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SHINING LIGHT ON THE PRACTICES OF PENSION FUND CONSULTANTS: Who Are They Really Serving?

By Gerald H. Silk and Stephen W. Tountas

> *"Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."*
>
> Justice Louis D. Brandeis

Pension fund consultants typically advise pension fund systems on critical financial and investment matters and, therefore, often occupy a position that is fiduciary in nature. As Justice Benjamin Cardozo noted, the standard of a fiduciary requires "something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior." Whether pension fund consultants are living up to this high moral standard is a question being raised as a result of recent revelations of consultant transgressions and an ongoing U.S. Securities and Exchange Commission ("SEC") review of consultant activities in the pension fund arena.

While most fund trustees have a reasonable basis to believe that the consultant to their fund is free from any conflicts of interest and is providing the fund with objective advice, this is not always the case. Recently, it has come to light that certain pension consultants may, in fact, suffer from certain latent conflicts of interest that could, at a minimum, create the appearance that they might be putting their own interests before their pension fund clients. More specifically, certain consultants derive significant revenues from the very money managers and broker-dealers whom they recommend to the pension fund. This situation would be akin to purchasing a new home based upon the advice of a real estate broker who tells you that the house is in perfect condition and is a must buy, but, at the same time, fails to inform you that he or she will receive double the ordinary commission if you purchase this particular home. Clearly, this is a fact that any reasonably prudent person would want to know prior to making such a purchase as it weighs directly on the objectivity of the broker's recommendation.

Ensuring that consultants are impartial is critical given that pension fund trustees rely on consultants for direction and advice in managing trillions of dollars of pension fund assets. Poor advice from a consultant can cost a pension fund millions of dollars. In order to ensure that consultants are acting in a responsible and conflict-free manner, the contractual parameters that govern the relationship between the consultant and the pension fund must be carefully reviewed and, if necessary, modified. At a bare minimum, pension fund trustees should require, as a condition of a consultant's contract, that, if the consultant is receiving compensation or gifts of any kind from the money managers that it recommends to the pension fund it advises, such compensation should be disclosed. The ultimate goal for the pension fund must be that it is receiving the fair and unbiased advice for which it contracted.

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The Critical Role of Pension Fund Consultants

Pension fund consultants play a critical role in the pension fund community. Many pension fund trustees do not possess a consultant's technical expertise and, invariably, must rely upon consultants to provide them with critical investment advice. This is particularly true in selecting money managers, as trustees are unlikely to know the specific risks and benefits to each manager's investment style or how their portfolios should be allocated to minimize risk and maximize return.

In 2003, the Nelson Pension Fund Consultant Survey reported that consultants were retained by nearly 50 percent of the 4,966 plan sponsors with assets in excess of $100 million. Pension funds typically retain consultants to perform a variety of services, including the strategic planning of their investment policies, the evaluation of return and risk analyses, and, most importantly, guidance on selecting (or retaining) a money manager to handle their portfolios. Thus, a consultant's advice on a fund's selection of a money manager plays a vital role in determining how the fund's money will be invested and an effective consultant will act as a gatekeeper by providing advice based upon each pension fund's individual needs and objectives.

Surprisingly, pension consultants also offer a variety of services to money managers with whom their pension fund clients are advised to invest in. In particular, money managers often retain pension consultants for services such as strategic planning, marketing strategy development and client servicing development. Further, consultants regularly host investment conferences and seminars that are paid for or "sponsored" by the money managers with whom a consultant has business ties. During these conferences, money managers are provided with access to a consultant's "other clients"—the pension fund trustees who pay a nominal fee to attend such conferences. Some consulting firms even provide training for a fee on how a money manager can "answer the tough questions posed by consultants and plan sponsors" and best position itself in "retaining client loyalty during times of crisis, such as periods of poor performance."

By performing these services, pension consultants receive compensation from pension funds as well as money managers. However, the similarity stops there. Consultants are generally paid by pension funds in the form of a fixed annual retainer. In contrast, a consultant might charge a money manager a large fee just to attend a single conference or to provide marketing advice. According to some reports, a typical consultant could receive as much as hundreds of thousands of dollars a year in payments from a money manager billed under the pretense of "search" services. In addition, certain consultants that have broker-dealer affiliates derive additional revenues from their consulting agreements with funds. These consultants advise and encourage their pension fund clients (or the money manager they recommended to the pension fund) to trade through their broker-dealer affiliate and obtain substantial fees that are then shared with them by their broker-dealer affiliate.

