

Alternatives present quandary for custodians

By Dan Jamieson

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Custody firms are engaged in a delicate balancing act, trying to accommodate a growing number of alternative investments while at the same time implementing stricter eligibility criteria for accepting those assets.

All firms ramped up their scrutiny of alternatives in the wake of the Bernard Madoff scandal, when it was revealed that the billions of dollars in assets Mr. Madoff claimed to have in hedge funds did not exist.

And in early 2009, when Schwab Advisor Services temporarily stopped accepting new alternative products, it caused a firestorm among advisers. Schwab's custody unit has since reopened the spigot, but its move left some big advisers reeling.

"Eight firms came to us from Schwab specifically around the alternatives question, and we've got two [more] big ones coming," said Mark Tibergien, chief executive of Pershing Advisor Solutions LLC. He declined to identify the advisers.

"It was more our response to how we deal with alternatives, not a reflection of other [firms]," Mr. Tibergien added. "We've taken a more deliberative approach to vetting alternatives."

"We are absolutely open for business on the alternative-investment front," said Rene Kim, senior vice president of product services at Schwab. "We're very much committed to making sure we can custody these assets."

Ms. Kim declined to comment when asked about advisers who might jump ship.


Schwab officials said that the movement of a few advisers to Pershing isn't reflective of any broader trend.

That the custody of alternatives has become such a competitive issue is no surprise. Observers said that the growing use of alternatives among advisers, combined with tighter criteria by the custodians, has put both the firms and advisers in a quandary.

Approving alternative investments for custody is costly and labor-intensive, and the custodian may not make money directly from the product.

Alternatives are "some of the most difficult things to do due diligence on," said Frank Maiorano,

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chief executive of Trust Company of America.

That is why his firm takes on few alternatives, he said.

Some advisers are finding it necessary to use multiple custodians in order to handle alternatives, said Christopher Winn, managing principal at AdvisorAssist LLC, a consultant. "I have a number of [adviser] clients trying to navigate that scenario" where some custodians won't take certain assets, he said.

Mr. Winn, who works closely with most of the custodians, declined to be more specific. But he said that an advisory firm's resources, its experience with particular types of assets and the technology it uses all play a role in determining what assets a custodian will accept.

Pershing, like other firms, set up a review committee to vet alternatives.

Mr. Tibergien declined to discuss details of the program other than to note that alternatives must be audited by firms registered with the Public Company Accounting Oversight Board to be eligible.

The Pershing custody unit holds \$9.1 billion in alternative assets for advisers, out of \$85 billion in total assets.

Pershing is "making sure [an alternatives sponsor] has a certified auditor and financials for a number of periods," said John Morris, chief operating officer at Exos Partners LLC, which holds assets in custody at Pershing and manages about \$100 million.

Schwab accepts domestic and offshore hedge funds, and certain private securities, including deals underwritten by broker-dealers. Schwab won't hold promissory notes but has referral arrangements with several trust banks for that service.

To be eligible at Schwab, investments also must have an up-to-date offering document, audited financials for the past three years and an independent valuation.

Schwab's new review process "has been working fairly smoothly," Ms. Kim said. The firm acts as custodian for about \$5 billion in alternatives, out of more than \$600 billion in total.

Fidelity Investment's custody unit holds more than \$8 billion in alternatives, spokesman Adam Banker wrote in an e-mail. The firm doesn't disclose total assets.

Last summer, Fidelity tightened some of its eligibility requirements. The firm requires a PCAOB auditor for non-publicly-traded real estate investment trusts, non-proprietary private debt and equity, and private-investment funds, spokesman Steve Austin wrote in an e-mail.

He declined to provide further details.

Fidelity will hold offshore programs if they are managed by an entity domiciled in the United States, said Mike Zarren, director of relationship management at Ceros Financial Services Inc., which uses Fidelity as a subcustodian and clearing firm for its hybrid advisers. For its review process, Fidelity requires offering memoranda, subscription agreements and other documents, he said.

Broker-dealer firms such as Ceros also have to perform a separate due-diligence process focusing on suitability, Mr. Zarren said.

TD Ameritrade is flexible in accepting nearly all categories of alternative investments, spokeswoman Kristin Petrick wrote in an e-mail.

"We continue to work with advisers on a case-by-case basis," she wrote. "We have found this to work for 99% plus of advisers."

The firm doesn't disclose asset data.

Acceptance into the Depository Trust and Clearing Corp.'s Alternative Investment Product service usually helps qualify an asset for custody. The AIP program creates standards, centralizes data and automates transactions involving alternatives.


At Schwab, assets that are in the AIP program are eligible for custody without going through the approval process.

Pershing, which was a beta participant with DTCC in the AIP platform, is using the service. Schwab recently went live on AIP with one hedge fund and now is set up on AIP with any provider who is on it, Ms. Kim said,

Fidelity plans to establish initial DTCC AIP connectivity in 2011, Mr. Banker wrote in his e-mail.


The AIP connection should help firms track alternatives on customer statements and reports more formally, and allow alternatives to be held in both qualified retirement accounts and non-qualified accounts, Mr. Morris said.

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