

Service provider due diligence and selection best practices

A due diligence handbook for manager and fund board selection of fund administrators



Service provider selection overview

The service provider selection and due diligence processes are increasingly scrutinized as critical components of operations for both mutual funds and hedge funds. Due to both liability and risk, investment managers and fund boards are confronted with increased due diligence efforts to understand all aspects of the service provider business and processes in order to justify the use of fund assets to pay these service expenses.

As financial services regulatory agencies impose increased regulation and reporting requirements on both mutual funds and hedge funds, fund sponsors and fund boards are well served to formalize their service provider due diligence process, with the intent to objectively justify and document the selection and ongoing relationship management. The following due diligence process and criteria will provide the framework for selecting the best service partner.

Service provider selection criteria

The due diligence program should begin with the criteria required and business characteristics of the best possible service firm – those service attributes that provide the greatest distinction of service capability aligned with your weighting of the importance of each criteria to your specific business and investor needs. See page three for specific components within each of these selection criteria.

Service provider due diligence criteria

1. Service provider credentials
2. People and service team
3. Firm compliance programs
4. Service quality programs
5. Technology
6. Service innovation

“A critical service provider distinction you should identify is the current client base of products similar to yours - both structure (e.g. LP, CEF, RIC, BDC, FOHF, etc.) as well as client funds with your similar investment securities.”

Bob Kern
Executive Vice President
U.S. Bancorp Fund Services

Formal due diligence process

The due diligence process should be a formalized program with a focus toward both selection and ongoing management of the service firm relationship, containing the following elements supporting your process and decision:

- **Due diligence plan** – Your plan describes your business goals and specific factors you will use in selecting the correct service provider as well as how you will conduct your due diligence.
- **Research and validation** – Early in the process, be sure to identify all industry service providers through research and discussions with industry players such as legal, audit, consulting firms, and other contacts that work with the providers – these may be your greatest source of market intelligence and provider distinctions.
- **Documentation** – Develop thorough and detailed documentation either directly or through a formal Request for Proposal (RFP) process.
- **Analysis** – The single greatest component of your due diligence plan is the objective analysis of your findings – identifying differences between providers that will be important to you and your investors.
- **Recommendation** – The results of a successful formal due diligence process should spring from your formal methodology and data analysis.

Expectations of service providers

Before you engage in a formal relationship with any firm, you should expect complete transparency into all aspects of the service provider’s business in order for you to make your decision. If the provider chooses not to disclose certain information requested, you will need to determine how critical the information is to your selection.

As you prepare for, and conduct your due diligence of the different providers, keep in mind the two greatest criteria for any business – talent and technology. These two resources drive all other criteria, service capability, success, and risk of any business relationship. In addition, your primary goal in performing due diligence is to assess and quantify risks, including risks associated with your service provider selection – financial, operational, personnel and compliance risks.

Two important discoveries you will identify in your due diligence of different service firms are their “service culture” and demonstration of success. Service culture defines “how” the firm will service your requirements, business needs and problem resolution. As you inquire of each firm’s service capabilities, make sure each firm provides not just a discussion, but a demonstration of their service capability, including examples of described service.

Due Diligence Criteria for Mutual Fund and Hedge Fund Administration Services

1. Service provider credentials	
<ul style="list-style-type: none"> • Financial condition • Firm history, business diversification/concentration • Service inception, history of each service • Acquisition history • Commitment to your specific service businesses • Firm background check • Third party industry ranking – size, quality 	<ul style="list-style-type: none"> • Complete client base • Specific client base to your similar product, size • Complete scope of services • Insurance coverage • Transparency of information requested • Client base tenure • Client turnover – wins/losses and reasons
2. People and service team	
<ul style="list-style-type: none"> • Management team tenure, staff tenure • Management and staff turnover • Individuals assigned to your relationship, bios, workload, onshore/offshore • Talent sourcing and development programs 	<ul style="list-style-type: none"> • Quality of firm's reference research results • Management and service team interview results • Willingness/ability to customize services • Frequency of relationship/management interaction
3. Service provider compliance programs	
<ul style="list-style-type: none"> • Firm regulatory exam results • Compliance culture, commitment • Compliance resources and management structure • Internal training programs 	<ul style="list-style-type: none"> • Internal audit exam programs • Third party audit program, results • Chief compliance officer resources • SOC 1/SOC 2 assessment
4. Service quality programs	
<ul style="list-style-type: none"> • Formal quality programs – ISO, Six Sigma, etc. • Key performance indicators (KPIs) • Service level agreements (SLAs) • Service measurement programs • Frequency of client service performance reporting/review 	<ul style="list-style-type: none"> • Continual improvement programs • SLA service reporting to clients • KPI measurement automation tools • External quality verification/testing reporting sources • Service conversion history, methodology, examples
5. Technology	
<ul style="list-style-type: none"> • Client data delivery capabilities, reporting • Core technology infrastructure, history, tenure • Recent, pending, anticipated technology changes • Ability to customize for client-specific requirements • Technology support teams – within/outside the business 	<ul style="list-style-type: none"> • Information security program, test results • Business continuity plan, program, test results • External/internal technology dependencies • Outsourced technology provider management program • Development methodology
6. Service innovation	
<ul style="list-style-type: none"> • Relationship management focus, attention • Capability to champion client regulatory change solutions • Customized services specific to client requirements • Ability to serve as a resource regarding all industry topics 	<ul style="list-style-type: none"> • Value – add service or support distinctions • Demonstration, examples of innovative client support • Technology innovation demonstrated • Client access to legal and tax resources

Conclusion

Our financial environment encourages increased regulation, leaner business practices and more sophisticated technology. More than ever, investment managers must perform robust due diligence on all fund services in order to support investor and regulatory scrutiny. A comprehensive due diligence program will identify the optimal service provider and minimize operational, financial and compliance risks for the manager and ensure high quality services for investors.



About the author

Bob Kern is a managing director and executive vice president of U.S. Bancorp Fund Services. He began his career with U.S. Bancorp in 1982 and has served as a manager within the fund services subsidiary since 1984. From 1984 to 1994, Bob managed business development efforts as well as the mutual fund Transfer Agent operation including the Investor Services group, Account Services, Legal Compliance, Document Processing and Systems Support divisions. During that time, Bob assisted in the management and implementation of both services and technologies related to transfer agent and shareholder services, fund accounting, fund administration, literature fulfillment and fund distribution services.

“We have supported our clients’ due diligence process for over 45 years, providing transparency to our service programs, resources, testing, controls, technology and compliance processes.”

Education and credentials

Bob received his undergraduate degree from Marquette University in business administration with specializations in finance and marketing. Bob serves as a board member of U.S. Bancorp Fund Services, Quasar Distributors and interested Trustee and Chair of Managed Portfolio Series, an open-end mutual fund multiple series trust.

About us

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