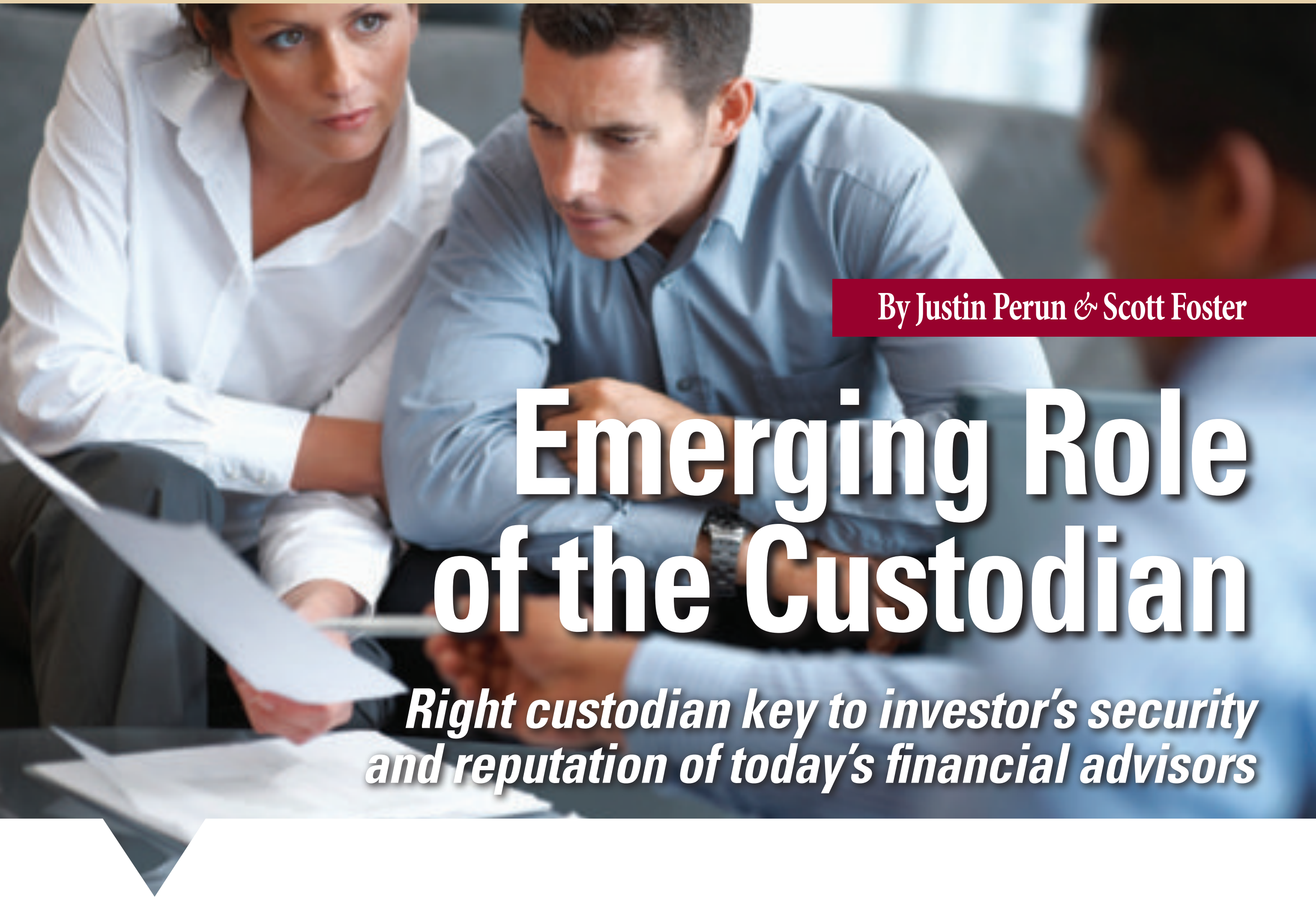


By Justin Perun & Scott Foster

Emerging Role of the Custodian

Right custodian key to investor's security and reputation of today's financial advisors

In the first of a three part thought leadership series entitled "Opening The Door," we provided an overview of the alternative investment industry with a strong emphasis on the growth of the industry post 2008 financial crisis. Historically, the growth of the industry has been highly correlated to high net worth, ultra high net worth and family offices.

OPENING THE DOOR

Over the next several weeks, Kingdom Trust will be publishing a series of white papers focusing on alternative assets and the value that they offer the investor, as well as the advisor.

It has only been over the last year that investment management firms have broadened their product offerings to accommodate increased retail investor demand by lowering investment minimums, increasing transparency/liquidity via managed accounts and compressed fee structures. The latest firm to publicly announce their broadening of product offerings is Washington, DC-based Carlyle Group. Many of these investors are allocating to alternatives for the first time, in search of un-correlated, alpha generating returns. Many of these individuals and firms confide in their financial advisor(s) as the expert in sourcing, selecting and allocating to alternative assets. Today, many of these advisors are unaware of the highly specialized and sophisticated custodial, administration and reporting services required when allocating to alternatives (ie: hedge funds, fund of hedge funds, private equity, real estate and precious metals).

