligence under Rule 206(4)-7 of the Investment Advisers Act of 1940. However, little guidance is given in the SEC's public literature as to the extent and scope. Therefore, the SEC generally looks for what is "reasonably designed."

In practice, there are different ways to conduct due diligence. Some firms opt to outsource in order to have an "independent review." However, this can be extremely costly. Others rely on third-party reports. Typically, for this type of arrangement, the cost is borne by the sub-adviser or service provider. However, the disadvantage lies in the party providing the report and whether or not it is reliable.

For those firms who opt to perform due diligence internally with existing staff, it is imperative for the due diligence team members to know what they are looking for and which documents to request. Some more common requests include:

- Policies and Procedures
- Internal Control Documents and Reports Evidencing Strong Compliance Systems
- Forms ADV
- Prior SEC Deficiency Letters
- Risk Assessment Reports
- Performance Track Record
- SAS-70 Report
- Information related to SEC, State, SRO and/or other regulatory body investigations or enforcement proceedings
- Organizational Charts and biographies of senior management team members
- Certified Financials
- Business Continuity Plans

For those persons who are responding to due diligence questions, be sure to prepare accordingly. In preparing for in-person meetings, be sure to:

- Provide Training to Respondents on How to Respond to Questions Relating to Conflicts of Interest
- Review Written Responses to Ensure They Address the Question Posted; Non-Responsive Answers are Often Highlighted as an Area of Potential Concern
- Consider the Regulatory "Hot Areas" During Your Preparations (e.g., internal controls, customer complaints, regulatory investigations/actions, evolution and enhancement of policies and procedures, strength and longevity of performance track record and investment management team, etc.)

- Evaluate strength of the Firm's Overall Investment Process (*i.e.*, the products offered, intended investors, assumptions and risks associated with the investments, etc.)

For those persons assessing due diligence responses, be sure to:

- Assure that the respondent is carrying out responsibilities as outline in the underlining agreement
- Prioritize due diligence reviews according to identified risks (based on questionnaire responses)
- Identify "gaps" identified based on due diligence materials received
- Follow-up and address issues identified in the due diligence review
- Document any potential wrong-doing and escalate, as appropriate, to senior management

Due diligence continues to be a particular focus for the regulators. Jacko Law Group, PC has developed the following list of considerations for you to review in your day-to-day business practices.

Top Due Diligence Considerations

1. Do not approach request for proposal (RFP) responses with a "checklist" or "canned response" approach; be personal and customize, where possible
2. Be sure to follow-up with a telephone call, especially if you do not hear from the sponsor firm; it is likely they may have not understood your responses
3. Make it a firm policy to have Compliance do cursory checks on the RFP responses; this allows for a second set of eyes to catch inaccuracies
4. Develop internal policies for each area within the firm and be prepared to show them to the due diligence officer
5. Consider whether the firm's responses to the RFP are appropriate; do they provide for a good first impression
6. Execute an NDA prior to responding; it goes a long way to assure that the information is protected and not compromised, especially to competitors
7. Be familiar with recent enforcement cases for inadequacies of disclosure
8. If you use a RFP database of responses, make sure that compliance reviews all new responses prior to use and typical, standard responses no less than annually; this will help to ensure accuracy
9. Remember that RFP responses could be deemed as "advertisements;" consider whether disclosures are required, particularly with performance numbers and to on-line data bases
10. Be consistent – due diligence is not just a one time thing, make time to do it regularly

For more information, or to learn about how JLG may be of assistance, please do not hesitate to contact us at (619) 298-2880.

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