How pension consultants' hidden financial incentives may be hindering your plan's performance

Who's Minding the Gate?

BY EDWARD E. SHARKEY

The problem with the Harbor City Chemical Company's pension plan came to light quite suddenly, and no one was prepared. The managers and directors found themselves listening to their accountant in disbelief. They had all been working for a year to keep the company afloat amidst rapidly shrinking margins. Asian companies were dumping product on the U.S. market at less than it cost to manufacture. Buyers were suffering through a drop in demand and were cutting orders. Meanwhile, here was the chief financial officer reporting that the pension plan needed money . . . a lot of money. The actuary calculated that the company was required to contribute $1.6 million for the coming year. This was four times the amount needed the previous year.

No one had expected it. The financial markets hadn't performed badly. More important, the plan was well managed. The pension committee included able company officers and well-regarded representatives from the union. They met every month. There were no finance experts on the committee, but they knew their fiduciary obligations. They were required to oversee the money as if they were prudent persons experienced in such matters. Like most pension committees, they had fulfilled this duty by hiring a professional. And they had hired the best—for a great price.

The committee had turned to a leading national broker-dealer that had its own pension consulting group. The consultants came to meet with the committee. They explained that they would advise the committee on all aspects of managing the plan. The consultants would use sophisticated software to determine the best investment allocation for the fund, then would recommend money managers and monitor the managers' performance. Moreover, the consultants offered to perform all of these functions for no fee. All the committee had to do was agree that the money managers would direct trades on behalf of the plan to the consultants' affiliated broker. It was a no-lose proposition. After all, the plan had to trade somewhere.

After creating a statement of investment policy, the consultants used a proprietary database to help the committee choose the best money managers. Then they established a procedure for monitoring and reporting performance. After that, the consultants kept the committee well informed. They returned quarterly to meet with the committee, reporting on the status of financial markets and the plan's performance. Yes, the plan lagged the market somewhat over a period of years, but the committee was sophisticated enough to know that poor returns didn't mean poor decisions had been made. They knew that sometimes performance falters in spite of prudent decision making. And the committee was confident that they had reliable professionals in charge. The consultants' firm managed billions of dollars of investments.

It wasn't until the actuary crunched the numbers for the coming year that anyone really worried. Then, everyone worried. The modest lag in the plan's performance over a lengthy period of time added up. After spending an afternoon with the plan's financial reports, *The Wall Street Journal*, and a calculator, the CFO figured that, in the aggregate, the plan had lagged its benchmark by about 9% over the past 24 months. On a $25 million plan, that was a lot of money. Now the bill was coming due, and the company didn't have the money.

There was distress but no immediate call to action. After all, everyone involved with the pension plan was doing a good job. The results simply weren't there. Thus, the officers and directors turned to finding a way to weather this latest blow. They didn't imagine that their consultant might have failed them. They didn't question the advice they received. They didn't consider that the managers investing the plan's money might not be the best available or that the costs they were paying weren't competitive.

Like most companies, Harbor City (not the company's real name) was oblivious to practices in the pension consulting industry that the Securities & Exchange Commission (SEC) and the Department of Labor (DOL) have only begun to understand. Yet they are practices that have been prevalent for more than a decade, and they can cause substantial harm to pension fund performance in very subtle ways.

THE PENSION CONSULTING INDUSTRY

Pension consultants come in varying forms, and they differ in their business model and in the services they offer. Some consultants are single-person shops, while others are institutional firms associated with large, integrated financial services companies. A few pension consultants focus exclusively on advising pension plans, earning a living solely on the fees paid by the plans. Inherent in most pension committees, however, is a general sensitivity to costs that makes this business model less lucrative. It's more common for pension consultants to be affiliated with a firm that offers other services, including brokerage, money management, and financial analysis.

Pension consultants usually play the most influential role with respect to managing a pension plan. Frequently, they are a pension committee's only source of information and advice concerning the establishment of investment objectives, creation of investment policy, allocation of assets, and monitoring performance. When a pension committee lacks a member or independent advisor with experience in finance and investments, it is typically the consultants' recommendation that determines the committee's course of action. In this way, the pension consultant acts as gatekeeper for the plan. By means of their recommendations, the consultants decide, amid a multitude of money managers and other service providers, who gets to do business with the plan and who gets left out.

Consistent with this sensitive role, pension consultants are fiduciaries to the pension plans they advise. A fiduciary owes the pension plan a duty of utmost good faith and full disclosure of all material facts. This includes a duty to disclose any conflict of interest created by a personal financial interest or the interests of an affiliated party. The law recognizes that pension plans need information about conflicts in order to ensure the independence and reliability of advice upon which significant decisions affecting the plan are made. Hence, it's a breach of fiduciary duty—and illegal—for a pension consultant to fail to disclose a hidden financial motive that may affect the advice it renders.