The role and function of an alternative investment custodian is particularly challenging. An independent custodian or custodial service by definition is a "financial institution that holds customers securities for safekeeping so as to minimize the risk of their theft or loss. A custodian holds securities and other asset in electronic or physical form."[1] Custodians are prohibited from providing clients with financial/investment advice, the selling of investment products and collecting any form of compensation from a financial advisor or by anyone who does. In addition, custodians who specialize in alternative investments are challenged with valuation issues and requirements of servicing non-publicly traded alternatives such as but not limited to real estate, commodities and promissory notes.

The growth of the independent alternative investment custodian is directly tied to the issues shaped by the 2008 financial crisis. The financial markets over the past four years have been subjugated to Ponzi schemes (the largest being Bernie Madoff), a rise in government intervention via the Dodd-Frank Financial Reform Act as well as concerns around counter-party risk (ie Bear Sterns, Lehman Brothers etc…) as well as many other factors. Despite the well documented benefits of incorporating alternative investments into a traditional 60/40 investment portfolio, it has become increasingly difficult for advisors of large wirehouses and major banks to custody alternative investments internally.

Custodian:

A financial institution that holds customers' securities for safekeeping so as to minimize the risk of their theft or loss. A custodian holds securities and other assets in electronic or physical form.

[1] Investopedia – www.investopedia.com

In an article by *Investment News* dated March 4, 2013, "The Securities and Exchange Commission on Monday warned that it has found 'significant deficiencies' in the way that investment advisors are handling the custody of client assets."[2] The significant deficiencies identified by the SEC are described below: [3]

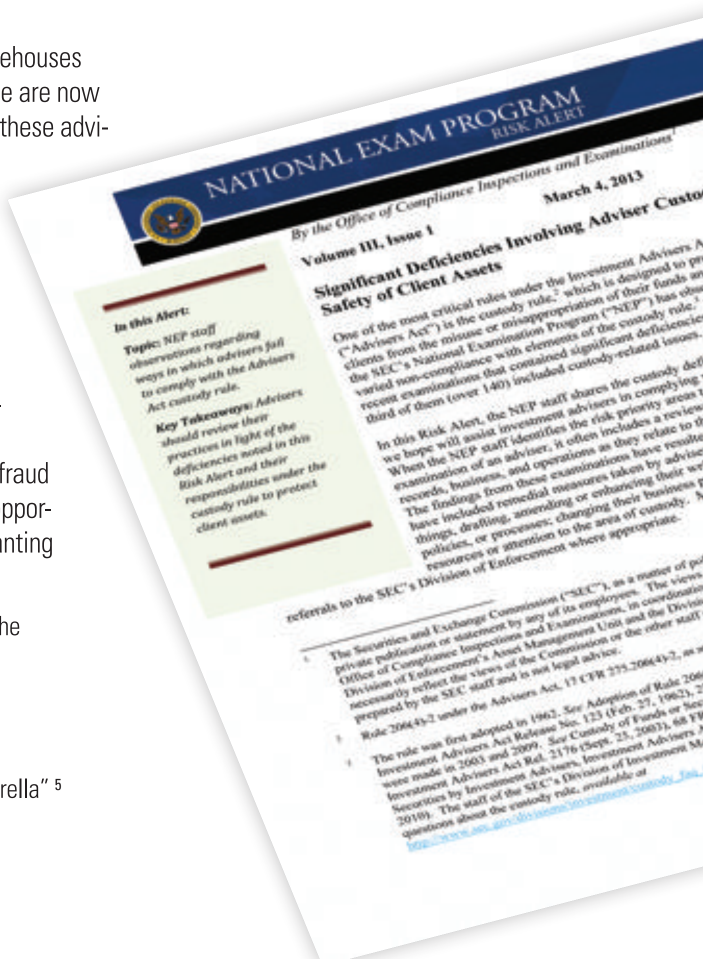
- Failure to recognize that the adviser has custody. This may arise in situations where the adviser serves as trustee, is authorized to write or sign checks for a client or is authorized to make withdrawals from a client account as part of bill-paying services.
- Failure to meet the custody rules surprise examination requirements.
- Failure to satisfy the custody rules qualified custodian requirement. A violation of this nature may be found, for example, where an adviser comingles client, proprietary and employee assets in a single account, or where an adviser lacks a reasonable basis to believe that a qualified custodian is sending quarterly account statements to the client.
- Failure to meet requirements specific to advisers to audited pooled investment vehicles. For example, failure to engage an independent accountant and demonstrate that financial statements were distributed to all fund investors.

