

## Keys to a Successful Due Diligence Program

### Knowing and Evaluating Hedge Fund Service Providers

The credit crisis and ensuing market downturn of 2008-2009 has revealed a number of scandals in the hedge fund industry. One matter that has been highlighted repeatedly in the dénouement of these scandals is the importance of truly meaningful due diligence programs. Understandably, much of the focus has been on the adviser and/or sub-adviser; however, the renewed focus on due diligence also provides an excellent opportunity for hedge funds to reassess the due diligence programs with their service providers and vendors. Most hedge funds utilize an array of firms to provide functions ranging from critical operations support to research analytics. Some of course, do not, which may be a warning flag. Having a well designed and documented due diligence process can provide several benefits including:

- Fulfilling manager fiduciary/regulatory requirements
- Mitigating operational risks
- Meeting the expectations of prospective clients and their due diligence processes
- Aiding the development of disaster recovery or business continuity plans

This Element provides a high level overview for developing a meaningful service provider and vendor due diligence program.

### Policy Statement / Background

As with any policy or procedure, an effective due diligence program should begin with a policy statement and background as to why the program exists. This serves to document the importance a firm places on selecting service providers, which in many instances directly relates to overall client service.

### Service Provider / Vendor Matrix

The first step in the due diligence process is to identify all service providers and vendors and to create a list of their functions. Information can be assembled into a matrix that should include such data as service provider/vendor name, contact information, a brief description of service/product, the date of the last due diligence review and whether the service provider/vendor is critical or non-critical to operations.

### Product / Service Assessment

Effectively performing due diligence on a service provider and/or vendor requires a full understanding of the service or product being provided. An excellent place to begin is the service agreement and/or contract, keeping in mind that some functions may not be enumerated. To complete the picture, it can be helpful to interview the staff members who have primary contact with the service provider. Once services have been identified, a logical way to assess risk is to utilize a matrix/checklist which reflects the firm's risk assessment and/or compliance program. Two principal factors to consider in the evaluation include:

- *Data Access* – does the vendor or service provider have access to non-public and/or client sensitive information?
- *Operations* – is the product or service essential to day-to-day operations (trading, research, proxy voting, statement delivery, etc.)?

In completing this assessment for each service provider/vendor it is also essential to classify each as critical or non-critical and the relevant timeframe. For example, a prime broker is a critical vendor on a day-to-day basis. Another critical service provider is the auditor; however, on a much less immediate timeframe. An outsourced human resource service, on the other hand, might be deemed a non-critical function. Determining what classification each service provider/vendor falls under will dictate to a large extent the level and type of due diligence required.

## Keys to a Successful Due Diligence Program continued

### Due Diligence Focus Areas

Once the matrix has been prepared and the products and services assessed, the firm is in a position to complete meaningful due diligence review. The depth of the due diligence process may vary greatly between service providers/vendors based on the results of the product/service assessment and, if applicable, the classification assigned. Regardless, it may still be beneficial to document the different focus areas analyzed in completing due diligence, stressing the importance of each case based on an initial assessment. Certain items you may want to consider when completing due diligence include:

- Company History
- Key Employee Profiles/Bios
- References
- Financial Status
- Technology
- Internal Control Structure
- Third Party Reviews (SAS 70's)
- Business Continuity Plan
- Legal and Regulatory Actions
- Staff Training

## Conclusion

A well-designed and documented process for service provider and vendor due diligence is an essential part of the operational controls for a modern day hedge fund. In addition to potentially mitigating risk and fulfilling fiduciary and regulatory requirements, it can also provide a competitive marketing advantage when dealing with sophisticated investors.

## Other Considerations

Note that this discussion addresses common elements of a successful due diligence program and is not intended to be an exhaustive list of due diligence considerations. Each management firm, based on its circumstances and structure, should develop a due diligence program that meets its individual needs.

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