THE SEC INVESTIGATES

On May 16, 2005, the SEC disclosed what, until now, has been a little-known secret of the pension consulting industry. On that date, it released the results of the government's first significant investigation focusing on practices in the pension consulting industry: *Staff Report Concerning Examinations of Select Pension Consultants*. The SEC said the investigation was prompted by questions that "have been raised regarding the independence of the advice that pension consultants provide in light of the fact that many pension consulting firms provide services both to pension plans who are their advisory clients and to money managers." The Commission found widespread conflicts of interest that may affect the objectivity of advice rendered by consultants.

The investigation focused on 24 pension consultants that represented a cross-section of the pension consulting industry. They varied in size and mixture of services offered, with approximately half representing the largest pension consultants in terms of assets they managed. The SEC tried to determine the extent to which the consultants were taking money from money managers interested in doing business with the consultants' pension plan clients. In particular, the SEC examined practices with respect to (1) the products and services provided to pension plans as well as to money managers, (2) the method of payment for these products and services, and (3) the disclosures provided to the pension consultants' clients.

The SEC found that *more than half* of the consultants were actively selling products and services not only to pension plans but also to money managers and mutual funds interested in doing business with pension plans. Most disconcerting was the form that this selling took. In practice, it looked exactly like the consultants were leveraging their status as pension plan gatekeepers to solicit money from firms interested in access to those plans.

The majority of the consultants were found to host "investment conferences," which they encouraged pension clients to attend by charging them no fee. Eight of these consultants then allowed money managers to attend if they paid the consultants a fee. Some consultants operated recurring training courses on investment topics. Typically, the consultants didn't charge their pension clients a fee and generated revenue by charging money managers tuition or an annual fee.

Ten of the 24 consultants investigated sold investment software programs to money managers, the cost of which ran as high as $70,000 per year depending on the function of the product. Finally, the majority of the consultants had affiliated broker-dealers who allowed them to generate revenue with brokerage "commission recapture." The SEC also found that money managers appeared to purchase overlapping products from more than one consultant, raising the concern that the purpose of the payment wasn't the product.

The SEC further found that these arrangements weren't well documented and raised many issues. For example, the SEC questioned whether pension plans were receiving "best execution" on their trades and whether they were overpaying for advisory services. Without capping commissions at the level of the consultants' regular fees, the consultants could reap a windfall through directed commissions. Finally, the SEC noted the obvious: that a "concern exists that these arrangements may provide an incentive for a pension consultant to recommend an active trading strategy, because the pension consultant may receive more money in commission payments."

The SEC found that consultants' disclosure of these conflicts of interest was abysmal. Of the 19 pension consultants or their affiliates that earned money by selling to money managers, none of them provided full disclosure to their pension clients. Three gave no disclosure at all, and 16 gave only limited disclosures. Of the 16 that made some disclosure, the SEC found that the disclosures either failed to reveal the financial conflict of interest or "were not specific enough for a reasonable person to discern the potential harm." For example, the disclosure would state simply, "*The firm also provides performance measurement and investment product review to money manager clients,*" and leave the client to infer that the consultant was being paid by money managers.

The SEC also discovered that two of the consultants had secret referral arrangements with unaffiliated broker-dealers that weren't disclosed at all. In those arrangements, the SEC report said, the consultant directed its pension plan client to use the broker-dealer for commission-based trades. The broker-dealer, in turn, paid kickbacks to the consultant based on the amount of commissions earned. Only one consultant made client-specific disclosures that it had sold products and services to the same money managers it recommended to a pension plan. That consultant gave no information concerning the dollar amounts involved, thereby concealing the magnitude of its conflict.

NEW GUIDELINES ISSUED

Just like the insurance and mutual fund industries, targets of their own investigations in the past two years, the pension consulting industry is fraught with conflicts of interest. Those conflicts of interest call into question the objectivity and reliability of advice given by consultants regarding the adoption of investment strategy, selection of money managers, and monitoring of investment performance.

To what extent have conflicts of interest skewed the advice given by pension consultants? What is the amount of damages resulting from biased advice concerning investments? The SEC said it wasn't able to "fully analyze" the effects of the conflicts of interest because of the way the consultants kept their records. Of the six consultants that kept records useful to the task, the SEC found that 50% more frequently recommended money managers who paid them money than those who didn't.

On June 1, 2005, the SEC and DOL jointly issued guidelines to pension trustees concerning these potential conflicts of interest. The guidelines are aimed at helping trustees fulfill their own fiduciary obligation to manage pension plans and monitor service providers with prudence. Recognizing that trustees usually rely heavily on pension consultants, the regulators promulgated a series of questions that trustees must direct to their consultants to help them assess the objectivity of the advice they are receiving.

Here are some of the questions:

1. Are you registered with the SEC or a state securities regulator as an investment advisor? If so, have you provided me with all the disclosures required under those laws (including Part II of Form ADV)?

A pension committee can check for itself by viewing the consultant's form ADV on the SEC's investment advisor website at www.adviserinfo.sec.gov.

