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Financial Product and Money Manager **Due Diligence**

Many of the broker-dealer firms we represent offer and sell interests in commodity pools or managed futures programs, hedge funds and other financial products. The recent Madoff scandal is only the latest illustration of the need to investigate thoroughly those with whom clients' funds are entrusted. The purpose of this memorandum is to address the need for due diligence of financial products and their advisors and to explain the role of a third party law firm in the process.

Arguments for Limited or No Third Party Due Diligence

It has been our experience that some sponsors of commodity pools, hedge funds and other financial products discourage broker-dealers from engaging a law firm such as ours to assist them in connection with due diligence of their offerings. These sponsors give several reasons for treating these programs differently than other investment programs when it comes to due diligence. First, some such programs don't include an allocation of offering proceeds to pay for due diligence, which means that the sponsor or broker-dealer would bear the cost of due diligence, rather than it being paid out of offering proceeds. Second, some sponsors argue that independent due diligence is not necessary because they are heavily regulated in that they are registered investment advisers or commodity pool operators, and their offerings are reviewed by the Securities and Exchange Commission and the states. Finally, some argue that because these programs offer liquidity through redemption programs they are lower risk hence a different degree of due diligence is warranted.

For the reasons summarized below, we believe that despite these arguments thorough due diligence of financial product offerings is warranted, and broker-dealers that do not possess the in-house capability to adequately review such programs should consider utilizing the services of a third-party firm.

Rationale for Third Party Due Diligence

Commodity pools and hedge funds involve the same potential liability under federal and state securities laws as other investment programs. Broker-dealers that sell commodity pool and hedge fund offerings that have been registered with the SEC are subject to the same possibility of underwriter or seller liability as they are in connection with other types of registered offerings, including those by non-traded REITs, oil and gas programs, and equipment leasing programs. If a prospectus includes a material misstatement or omission, the broker-dealer can be liable, but if it conducts reasonable due diligence it has a defense against that liability. Likewise, while the standard for liability for sale of a private offering is different, broker-dealers that are grossly negligent or reckless can be liable, and appropriate due diligence can protect them from liability.

Regulation does not eliminate risk and has never been considered a substitute for due diligence. While regulation by the SEC or the CFTC may provide some additional protection, regulation alone does not eliminate the possibility of fraud, misleading disclosure, unfavorable transaction terms, and the other conditions that due diligence is designed to detect. Those with experience in the securities industry know that over the years there have been many instances of fraudulent offerings or problem transactions that occurred despite the fact that they were reviewed by regulators and the fact that they involved entities, such as investment advisers and broker-dealers, subject to regulatory oversight. The due diligence defense was included in the securities laws to encourage self-regulation precisely because Congress recognized that regulators lacked the resources to adequately police all offerings and market participants.

In this regard, it has been widely reported in the media that the SEC failed to take action against the Madoff organization, despite numerous complaints and other red flags over the years and the fact that the Madoff organization included a registered broker-dealer and a registered investment advisor. As reported by the *Washington Post* On December 16, 2008, "Lori A. Richards, director of the SEC's Office of Compliance Inspections and Examinations, said that only 10 percent of the 11,300 investment advisers registered with the SEC are examined on a regular basis -- those with high-risk characteristics. They are examined every three years. Others might be examined randomly or where there is cause, Richards said."

FINRA has never suggested a lower standard of due diligence for commodity pools. FINRA treats commodity pools as direct participation programs (see, for example, NASD Notice to Members 04-50) and, accordingly, they should be held to the standards for due diligence applicable to DPPs. Moreover, they almost certainly fall within the broad definition of "non-conventional investments" set forth in Notice to Members 03-71, which stresses the need for appropriate due diligence of such products. To our knowledge FINRA has never published guidance suggesting that commodity pools be held to a lower standard.

Liquidity is not a substitute for due diligence. While a liquidity feature certainly reduces certain risks to investors, it is not a substitute for due diligence. As indicated above, potential seller liability exists in any registered securities offering, and due diligence provides broker-dealers a defense against that liability. In addition, due diligence may detect facts or circumstances that would cause that liquidity to become unavailable at some future point in time. The fact that a commodity pool offering might be perceived as having lower risk because of the presence of a liquidity feature argues in favor of conducting due diligence sufficient to ascertain whether all material risks are identified and adequately disclosed to investors.

Refusal to be subject to independent due diligence can itself be a red flag. While there may be valid business reasons for not wanting to bear the cost and inconvenience of an independent due diligence review, it is entirely reasonable to expect an investment adviser or commodity pool operator to agree to the process, particularly if the organization is raising tens or hundreds of millions of dollars through the independent broker-dealer channel. Responding to a document request, agreeing to management interviews, and reimbursing a fee typically equal to single-digit number of basis points of the raise is a minor inconvenience and a small cost to obtain access to a large number of broker-dealers' customers.

Independent due diligence by a law firm complements in-house due diligence. While many broker-dealers have skilled analysts capable of assessing an investment adviser's or commodity pool operator's business acumen, its prior performance, and its investment strategy, there are many components of an independent review by a law firm that may not be covered by in-house personnel. These include a review of key agreements and related disclosure; a review of organizational documents and minutes; verification of relationships with and reference calls to auditors, custodians, and administrators; a review of regulatory matters, including compliance policies and procedures and regulatory exam results; background checks; litigation searches and analysis; and an overall review of the adequacy of offering disclosure. While no set of procedures can guarantee that fraud will be detected, an appropriate investigation greatly increases the likelihood that problem programs and sponsors will be avoided.

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