

## **PHD Consulting Services**

### **“Due Diligence White Paper Report”**

#### **Referral Advisor Due Diligence on Third Party Money Managers**

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Many Registered Investment Advisers act as solicitor-referral advisors (Referral Advisors) and refer their client accounts to SEC registered investment advisers that act as third party money managers (Money Managers). When establishing a Money Manager relationship a Referral Advisor must comply with SEC Rule 206(4)-3 and state laws on solicitor-referral relationships. In addition, they should also establish formal “Money Manager due diligence policies and procedures.”

If a Referral Advisor fails to conduct proper due diligence on a Money Manager they refer clients to they could open themselves up to liability and risk issues regarding the fiduciary duties they owe their clients. In addition, after the recent financial industry scandals regulators are expecting Referral Advisors be more thorough in their due diligence reviews of the Money Managers.

Money Managers generally provide prospective Referral Advisors with access to marketing and due diligence documentation and information regarding their money management activities. A Referral Advisor’s Money Manager Due Diligence Policies and Procedures should be built around reviewing this marketing and due diligence information.

As a general rule, a Referral Advisor should review all of the Money Manager’s portfolio management programs, documents, systems, reports, and key personnel individually and collectively. Are the Money Manager’s portfolio management programs, documents, systems and reports consistent with each other and with what is being conveyed to clients?

Although there are various business models that can be established to conduct Money Manager relationships the following is a general discussion and outline of what a Referral Advisor should look for in their due diligence reviews of prospective Money Managers:

- **Investment Strategy and Model Portfolio Information**
  - Are the Money Manager’s investment strategies and model portfolios clearly defined and consistent with their stated investment objectives?
  - How are the investment strategies and model portfolios designed and managed?
    - Institutional asset allocation models;
    - Overlay models on a wide variety of mutual fund/variable annuity sub-accounts;
    - Actively traded accounts based on a technical analysis models; or
    - Separate accounts that are individually managed.
  - Does the Money Manager use sub-advisors from other registered investment advisers?
  - Does the Money Manager sponsor a wrap-fee program, or are they a wrap fee sub-adviser?
  - Are the Money Manager’s performance reports easy to analyze and understand?

- Does the Money Manager provide a newsletter to clients and Referral Advisors? If yes, does it provide direct and accurate commentary on the Money Manager's investment strategies and performance or does it just provide "canned" generic commentary?
- **Portfolio Manager Profiles**
  - How experienced are the Portfolio Managers and what credentials do they have?
  - Are portfolios managed on an individual or team basis?
  - How accessible are the Portfolio Managers to Referral Advisors or clients?
- **Marketing/Advertising Material, and Website Access**
  - Is the website professionally designed, current and supportive to the Money Managers programs and services?
  - Are accurate disclosures and disclaimers used in the Money Manager's advertising?
  - Is password protected client account information available on the website?
  - Is the Money Manager using testimonials that could be prohibited under SEC Rule 206(4)-1?
- **Performance Advertising Information**
  - Is the Money Manager claiming that their performance is Global Investment Performance Standards® (GIPS®) compliant? If the Money Manager is claiming their performance numbers are GIPS® compliant have they had their performance GIPS® verified by an independent verification service?
  - How long is the Money Manager's track record, 3 years, 5 years, 10 years or some other time frame? Has the Money Manager taken their investment strategies through a complete market cycle or two? How current are the performance numbers?
  - Is the Money Manager's performance presented gross of fees and net of fees?
  - Does the Money Manager's performance appear to be too good to be true and too consistent? Is the advertised performance primarily based on back-tested models with very little actual performance?
- **Broker-Dealer and Custodian Relationships**
  - Does the Money Manager have a broker-dealer and custodian relationship with a large financial institution, such as Charles Schwab, TD Ameritrade, or Fidelity/National Financial Services? Does the custodian or broker-dealer provide services that are independently structured for registered investment advisors?
  - Does the Money Manager manage mutual funds and variable annuity sub-accounts directly at fund and annuity custodians?
  - Is the Money Manager using an affiliated broker-dealer? If they are using an affiliated broker-dealer how do they deal with the potential conflicts?
  - What type of pricing is the Money Manager getting from their broker-dealer and custodian relationship(s)? Are they meeting their best execution duties to their clients? Do they conduct periodic best execution reviews?
- **Solicitor-Referral and Money Manager Relationship Agreement**

This is the Agreement that is required under SEC Rule 206(4)-3 to be signed by the Money Manager and Referral Advisor. This agreement describes the referral-solicitation activities and compensation to be paid to the Referral Advisor by the Money Manager. This agreement

should be reviewed in conjunction with the Money Manager's Form ADV and Client Asset Management Agreement to verify the consistency between the documents.