2. Do you or a related company have relationships with money managers that you recommend, consider for recommendation, or otherwise mention to the plan? If so, describe those relationships.

3. Do you or a related company receive any payments from money managers you recommend, consider for recommendation, or otherwise mention to the plan for our consideration? If so, what is the extent of these payments in relation to your other income (revenue)?

4. Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being a factor when you provide advice to your clients?

5. If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it doesn't overpay its consulting fees?

6. If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?

7. Do you have any arrangements with broker-dealers under which you or a related company will benefit if money managers place trades for their clients with such broker-dealers?

8. If you are hired, will you acknowledge in writing that you have a fiduciary obligation as an investment advisor to the plan while providing the consulting services we are seeking?

All pension consultants who provide advice concerning allocation of plan investments or selection of money managers are fiduciaries. Historically, many pension consultants sought to insulate themselves from potential liability as fiduciaries by means of self-serving language in their service agreements. No pension plan should hire or maintain a relationship with a pension consultant who won't acknowledge in writing that it is acting in a fiduciary capacity.

9. Do you consider yourself a fiduciary under ERISA with respect to the recommendations you provide the plan?

An ERISA fiduciary who receives fees from third parties as a result of their recommendations perpetrates a prohibited transaction under ERISA unless the fees are used for the benefit of the plan (e.g., offset against the consulting fees charged the plan) or there is a relevant exemption.

10. What percentage of your plan clients utilize money managers, investment funds, brokerage services, or other service providers from whom you receive fees?

UNMASK CONFLICTS OF INTEREST

The SEC and the Department of Labor have put pension committees on notice. Pursuant to ERISA, committees have an independent fiduciary duty to act with prudence in all matters affecting administration of a pension plan. This now includes a duty to determine whether any prospective or current consultants are conflicted by a hidden financial interest in selling money managers access to the pension plan.

But this poses a new difficulty. How is the committee to undertake an evaluation of its advisors? Is it prudent to rely solely on responses given by the pension consultant concerning its conflicts? If the consultant discloses previously hidden conflicts of interest, is there a duty to investigate whether the pension plan suffered any harm?

The SEC and the DOL have failed to provide guidance here, but a few things seem evident in light of the subjective nature of the fiduciary duty of prudence. The duty of prudence requires a fiduciary to act with the care and skill under the circumstances then prevailing that a person familiar with such matters would use. In all cases, prudence is a question of fact to be determined based on what a "prudent" person would do under the particular facts and circumstances that existed at the time the decision was made.

It isn't clear whether a pension committee must independently verify the veracity of disclaimers and disclosures made by its consultants. Surely the undertaking would be difficult, and the regulators have provided no guidance indicating whether or how this should be accomplished. In that context, a pension committee, having prudently solicited and evaluated the disclosures recommended by the SEC and the DOL, would have a viable defense to any claim that they breached their duty if it were later discovered that the consultant lied about conflicts of interest, unless the committee had some reason to know.

On the other hand, only after pointed questioning of the consultants, any committee presented with revelation of conflicts of interest that were previously undisclosed faces a different situation. In that context, the committee would be on notice that the consultant had failed to disclose material information when it was under a fiduciary obligation to do so. Blind reliance on any subsequent statements by the consultant concerning its ability to manage the conflict, or concerning the lack of harm resulting from the conflict, would be questionable.

If a committee discovers its consultant has previously undisclosed conflicts of interest, it isn't a stretch to say that a prudent committee would attempt to verify, independently, the nature and extent of the conflicts as well as whether the undisclosed conflicts harmed the plan. In the case of Harbor City, the pension committee ultimately did undertake a forensic investigation that revealed the consultant had hidden conflicts of interest. The consultant had recommended unsuitable investment managers based upon their willingness to direct commission-based trades back to the consultant's affiliated broker-dealer. The consultant charged "no fee" for advisory services, but it reaped hundreds of thousands of dollars in commissions on the trades, more than it would have earned with a flat fee.

The money managers selected lacked experience investing a portfolio the size of the pension plan's. They failed to allocate the investments properly, thereby impairing the fund's performance. Over a two-year period, the pension plan significantly lagged its benchmark, which cost it millions of dollars in lost returns. The losses aggregated slowly, and they arose in a portfolio that was handled in a seemingly professional manner. In this way, the losses didn't appear to be the result of fault, but they were. Ultimately, Harbor City pursued litigation and was able to recover its losses.

In order to manage their plans prudently, pension committees need to know whether the advice they are receiving from consultants is tainted. Now that the regulators have expressly stated that conflicts of interest may be harming pension plans, there is no question that there is a duty to investigate and, upon discovery of conflicts, a duty to determine any harm. ■

Edward E. Sharkey is a lawyer who represents pension fiduciaries in the investigation and resolution of violations of the pension and securities laws. You may direct questions or comments concerning this article or related issues to Edward at (301) 657-8184 or esharkey@sharkeylaw.com.