JACKO LAW GROUP, PC

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The Distinctions Between Sub-Advisory and Third-Party Asset Manager Arrangements

For many investment advisers, using an outside money manager provides a valuable means to increase efficiencies. As every investment adviser has a fiduciary duty to act in the best interest of its clients, the adviser must consider its expertise and ability to actively manage client accounts at all times. An external manager has the ability to devote full time and attention to managing client portfolios, but moreover, the manager often has specialized capabilities to manage certain investment strategies that are not available to all investment advisers.

For that reason, it is a common practice for investment advisers to utilize the service of external managers to provide its clientele with certain investment strategies, funds or other opportunities the adviser is incapable of providing itself. The structure of the relationship between the adviser and the manager typically takes one of two forms: either through a sub-advisory relationship or a third-party asset manager ("TPAM") arrangement. These arrangements are separate and distinct, with each having pros and cons for the adviser to consider.

This month's Legal Tip will discuss the distinctions between the two types of arrangements and explore the most common legal issues and business considerations that advisers must weigh when selecting the appropriate structure for their practice.

Distinctions Between Sub-Advisory and TPAM Arrangements

A sub-adviser is an external manager hired by the adviser to assist with the management of a client's particular investment portfolio. Generally, the sub-adviser manages all or some of the client's assets in accordance with stated guidelines and objectives which are communicated by the adviser. On the other hand, a TPAM is an external manager who is hired directly by the client or asset owner to manage its assets based on the investment objectives set forth by the client.

The most important distinguishing characteristic involves the relationship held between the adviser and its client. In a sub-advisory relationship, the adviser is responsible for the recommendation and selection of the external manager on behalf of the client, and has the ability to hire and fire that manager. Conversely, while the adviser may recommend a TPAM to a client, the client ultimately enters into a separate and distinct contract with the TPAM, thereby giving only the client the ultimate authority to hire and fire that manager. Consequently, there are some important considerations to consider when deciding which arrangement is best for your business model.

1. Maintaining the Direct Relationship with Clients

Unique to the sub-advisory arrangement is the adviser's ability to select the external manager directly, and negotiate all terms, fees and services to be provided on the client's behalf. Assuming the adviser has entered into a fully discretionary contractual relationship with the client, the adviser is able to do this without any formal approval from the client (although often a client's input is solicited). As a result, in sub-advisory relationship, the adviser is free to hire and fire sub-advisers as necessary, particularly if performance is in a downward spiral, in order to act in the best interest of the client. This enables the adviser to act as the primary liaison with the client throughout the relationship with any sub-adviser. It also permits the adviser to maneuver and adjust quickly to changes in the market, or the client's objectives, by utilizing new sub-advisers at will.

2. Common Contractual Considerations

In contrast, with a TPAM relationship, the client has entered into a direct agreement with the external manager. This means that the external manger often has a direct relationship with the client with or without the adviser's involvement. As a result, only the client has the ultimate authority to terminate its relationship with the TPAM. While the adviser will continue to discuss the TPAM's performance with the client and make recommendations that the client continue or discontinue the relationship with the external manager, the decision to hire or fire the TPAM rests solely with the client, absent a written agreement to the contrary. Moreover, in a TPAM relationship, the manager may interface directly with the client without the adviser's involvement. Should the client decide to terminate its relationship with the adviser, the client can maintain its relationship with the TPAM without incident.

Sub-advisory controls specify the services, fees and expectations between the adviser and external manager. There are several legal and compliance matters that, if not reflected in the agreement, can cause trouble for both parties down the road. This includes, among other things, ensuring that the contract specifies which party is responsible for: delivering the sub-adviser's disclosure brochure and privacy documents to clients; preparing and sending performance reports and marketing materials to clients; determining who will execute trades and how books and records will be maintained and delivered to the other party; updating client guidelines and restrictions; and primary responsibility for performing initial and ongoing client suitability reviews.

With TPAM contracts, the adviser is responsible for the initial review and modification of the general contract terms to help ensure that the services outlined meet the needs of its clients. However, the adviser may not be able to weigh in on future amendments and modifications to the TPAM's agreement absent a separate and distinct agreement between the TPAM and adviser. Because the TPAM will have a separate and distinct relationship directly with the client, the TPAM generally is responsible for the direct delivery of its client disclosure documents, performance reports and portfolio fact sheets, and will need to maintain its own trading records and suitability documentation.

3. Due Diligence Considerations

"Due diligence" is the level of investigation expected of a prudent RIA to determine whether an investment or business arrangement makes sense. RIAs owe this duty as part of their fiduciary obligation to clients. Generally, the ongoing due diligence process may be greater when an adviser uses a sub-adviser as opposed to recommending a TPAM. Most advisers perform due diligence on sub-advisers on a quarterly basis, using a combination of due diligence questionnaires, in-person and telephonic meetings and performance reporting to ensure the sub-adviser is adhering to the guidelines, objectives and services specified by the adviser. On the other hand, TPAM due diligence may be conducted on a semi-annual or annual basis to review such items as performance, changes in the manager's team and overall services being provided to the client. Regardless if the due diligence is being conducted on a sub-adviser or TPAM, the adviser should review the external manager's expertise, fees, regulatory status, disclosures to clients, and adherence to the overall investment management strategy in light of suitability objectives of the client. Prior to recommending any sub-adviser or TPAM, the adviser should review the manager's compliance controls and set expectations as to how client interfacing will occur. This will help to solidify expectations between all parties, including the client.

Conclusion

While similar objectives are at work when considering whether to enter into a sub-advisory or TPAM relationship, which structure the adviser selects can impact both the adviser and the client. It is important to understand the difference between these two relationships in order to properly set client expectations, govern the relationship and remain compliant with relevant state and federal laws.

For more information on these and other considerations, please contact us at info@jackolg.com, or (619) 298-2880. Also, please visit our website at www.jackolg.com.

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