- **Form ADV Part II, Schedule F Brochure**  
The Money Manager is required by SEC Rule 204-3(a) to deliver a copy of their Form ADV Part II Disclosure Brochure to a client before or at the time they sign the agreement with the client. The Referral Advisor should verify that the Form ADV Part II Disclosure Brochure is professionally drafted and clearly discloses the Money Manager's asset management program(s), code of ethics, conflicts of interest, fees and Referral Advisor relationships. In addition, the ADV Part II Disclosure Brochure should be consistent with the Money Manager's Client Asset Management Agreement and advertising material.
- **Privacy Policy Statement**  
The Money Manager is required by Regulation S-P to deliver a copy of their Privacy Policy Statement to the Referral Advisor at the time they enter into an agreement with a Referral Advisor and also to a client when they enter into an asset management agreement with the client. Does the Money Manager's Privacy Policy Statement provide for adequate protection of confidential client information? Failure to properly protect confidential client information could have catastrophic consequences if client information is inadvertently or intentionally disseminated in violation of the Money Manager's Privacy Policy or Regulation S-P.
- **Client Asset Management Agreement**  
The Client Asset Management Agreement is the agreement that the Money Manager signs with the clients referred to them by the Referral Advisor. This agreement should be reviewed to verify that it is consistent with their Form ADV Part II Disclosure Brochure, and the Solicitor-Referral and Money Manager Relationship Agreement. Does the agreement disclose potential conflicts and the management fee schedule?
- **Referral-Solicitor Disclosure Statement**  
This is the disclosure statement that is required under SEC Rule 206(4)-3 to be signed by clients that are referred by a Referral Advisor to a Money Manager to verify that the client understands that the Referral Advisor is going to receive a referral fee from the Money Manager. The Referral Disclosure Statement may be a separate document or be included in the Client Asset Management Agreement. This statement should be reviewed to verify that it is consistent with their Form ADV Part II Disclosure Brochure, and Client Asset Management Agreement.
- **Errors & Omissions Insurance (E&O Insurance)**  
Does the Money Manager have insurance coverage that covers their asset management activities? A Referral Advisor should have the Money Manager provide them with a copy of the E&O Insurance coverage declaration page or a certificate of insurance from the insurance company that verifies the Money Manager has the proper asset management insurance coverage.
- **Business Continuity and Disaster Recovery Plan**  
Does the Money Manager have a viable Business Continuity and Disaster Recovery Plan to constructively deal with potential business disruption events?

The following is a list of due diligence items that should also be obtained or reviewed online through the FINRA IAPD and CRD systems.

- **Form ADV Part 1**
  - Even if the Money Manager provides a Referral Advisor with a printed copy of their Form ADV Part 1, the Referral Advisor should go online to the FINRA IAPD system and review the most current form which could identify any potential regulatory issues.
  - The Referral Advisor should also verify that that the Money Manager is notice filed in the state(s) where the Referral Advisor conducts business.
  - Finally, the Referral Advisor should verify that the Form ADV Part 1 is consistent with the Money Manager's Form ADV Part II Disclosure Brochure.
  
- **CRD Reports for the Money Manager Associates who are also Broker-Dealer Representatives** (If applicable)

If any of the Money Manager's associates are broker-dealer registered representatives, the Referral Advisor should go online to the FINRA CRD system and review their CRD reports to verify there are no significant arbitration or regulatory actions disclosed in their CRD reports.

