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SEC to Pension Consultants: “We Are Watching”

by Joshua H. Sternoff

On May 16, 2005, the Securities and Exchange Commission’s Office of Compliance Inspections and Examinations issued a report highlighting conflicts of interest in the pension consulting industry that call into question the independence of the advice pension plans receive from their investment consultants. The report recommends changes in the industry’s disclosure and compliance policies and procedures to ensure that investment consultants to pension funds and the plan trustees and other fiduciaries whom they assist comply with their respective obligations under the Investment Advisers Act and ERISA. Ann Combs, assistant secretary for the Employee Benefits Security Administration of the Department of Labor, praised the SEC report and announced that the DOL, which regulates pension plan fiduciaries, will work together with the SEC, which regulates pension consultants, to “ensure that conflicts of interest are disclosed and appropriately addressed” in the future. This report and the issues that it raises should be carefully considered not only by the pension consultants at whom it is aimed, but also by pension fund trustees, investment managers and other fiduciaries that have relationships with such consultants.

Overview

The SEC staff report is based on its examination of 24 pension consulting firms representing a cross-section of the approximate 1,750 in the industry. The firms examined range in size based on the number of plan clients and assets managed, with approximately half of the sample including the largest pension consulting firms, measured in terms of the assets of the plans they advise. The SEC also examined pension consultant arrangements from the perspective of money managers to whom pension consultants refer business.

The report concludes that, based on its examination, pension consultant disclosures, procedures and controls are deficient relating to conflicts of interest material to the advice that they provide to pension plans. According to the report, many consultants take the position that they are not fiduciaries under ERISA, and appear to fail to appreciate the fiduciary responsibilities imposed on

them by virtue of their status as investment advisers under the Advisers Act. Key areas of concern identified by the SEC include: receipt of income from the investment managers to whom they refer their pension clients, brokerage arrangements that compromise the independence of the consultant’s advice, skewed recommendations based on money manager relationships, steering pension clients to affiliated products or services, and the absence of policies and procedures, or effective disclosures, directed at these inherent business conflicts.

The SEC report sends a warning to the industry that such practices will not be tolerated in the future, with both the SEC and the DOL pledging to work together to address the issues raised by the report. Lori Richards, Director of the Office of Compliance Inspections and Examinations, urges “pension consultants to take a hard look at their disclosure and make improvements. And, when a consultant holds itself out as providing unbiased, objective advice, that obligation must be met.”

The SEC’s findings are described in more detail below. One important consideration for pension consultants and the plan fiduciaries with whom they work that is not highlighted in the report is whether the consultants’ view that they are not ERISA fiduciaries holds up under an analysis of ERISA’s fiduciary “investment adviser” definition. While consultants that limit their services to assisting plan fiduciaries in selecting investment managers might not be fiduciaries under ERISA, other consultants to pension funds may be making investment recommendations that make them fiduciaries. In that event, the conflicts of interest identified in the report subject them and the plan trustees, investment managers and other fiduciaries that employ them or cooperate with them to further exposure. These conflicts may result in ERISA prohibited transactions that cannot be cured merely by the disclosures called for by the SEC.

Findings

The report found that more than half of the consulting firms examined provide products and services to pension plan advisory clients as well as to

money managers and mutual funds on an ongoing basis. Moreover, some of these firms receive a significant portion of their annual revenue from money managers who profit from the consultant's referrals. The SEC and DOL are both concerned that such conflicts of interest cloud the judgment of the consultants, who, as fiduciaries subject to the Advisers Act (and potentially ERISA), are obligated to make recommendations based on the best interests of their pension plan clients.

In addition, nearly 60% of the pension consultants examined have affiliated broker-dealers or relationships with unaffiliated broker-dealers. The report states that pension plan advisory clients often seek to "recapture" money by directing that a portion of the brokerage commissions paid by the plan be rebated to the plan, or be used to pay the pension consultant's fee. According to the report, such "commission recapture" is not well documented and could hinder "best execution" if trades are directed to brokers that provide rebates. Additionally, "commission recapture" may increase the likelihood of an active trading strategy recommendation so that the pension consultant or an affiliated broker may profit from additional commission payments. The report expresses concern that pension consultants fail to disclose to their pension plan clients that they may receive a kickback, or a portion of the commission received by the broker-dealers, for the recommendation.

The report also uncovers evidence that many pension consultants fail to disclose to clients conflicts of interest from relationships between them and affiliates that also provide services to plan clients. For example, nearly 40% of the firms examined have employees that act as both pension advisers and broker-dealer representatives, but not all of the firms disclose that such employees may receive compensation based on the volume of securities transactions executed by the client.

The report also concludes that of the six pension consultants for whom data is available for analysis, half of them recommend money managers who purchase products or services from them more frequently than money managers who do not purchase such products or services, suggesting that the consultants skew their recommendations to favor certain money managers rather than providing disinterested advice. Additionally, 3 of the 19 consultants or their affiliates that provide products or services to money managers fail to disclose such services. While 16 provide limited disclosure, this disclosure is generally presented in a generic manner that obscures the details of relationships whereby consultants receive compensation in various forms from the money managers that they recommend to their pension plan clients.

SEC Recommendations

In light of the findings, the report concludes that the consulting industry should enhance compliance policies and procedures to ensure that pension consultants fulfill their fiduciary obligations to their advisory clients. For firms providing a bundled package of services, the report suggests that those consultants adopt policies and procedures that will insulate the firm's advisory activities from

its other business activities, thereby eliminating or mitigating conflicts of interest. Additionally, to ensure that recommendations are unbiased and in the best interest of plan clients, the SEC urges the industry to adopt policies and procedures to ensure that consultants comply with fiduciary disclosure obligations, particularly in conflict of interest situations in which consultants may be incentivized to recommend affiliates or certain money manager or broker-dealers.

The report shines a spotlight on practices that have become commonplace in the industry and serves as both reminder and wake-up call to the industry. Pension consultants, plan trustees, investment managers, and other plan fiduciaries would be well advised to carefully review consulting relationships and attendant disclosures to ensure satisfaction of their duties under the Advisers Act and ERISA.

For further information regarding the SEC report, please do not hesitate to contact Joshua H. Sternoff, the author of this alert, at (212) 318 6011 or joshsternoff@paulhastings.com, or any other member of Paul Hastings' Institutional Investment, Benefits and Compensation Group or Investment Management Group listed below:

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