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Custodians taking closer look at adviser compliance

Quietly, they have tightened their scrutiny of new and established RIAs

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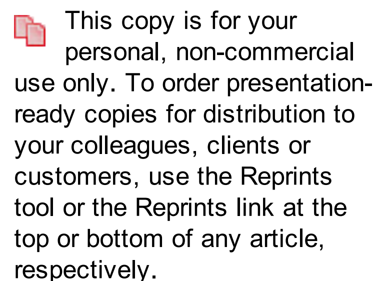

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Custodial firms have been raising the compliance bar for registered investment advisers, in some cases making it tougher for them to find a home.

Since the financial crisis and the Bernie Madoff fraud, custodians have become more concerned about the reputational and legal risks they could face from an adviser gone bad.

“They're definitely getting tougher [about] whom they accept,” said Christopher Winn, managing principal at AdvisorAssist.

The larger custody firms have always been conservative in taking on advisers, but they’ve “absolutely” tightened up since the crisis, agrees Patrick J. Burns Jr., an attorney who works with breakaway brokers.

For a new RIA who has some regulatory issues, “we may have nowhere to recommend for [a custodial] affiliation,” he said.

The extra scrutiny also applies to advisers who are already established at a custodian.

“If something came up on the ADV or on a background check, we would make the appropriate decision about” letting an adviser go, said Frank Maiorano, chief executive at Trust Company of America.

Likewise, RBC Correspondent and Advisor Services has asked advisers to leave, said Craig Gordon, director of the clearing and custody unit — something the firm has always done.

The unit of Royal Bank of Canada does quarterly reviews of its adviser clients, he said, covering a range of business and regulatory issues.

Mr. Winn is working with an adviser at Schwab Advisor Services who was asked to leave over a state regulatory matter.

The adviser settled the case, “but Schwab said [to] find a new home,” Mr. Winn said.

Firms have so many clean advisers in the pipeline, they don’t feel the need to take a risk on someone with a black mark, Mr. Winn added.

Some aspects of the continuing review of advisers are "relatively new, maybe over the last year," said Robb Baldwin, chief executive of TradePMR Inc., a Florida-based custodian.

It's not just smaller RIAs being booted for alleged problems.

"We've seen them as large as $100 million" in assets, Mr. Baldwin said.

Tight-lipped oversight

Most custodial firms are tight-lipped about the due diligence they do on their advisers, because they don't want to show their hand or give any impression to investors or plaintiff's attorneys that they're responsible for supervision, or have approved an adviser's investment strategy.

Spokespeople for Fidelity Institutional Wealth Services and Pershing Advisor Solutions LLC declined to comment.

Spokespeople at Schwab Advisor Services and TD Ameritrade Holding Corp.'s custody unit did not respond by press time.

But observers say that the due diligence performed by custodial firms can be extensive, and rival the investigation a major brokerage firm would perform on a new hire.

"It's an issue of managing the risk of the firm," not a compliance issue, said Brian Hamburger, founder of MarketCounsel LLC, a consulting and law firm. "Custodians do not want to see their names in the paper."

Custodians generally use an independent review committee to vet new clients. They perform credit and background checks, in addition to reviewing ADV and U-4 forms for disclosure and business information. These screens should reveal past bankruptcies, criminal actions or pending complaints and regulatory problems.

A pattern of problems, criminal issues or doing business without a license can be deal killers for custodians.

Pending regulatory matters or customer complaints can also create problems, observers said. Custodians prefer to see those matters closed.

Advisers who already have a custodial relationship can face similar reviews.

Firms also analyze business plans, and some firms may look into an adviser's clients as well.

If an adviser's client had in the past failed to pay a margin loan or kited checks, for example, "we would be alerted to that," said Mr. Maiorano, whose firm does background checks on the investors it takes in.

"Any custodian takes on the risk of their [advisers'] clients," he said.

The vetting of new clients and the continuing due diligence, while not a trade-by-trade overview, does counter somewhat the argument made by the broker-dealer community that independent RIAs lack firm-level oversight.

Since custodians are service providers to advisers and have no official power to supervise them, their power is limited, observers said. While they can decide whether or not to provide custodial

services, they can’t discipline an adviser the way a brokerage firm can.

Still, observers believe custodians should get some credit for keeping watch.

“The brokerage industry paints the independent RIA industry as the Wild West,” said Frank Pizzichillo, director of business development for MarketCounsel.

“But I don’t think [the critics] have taken a close look [at] the infrastructure involved in [bringing aboard an adviser] and in looking on an ongoing basis” at advisers, he said.

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