



Due Diligence of Service Providers

Why It May No Longer Be Just a Best Practice

2023 Annual Compliance Conference
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If you have questions about the content of this course or need technical help, please contact us via the email address below:

ContEd@ria-compliance-consultants.com

Your Instructors

Shelly Welch, Compliance Analyst II

Shelly's experience as a securities regulator began in 2003 as an Examiner with the Kansas Securities Commissioner's office where she spent 10 years conducting on-site audits of broker-dealers and investment advisers. In 2012, she became the Registration Manager for the agency and began oversight of all registration applications for securities firms and individuals in Kansas. She served as Chief of Registration from 2019 until she joined RCC in 2022. Shelly appreciates being a part of the compliance team and using her experience to assist the Consultants and their clients with their regulatory filings.

▶ swelch@ria-compliance-consultants.com

▶ 877-345-4034 x 105

Teresa O'Grady, Senior Compliance Consultant

Teresa began her career in the financial services industry in 1989, when she joined Ameritrade, Inc. Throughout her career, she worked for several other local firms gaining experience in almost every facet of the broker dealer and investment adviser industry. Teresa joined RCC in 2016 and enjoys helping investment adviser firms meet their regulatory and compliance obligations.

▶ togrady@ria-compliance-consultants.com

▶ 877-345-4034 x 114

Course Overview

- Regulatory Resources
- Introduction
- Types of Service Providers
 - Importance of Understanding the Types of Service Providers
 - Direct Service Providers
 - Indirect Service Providers
 - Client-Neutral Service Providers
- Expectation and Proposed SEC Rule 206(4)-11
 - Requirements of New Rule
 - Defining a "Covered Function"
 - Conduct Detailed Due Diligence Before & During Services
 - New ADV Disclosures
 - Books and Records Requirements
 - Comply with Six Elements When Performing Due Diligence
- Performing the Due Diligence Review
 - Key Items to Review
 - Documentation of Review
 - Policies and Procedures for Due Diligence Review
- Questions

Regulatory Resources

- **SEC Proposed Rule 206(4)-11 – Outsourcing By Investment Advisers (10/26/2022):**
<https://www.sec.gov/files/rules/proposed/2022/ia-6176.pdf>

SEC Risk Alert: Investment Adviser Due Diligence Processes for Selecting Alternative Investments and Their Respective Managers (1/28/2014):

<https://www.sec.gov/about/offices/ocie/adviser-due-diligence-alternative-investments.pdf>

Regulatory Resources (Continued)

- **SEC Enforcement Action Against Firm and CCO With Due Diligence and Monitoring Failures:**
<https://www.sec.gov/enforce/ia-5061-s>
- **BrokerCheck**
<http://www.finra.org/Investors/ToolsCalculators/BrokerCheck/>
- **Investment Adviser Public Disclosure Website**
[IAPD - Investment Adviser Public Disclosure - Homepage \(sec.gov\)](#)

Introduction

- Current Regulatory Requirement
- Review is an Expectation
- Description of Proposed SEC Rule
- Importance and Necessity For Rule
- Should Be Part of Fiduciary Duty

Types of Service Providers

- Why It's Important to Know the Types of Service Providers
 - Protect Client From Harm
 - Act in Client's Best Interest
 - Fiduciary Duty Includes Knowing Who the Firm is Doing Business With
 - Helps Prevent Fraudulent, Deceptive or Manipulative Acts

Types of Service Providers

➤ Direct Service Providers

- Most Important
- Access to Confidential Client Information (PII)
- Provide Direct Access to Firm's Clients
- Perform Due Diligence on Each Provider
- Includes Custodians and Third-Party Managers
 - “Covered Functions” of the Firm
 - Investment Adviser Firm Must Identify and Determine that Outsourcing a “Covered Function” is Appropriate in Each Instance.

Types of Service Providers

- Investment Adviser Should Regularly Perform a Review of the Custodian Even When the Firm's Associated Persons are Registered Reps of the Broker Dealer.
- If an Investment Adviser Uses an Outsourced Service Provider to Calculate and Deduct Advisory Fees From Client Accounts, the Investment Adviser Must Verify Those Fees Are Correct.