Once a Referral Advisor has established a relationship with a Money Manager and starts referring client to the Money Manager the Referral Advisor should implement the following policies and procedures:

- **Periodic Management Fee Audits**

The Referral Advisor should periodically audit the management fees that the Money Manager is charging clients to make sure client's fees are being properly calculated and the client is not being overcharged. The Referral Advisor should also make sure the fees split between the Money Manager and Referral Advisor is done accurately. It is recommended that initially the fee audit be conducted on a quarterly basis for the first year and if there are no issues the fee audit can be cut back to an annual audit.
  
- **Ongoing Review**
  - How easy is it for a Referral Advisor and client to open up a new asset management account with the Money Manager?
  - How easy it is for a Referral Advisor to communicate with a Money Manager's Operations staff or Portfolio Management staff? How responsive is the Money Manager's staff to Referral Advisor representatives, staff and client issues?
  - Are the Money Manager's performance reports accurate and consistent with the clients' monthly and quarterly custodial statements?
  - Does the Referral Advisor receive advance notices of communications by the Money Manager with clients?
  - On an annual basis the money manager is required to make an offer to deliver their Form ADV Part II Disclosure Brochure and deliver their Privacy Policy Statement to clients. As a general rule the Money Manager should deliver these documents to their Referral Advisors as well. Is the Money Manager following through on these requirements?

- Does the Money Manager periodically request client investment profile updates? If yes, are the updates requested through the Referral Advisors?
- If a Referral Advisor is put on notice of a regulatory investigation or decision involving a Money Manager, the Referral Advisor has to duty to investigate the matter and make a determination on whether they should maintain the relationship with the Money Manager.
- **Portfolio Management and Performance Reviews**
  - Is the Money Manager managing client accounts within their stated investment objectives and investment profiles?
  - Is the Money Manager outperforming their investment benchmarks?
  - Is the Money Manager's Investment Strategies and Model Portfolios experiencing portfolio drift from the stated investment objectives?
- **Annual Due Diligence Review**

On an annual basis the Referral Advisor should conduct a scheduled Money Manager Due Diligence review of each Money Manager to whom they refer clients. A good time to conduct the review may be when the Referral Advisors conducts their annual compliance review.

## Conclusion

As previously stated, there are various business models that can be established to conduct Money Manager relationships. A Referral Advisor needs to understand that their Money Manager Due Diligence Policies and Procedures must be flexible enough to adjust to the various Money Manager models while stressing substance over form.

Referral Advisors need to remember that Money Managers must do more than a good job of marketing, advertising and generating fees. Money Managers must be able to provide quality asset management services and performance. If a Money Manager fails to deliver quality asset management services and performance the Referral Advisor may not only lose their clients they may also be exposed to undue liability and risk.

## Regulatory Websites References

Securities and Exchange Commission: [www.sec.gov](http://www.sec.gov)

Investment Adviser Public Disclosure: [www.adviserinfo.sec.gov/IAPD/](http://www.adviserinfo.sec.gov/IAPD/)

FINRA: [www.finra.org](http://www.finra.org)

North American Securities Administrators Association: [www.nasaa.org](http://www.nasaa.org)

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## PHD Consulting Services

**PHD Consulting Services** provides compliance consulting, business planning, risk management, and due diligence services to registered investment advisors and other related financial service firms.

Patrick H. Doyle, Esquire is the owner and Managing Director of PHD Consulting Services and has been professionally involved in the financial service industries for over 25 years as a Consultant, Attorney, Broker-Dealer/Investment Advisor Compliance Officer and Representative, and Insurance Company Claims Attorney. Mr. Doyle is a member of the Nebraska State Bar Association, the Nebraska Financial Planners Association's Board of Directors and he is an Arbitrator for the FINRA Dispute Resolution Program.

The following is a list of services that **PHD Consulting Services** provides to investment advisors:

- Securities and Exchange Commission ("SEC") and State Regulatory Consulting
- SEC Registration
- State Registration/Notice Filing and Licensing
- Document Drafting-
  - Form ADV
  - Client Agreements
  - Other RIA Agreements
  - Compliance Manuals
- Investment Advisor Document Templates
- Mock SEC and State RIA Audits
- Compliance Manual and Policy/Procedure Audit/Reviews
- Advertising Reviews
- Asset Management Suitability Reviews
- Business Planning
- Due Diligence Reviews
- Arbitration Expert Testimony

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