Due diligence is a serious responsibility

There are key areas to watch, whether reports are done by an in-house committee or contracted out to a service

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By Stewart Lewis

As licensed partici-pants in the mutual fund industry, advisors considering which products to sell have to take their due diligence responsibilities seriously, says Sandra Kegie, executive director of the Federation of Mutual Fund Dealers.

In order to assist dealers, especially smaller dealers, as well as the advisors who work with them, the FMFD is setting up a due diligence report service, Kegie says. The service will provide third-party, arm's-length reports that dealers can trust, says Kegie.

Due diligence can be contracted out or carried on in-house. Terry Ford, national compliance officer for Regina-based **Partners in Planning Financial Services Ltd.** , says dealers that want to conduct in-house reviews should have a committee with members coming from several departments — marketing, operations, technology and finance — and also should include legal and compliance personnel.

Having a compliance officer involved from the start, Ford says, means compliance is more likely to be considered a "co-developer" of the review process rather than coming in at the tail end of the process, when concerns might be considered a "roadblock" to the assessment of the product lineup, says Ford.

If dealers choose to outsource their due diligence, they can turn to firms such as **Paterson & Associates**, a Toronto-based independent consulting firm specializing in mutual fund and hedge fund research for financial advisors. It has a formula for due diligence. Dave Paterson, P&A's director of investment fund research, starts with a basic rule when he is talking to product providers: "You can always ask a question and see if they'll answer. If something doesn't sit right, then it's a red flag."

The first step in Paterson's due diligence process is achieving a basic understanding of the product, he says: "What is it? A traditional mutual fund? A seg fund? Principal-protected note? A hedge fund? The more complicated the product, the more thorough your due diligence has to be."

You should also ask who the intended investor is, says Ford. And if the product is not intended for a general audience, dealers need to establish how they will limit access to the product.

The second step is to look at the people behind the product. Is this an established company or a start-up? Who is at the helm?

Next, look into operations, says Paterson. What are the product developer's assets under administration? What is its operating history? Does the company have a disaster recovery plan? For example, says Paterson, how will the company cope if there's a power outage and the computer system crashes?

"I'm not so much concerned about the power going out for the afternoon," he says. "But more with the longer-term implications of an extended disruption in the firm's operations."

After getting through this initial level of questions, Paterson digs deeper into the product, looking at how it is being offered — for example, by a simplified prospectus procedure that is highly regulated or by an offering memorandum, which is not.

He looks for brand-name investment managers, auditors and legal counsel. None of these people should have a vested interest in the company or particular product undergoing due diligence.

Then Paterson wants to know about the company's internal controls. For example, he says, how does the company offering the product minimize the risk of market manipulations such as "front-running" (when an insider places trades before clients)?

Next comes a line-by-line analysis of the offering, looking at the investment guidelines, how the proceeds are used, how the fees are calculated and whether the product is unique or similar to a product the offering company already has on its shelf.

Ford points out that dealers have to know what their compensation will be. Then they have to figure out what conflicts result, and how those conflicts will be addressed.

One of Paterson's favourite questions in the fee analysis is: what would the return on the underlying investment have to be in order for the client to receive a 1% return? An investment that requires 7% performance to provide a 1% return to the client obviously reflects a fee structure that is more beneficial to the company than to the client.

Paterson tries to ferret out any clauses that can cause concern — possibly resulting in harm to investors. If he finds such a clause, he'll ask for clarification.

At the end of P&A's due diligence process, a formal report is issued. This acts as a reference for advisors, and also proves to regulators that due diligence efforts were undertaken. **IE**