> "The SEC found **'significant deficiencies'** in the way that investment advisors are handling the custody of client assets."
>
> **Investment News**
> **March 4, 2013**

Following these examinations, many of these advisors within the large wirehouses and major banks that have been cited by the SEC related to the custody rule are now conflicted. In addition to the challenges in allocating to alternative assets, these advisors and all advisors are required to update their "custody compliance policies and procedures, modify their business practices or devote more resources to custody issues."[4]

In addition to financial advisors being investigated, the SEC has increased their scrutiny and enforcement on investment managers, most recently the private equity industry. According to an industry mailing sent on April 3, 2013 by Reed Smith: "SEC Enforcement Focus on Private Equity Announcements about the AMU's (Asset Management Unit) priorities state that the AMU currently directs its attention to areas that lack transparency, where fraud may occur undetected, or where there may be ambiguity that creates the opportunity to engage in fraud. Specific private equity "industry stressors" warranting special attention include but are not limited to:

- Custody of client assets-both actual safekeeping and compliance with the Advisors Act custody rule
- Lack of product transparency on fees and valuation
- Use of valuation methods consistent with disclosure
- Trade allocations favoring preferred investors or management
- Managing different clients, investors and products under the same umbrella" [5]


NATIONAL EXAM PROGRAM
RISK ALERT
By the Office of Compliance Inspections and Examinations
Volume III, Issue 1
March 4, 2013

2 Investment News – "SEC Warns Investers That Advisors Could Be Mishandling Assets" Author: Mark Schoeff, Jr.
3 Thompson Hine – "Recent OCIE Examinations Highlight Importance of Advisor Adherence to Custody Rule" – March, 2013
4 Investment News – "SEC Warns Investers That Advisors Could Be Mishandling Assets" Author: Mark Schoeff, Jr.
5 Reed Smith – "Subject: Private Equity on Notice - Increased SEC Scrutiny and Enforcement in 2013"

Acknowledging these issues, many of the large wirehouses and major banks have re-evaluated the cost, time and responsibility that is required of providing alternative investment custody services to their financial advisors and independent clients. As a result, many of these organizations have decided to focus on their core business competencies and some have developed formal third-party referral relationships with independent custodians specializing in alternative investments. In the case of the organizations that have not done this, these financial advisors and independent clients are responsible for assessing and selecting the proper custodial relationship for their investments.

Sourcing and selecting the right custodial relationship can be a time consuming undertaking and at the same time a rewarding one. Unfortunately, there is no standard due diligence structure to follow when assessing various custodians. We would recommend that these individuals start assessing each custodian by conducting an organizational review. This review would include but is not limited to: reviewing their firm's website, requesting pertinent marketing materials and engaging in conference call(s) and/or on-site visits with the appropriate senior management individual(s) within the firm to address any/all questions.

"Given the state of today's economy, many firms are more concerned about the bottom line than about **building relationships** based on trust, honesty and moral character."

4 *There are four areas of significant differentiation that should be considered when evaluating a custodian specializing in alternative investments.*

The **first** and most significant and crucial differentiator is the firms' overall relationship value. Given the state of today's economy, many firms are more concerned about the bottom line than about building a relationships based on trust, honesty and moral character. Some questions to ask/consider when accessing a firm is:

- Do you think/feel that you can trust your custodian with your investments?
- Do you think the custodian is well educated in the area of need?
- Does your custodian have the proper business character?

The **second** area of significant differentiation is the firm's operational capabilities. Many of these firms fail to allocate the proper physical and financial resources to update or develop technology that would address common requests of their clients. Some questions to consider/ask:

- Does the firm offer the ability to open an account online? If so, requesting a demonstration of the process to assess its true capabilities and ease of use.
- What are the firms reporting capabilities? What technology feeds do they offer?
- Does the firm have the capabilities to custody "held-away assets" and report them back to the RIAs firm as a below the line item?

The **third** area of differentiation is the firm's client service initiative. The quality of the client service will determine how successful or unsuccessful the custodian will be in developing third-party relationships with large wirehouses/major banks or with individual clients. The key points to consider/ ask are:

- Does the firm assign a designated account representative from account opening to account closing?
- Does the firm offer live voice answering during business hours?
- Does the firm provide 24/7 online account access?

The **fourth** area is the firm's experience and product expertise. Regardless of the firm's strong organization structure, technology and client service capabilities; the firm'sindustry experience and product expertise is of most importance. Some questions to consider/ask:

- What are the combined years of experience of the senior management team working in alternative investments?
- What is the firms comfort level in working with alternative investments?
- What types of alternatives is the firm able to custody? What products within alternative investments are prohibited?

In summary, the role and function of an alternative investment custodian is particularly challenging and necessary in today's financial markets. Financial advisors and independent clients remain committed to allocating to alternatives and are looking for comfort that their assets (physical or electronic) will be safeguarded. As the alternative investment industry continues to grow, custodians with this expertise will be required to develop and maintain their institutional custody solutions to remain relevant.

Kingdom Trust is redefining the financial services industry standard in providing institutional custody solutions of assets for Investment Advisors, Family Offices and Investment Sponsors that seek flexible, innovative and cost effective custody solutions. Our intention is to provide the industry best practices and best execution when it comes to the custody and administration of investments.

ABOUT THE WRITERS

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Kingdom Trust is registered and regulated as a non-depository trust company in the state of South Dakota headquartered in Sioux Falls, SD. If you are interested in learning more, please visit our website at www.kingdomtrustco.com or by contacting Scott Foster (Institutional Custody) at (270) 226-1017.