Risks For Using Direct Providers

- Custodians/TPM – Disruption of Service/Technical Difficulties Could Prevent Adviser From Providing its Services to Clients
- Could Result in Increased Transaction Charges
- Poor Oversight Could Result in Market Losses for Client or Lost Investment Opportunities
- Inaccurate Performance Information or Pricing
- Errors in Computation/Debit of Advisory Fees

Types of Service Providers

➤ Indirect Service Providers

- No Access to Confidential Client Information (PII)
- No Direct Access to Firm's Clients
- Typically Includes Tools or Software a Firm Uses to Help Provide Advisory Services
 - Financial Planning Software or Trading Platform
 - Research
 - Newsletters

Risks For Using Indirect Providers

- Software/Newsletters – Cost Exceeds Value Making it Not Feasible for Adviser to Use
- Newsletters/Research – Inaccurate Data Causing Clients to Make Decisions Based on Misinformation
- Technology Fails to Provide Accurate Results
- Software Can Become Corrupted Risking Accuracy of Data

Types of Service Providers

- Client Neutral Service Providers
 - No Access to Client Accounts or Information
 - No Direct Impact to Firm's Clients
 - Includes Firm's Accountant, Consultant or Records Management Service Providers

Risks For Using Client Neutral Providers

- Accountant – Failure to Provide Accurate and Timely Financial Records to Adviser or Investors in a Fund
- Consultant – Reliance on Inaccurate Advice; Failure to Make Required IARD Filings
- Records Management Service – Failure to Retain Records as Required; Failure to Retrieve Records in a Timely Manner as Required By Regulators

Proposed SEC Rule 206(4)-11

- Rule Proposed in October 2022
- Would Require SEC Investment Advisers to Conduct Due Diligence

When Outsourcing “Covered Functions”

- Before Hiring the Service Provider
- Continued Oversight of Service Provider

Covered Function is a Function or Service That:

- 1) Is Necessary to Provide Advisory Services in Compliance With Federal Securities Laws
- 2) If Not Performed or Performed Negligently, May Likely Cause a Material Negative Impact on Clients or Firm’s Ability to Provide Advisory Services Such as Portfolio Management

Proposed SEC Rule 206(4)-11

- Rule Would Require Investment Adviser to Conduct Detailed Due Diligence Before Engaging in an Outsourced “Core Advisory Service”
 - Provide Disclosure Related to the Services
 - Conduct Periodic Monitoring of Service Providers to Ensure Reliability
 - Maintain Detailed Record Keeping Related to These Functions

“Core Advisory Services” would include model development, trade execution, provision of bespoke indexes, sub-advisory services, platforms for robo-advisory services, cybersecurity and record keeping.

Proposed SEC Rule 206(4)-11

- Proposed Rule Would Mandate New Disclosures to Advisory Clients on Form ADV, Including:
 - Disclosing Service Provider Names and Locations.
 - Disclosing the Types of Services Provided by the Service Provider.
 - Other Information About the Relationship to the Adviser, Including Whether the Outsourced Third-Party Service Provider Relies on its Own Subcontractors.
 - Persons Performing “One or More Covered Functions” Who Are Not “Supervised Persons” of the Investment Adviser, Would Be Deemed “Service Providers” and Would Need to be Disclosed on Form ADV.
 - Supervised Persons are Excluded From the Definition of “Service Provider”.

Proposed SEC Rule 206(4)-11

➤ The Due Diligence Review Would Require Investment Advisers to Comply With Six Elements

- 1) Identify the nature and scope of the covered function the service provider is to perform;
- 2) Identify and determine how it would mitigate and manage the potential risks to clients or to the investment adviser's ability to perform its services;
- 3) Determine that the service provider has the competence, capacity, and resources necessary to perform the covered function in a timely and effective manner;

Proposed SEC Rule 206(4)-11

- 4) Determine whether the service provider has any subcontracting arrangements that would be material to the service provider's performance of the covered function, and identifying and determining how the investment adviser will mitigate and manage potential risks to clients or to the adviser's ability to perform its advisory services in light of any such subcontracting arrangement;
- 5) Obtain reasonable assurance from the service provider that it is able to, and will, coordinate with the adviser for purposes of the adviser's compliance with the Federal securities laws; and
- 6) Obtain reasonable assurance from the service provider that it is able to, and will, provide a process for orderly termination of its performance of the covered function.

Performing the Due Diligence Review

- Currently, Pursuant to Section 206 of the *Investment Advisers Act*, Investment Adviser Firms Have a Duty to Their Clients to Conduct a Reasonable Investigation Concerning Any Service Provider Hired to Work on Behalf of the Firm.

