



Compliance Confusion:

Understanding the Importance of Due Diligence

BY JARROD H. JAMES

An integral component to an efficiently run investment advisory practice is the firm's level of commitment to compliance and fiduciary duty. In 2004, the Securities and Exchange Commission (SEC) passed two rules that have major impact on investment advisory compliance regimes.

Rule 206(4)-7 of the Investment Advisers Act of 1940 (the "Act") requires advisor firms to develop and implement written compliance programs. This rule is designed to protect investors by ensuring that all investment advisors have internal programs to enhance compliance with federal securities laws.¹ Rule 204A-1 requires investment advisors to develop written codes of ethics. This rule is designed to promote compliance with fiduciary standards among advisors and their personnel.²

When analyzed together, it's clear that one of the SEC's objectives for issuing these two rules is for advisors to institute a "culture of compliance." However, implementing a culture of compliance can be cumbersome and intimidating. In fact, it often leads to "compliance confusion."

By taking the time to develop effective compliance procedures,

an investment advisor more easily can navigate the terrain of regulatory expectations and obligations. This article discusses just one of the many concepts that can lead to compliance confusion: the proper role of due diligence. This article is specific to investment advisor compliance, but its concepts also can be applied to banks, broker-dealers, mutual fund companies, and other financial entities.

Fiduciary Duty Owed to Clients

In *SEC v. Capital Gains Research Bureau, Inc.*, the U.S. Supreme Court ruled that Section 206 of the Act imposes an obligatory fiduciary duty on investment advisors regarding their clients. As a fiduciary, an investment advisor always must place the interests of clients first, ahead of its own interests. This obligation mitigates conflicts of interest and prevents investment advisors from violating clients' trust.

An advisor's fiduciary duty must permeate the entire firm. Fiduciary duty is not limited solely to the selection of investment vehicles; it also includes circumstances where the firm must select an affiliated or unaffiliated person to provide services for clients. Fiduciary duty requires that due diligence play an integral role in any advisor's compliance program. Due diligence is the care a reasonable person takes before

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entering into an agreement or transaction with an individual, mutual fund company, broker–dealer, or other investment advisor.

Due Diligence

Due diligence easily is illustrated by the process advisors use to determine investment recommendations to clients. Before making a recommendation, the advisor gathers all information necessary to establish proper suitability of the client. Age, net worth, dependents, risk tolerance, financial knowledge, and other variables are analyzed. Based on the client’s objectives and suitability, the advisor then conducts due diligence on various suitable investment choices with an intention to make investment recommendations in the client’s best interest.

From our experience, whether advisors realize it or not, most are implementing effective due diligence in determining client objectives and investment recommendations. However, many policies and procedures are insufficient when it comes to making recommendations about third-party money managers, custodians, investment research tools, outside solicitors, and even the firm’s advisor representatives. These important decisions require effective due diligence policies and procedures. In fact, regulators have issued deficiencies to firms that have failed to simply establish such policies and procedures even when no harm has been done to a client or no other violation has occurred.

Due Diligence: Outside Money Managers/Investment Advisors

Before recommending an outside money manager, hiring an advisor representative, or selecting an outside solicitor, an advisor must conduct an official due diligence review and memorialize the findings of the review.

Prior to recommending an outside money manager or other investment advisor, an advisor needs to review the outside firm’s entire Form

ADV, disclosure brochures, marketing material, and client agreements in order to analyze the firm’s advisory programs, fees, and practices. Many reputable firms will have a packaged due diligence kit available for review; indeed, lack of such a kit may signal a weak commitment to compliance. Pay attention to the firm’s Form ADV disciplinary and financial disclosures, as well as other information provided in these documents such as assets under management, number of clients, number of accounts, and other important information.

Many firms develop predetermined minimums, e.g., \$100 million in assets under management, that the money manager must meet. Confirm that the money manager maintains errors and omissions insurance, a fidelity bond, and/or an ERISA fiduciary bond. Ask for a copy of the firm’s most recent regulatory examination letters.

Review Form U4 disclosures for the firm’s officers, directors, and portfolio managers to analyze reported regulatory actions, criminal actions, civil actions, customer complaints, arbitrations, and financial disclosures. This review—as well as a criminal background check—is critical when hiring a new advisor representative or solicitor.

Complete thorough due diligence of a money manager’s past performance before introducing a client. Measure the firm’s performance against various indexes. Is the firm Global Investment Performance Standards (GIPS) certified? If not, does it aim to achieve GIPS compliance? Does the firm have proper disclosure regarding its past performance so that you can make an accurate and fair interpretation? Finally, does the firm subject itself to an annual surprise audit?

Due Diligence: Recommended Broker–Dealers

When recommending a broker–dealer, an investment advisor must conduct due diligence and also ensure

that clients receive best execution. Regulations state “best execution” does not necessarily mean the lowest commissions or costs charged by a broker–dealer. The following are some additional factors that also should be considered:

- trading expertise
- execution capabilities
- reputation and integrity
- facilities
- the full range and quality of services available when placing trades
- financial services offered
- willingness and ability to commit capital
- access to underwritten offerings and secondary markets
- reliability in executing trades and keeping records
- fairness in resolving disputes
- the number of primary markets that will be checked
- timeliness of trade execution
- responsiveness of all parties involved in trade execution
- in relation to particular transactions, the character of the market for the security (e.g., price, volatility, relative liquidity, and pressure on available communications), the size, and type of the transaction

Conclusion

After completing an initial due diligence review, ongoing due diligence is absolutely crucial, and its absence creates a critical compliance program weakness. To honor your minimum fiduciary commitment to clients, complete annual reviews to buttress initial due diligence by re-evaluating factors analyzed during the initial review of outside money managers and outside solicitors.

After selecting a broker–dealer, conduct best execution and due diligence reviews at least quarterly in order to evaluate the services provided to your clients.

Developing sufficient compliance programs can be a confusing and daunting task. However, it should be clear that investment advisors need

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to create and maintain an effective due diligence program to maintain compliance with federal regulations and sustain their fiduciary responsibilities to their clients. **M**

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Endnotes

1. "Compliance Programs of Investment Companies and Investment Advisers," U.S. Securities and Exchange Commission, available at www.sec.gov/rules/final/ia-2204.htm (February 5, 2004).
2. "Investment Adviser Codes of Ethics," U.S. Securities and Exchange Commission, available at www.sec.gov/rules/final/ia-2256.thm (August 31, 2004).