The likelihood of a conflict of interest is only exacerbated when such fees or additional revenue streams remain entirely undisclosed to the pension fund. For instance, *The New York Times* reported on March 21, 2004 that a 2002 audit of Hawaii's pension fund revealed that its consultant recommended sixteen money managers over time and that fourteen of them were paying the consultant for so-called marketing advice and other services. Accordingly, the SEC has initiated an inquiry into the practices of pension consultants as a result of the often complicated and intertwined relationships that consultants enjoy with pension funds and the third-parties which seek to serve those funds, such as money managers and broker-dealers.

Pension Consultants Under Fire

The SEC's inquiry calls into question whether many of the largest pension fund consultants are truly offering independent advice to their clients. In mid-December 2003, the SEC issued a broad letter to a number of consulting firms, containing comprehensive questions and requesting information relating to their practices, compensation arrangements and disclosures. By gathering such information, the SEC seeks to determine whether pension consultants suffer from conflicts of interest as a result of their tangled relationship between the pension funds to whom they purport to provide independent advice and the money managers and broker-dealers whom they recommend to pension funds and from whom they earn substantial fees. According to Lori A. Richards, Director of the SEC's Office of Compliance, allegations of conflicts "are very serious and really triggered the [SEC's] interest."

While certain fund trustees have taken a pro-active role towards determining whether their consultants have received financial incentives from the money managers recommended by the consultants, many trustees are either unaware of this ongoing practice or are reluctant to take any action. On February 23, 2004, Bloomberg News reported that a former trustee of a $9.4 billion pension fund demanded that his fund's consultant

disclose how much compensation, if any, the consultant had received from money managers. When the consultant refused to provide such information because it violated "client confidences," the trustee successfully made clear that his fund, not the money manager, was the consultant's actual client. Unfortunately, such pro-active measures have not always been successful, as some consultants have refused to comply with a trustee's request because of a supposed "duty of confidentiality" to the money managers. In addition, some fund trustees have simply made a conscious decision to ignore potential conflicts because they believe that their actions will be futile.

Protecting Your Fund's Assets from Potential Consultant Conflicts of Interest

Given that consultants occupy a position that is fiduciary in nature, there is little debate as to the obligations that they must abide by. It is beyond peradventure that fiduciaries have a strict obligation to act in the best interests of their clients — the pension funds that retain them. Under the law, a fiduciary must avoid acts that put his or her interests in conflict with the client he or she is serving. This standard requires that a consultant disclose to a pension fund client all potential conflicts of interest it could foreseeably have with the fund. In addition, as a fiduciary, a consultant is required to disclose all material information, such as other sources of income generated by the consultant which may bear on the consultant's objectivity to the pension fund that he or she serves. In short, a consultant who is a fiduciary must avoid acts that may put his interests in conflict with the beneficiary's.

The SEC has yet to provide a time frame on when, if at all, it will institute regulatory changes or seek legal action against the pension consulting industry. For the time being, pension fund trustees can take certain measures to prevent the occurrence of the above practices, including: (1) carefully reviewing current consulting agreements to determine if they have any provisions requiring disclosure of a consultant's receipt of fees from those who the consultant recommends as money managers to the fund; (2) re-negotiating retention agreements and demanding the inclusion of covenants regarding full disclosure of a consultant's compensation from money managers; (3) issuing a request for proposals to ensure that the fund is getting the best and most objective representation possible; (4) asking the right questions to determine the extent of a consultant's relationship with various money managers and broker-dealers; and (5) if necessary, commencing litigation to recover potential losses.

Conclusion

While it appears that some pension fund consultants may have forgotten – or ignored – the basic precepts of honesty and fair dealing that should guide their relations with the pension fund community, there is no question that those who advise the investments of others must live up to their requirements of full and fair disclosure and, at the very least, provide their clients with the totality of information for the funds to make informed choices regarding their investments. We strongly encourage the pension fund community to keep a careful eye on the SEC's actions with regard to pension consultants. In the meantime, it is in each fund's best interest to protect their assets by taking the steps outlined above.

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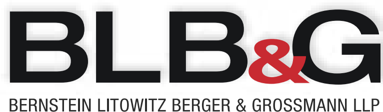

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