Performing the Due Diligence Review

- Some Key Items to Review Initially When Performing Due Diligence of Service Providers
 - Conduct a background check of the service provider via FINRA Broker Check, the Investment Adviser Public Disclosure website or by other means;
 - Review the service provider's entire Form ADV, disclosure brochures, marketing material, and client agreements, if available;
 - Assess whether the service provider will have access to confidential client information;
 - Review state licensing rules and the current status of professional licenses and designations of the service provider.

Performing the Due Diligence Review

- Some Key Items to Request and Review From the Service Providers
 - Verify if the service provider maintains errors and omissions insurance, a fidelity bond, and/or an ERISA fiduciary bond;
 - Review the service provider's most recent regulatory examination letters;
 - Review any Form U4 disclosures of the service provider's officers, directors and portfolio managers to analyze any reported regulatory actions, criminal actions, civil actions, customer complaints, arbitrations, and financial disclosures;
 - Examine the service provider's experience level in providing said service.

Performing the Due Diligence Review

- As a Best Practice, Prior to Entering Into an Agreement With a Third-Party Service Provider, an Investment Adviser's Initial Investigation of the Service Provider Should Include the Following Items:
 - Measures the Service Provider Has Taken to Secure the Data of the Investment Adviser's Clients (Such as Firewalls, Encryption, etc.)
 - How Often a Backup is Performed on the Investment Adviser's Data and How Many Copies Are Maintained
 - Whether the Service Provider Has a Business Continuity and Disaster Recovery Plan and How Often it is Tested
 - If There Are Legal Restrictions Regarding Responsibility or Liability, Choice of Law/Forum, or Limitation of Damages in the Agreement

Documenting the Due Diligence Review

- The Investment Adviser Should Determine the Most Efficient Way to Document the Due Diligence Review
- Maintain the Review in Paper Form
- Maintain the Review in Electronic Form
- Who Will Need Access to the Review
- Determine a Course of Action if Red Flags Are Found
 - Document the Decision to Keep or Remove the Service Provider

If the Review is Not Documented, the Review Did Not Happen

Policies and Procedures For Due Diligence Review

- Should Be Reasonably Designed to Ensure That Each Service Provider is Properly Investigated Before an Agreement is Signed With the Service Provider and Before the Service Provider Does Work on Behalf of the Investment Adviser
- Investment Adviser Must Make a Determination of the Scope of its Investigation Based Upon the Unique Facts and Circumstances of Each Service Provider
- Should Not Rely Blindly Upon the Service Provider for Information Concerning the Service Provider in Lieu of the Investment Adviser Conducting Its Own Reasonable Investigation

Policies and Procedures For Due Diligence Review

- Should Have a Procedure to Conduct a Reasonable Investigation to Follow Up on Any Red Flags Investment Adviser Encounters During Its Review As Well As to Investigate Any Substantial Adverse Information About the Service Provider
- Retain Records Documenting
 - Descriptions and Notes From Meetings That Were Conducted
 - Tasks Performed and Documents Reviewed
 - Dates When Such Events Occurred and List of Individuals Attending the Meetings
 - Any Investigations of Red Flags
 - Results of Investigations and Red Flags With Outcome
- Name the Supervisor Responsible For Conducting Due Diligence Reviews
- Document the Frequency of the Due Diligence Reviews

Policies and Procedures For Due Diligence Review

Even Though This Presentation is Limited to the Due Diligence Review of Service Providers, Investment Adviser Firms Have a Duty to Review Investment Products, Including Alternative Investments, Private Funds, Auditors, etc. and Have Policies and Procedures in Place For These Reviews Also.

Sample Due Diligence Review

▶ Review of Software Vendor – Some Items to Look For

- Verify that the investment adviser's data will be encrypted and that the vendor has implemented firewalls, socket security features, electronic audit trails and intrusion-detection systems;
- Verify that the investment adviser will have unrestricted access to client data;
- Verify that client data will be easily retrievable in any format requested;
- Verify that the vendor does not retain any portion of the data once it is deleted by the investment adviser;
- Verify that the vendor has security measures in place for vendor personnel who will have access to the investment adviser's data;
- Verify that the vendor is required to notify the firm in the event of a security breach; and
- Review the vendor's security audit.

Questions

Please submit any question online or email with any questions about the content of this course.

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Thank You

