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SEC Scrutiny of Pension Consultants: A Call To Action

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Today stated, disclosed pension consulting fees are artificially low as a result of the willingness of consultants subject to conflicts of interest to offer their services virtually "for free" (and indeed, without any stated fee in certain cases) in exchange for the opportunity to serve as "gatekeeper" to a fund. Fees derived from advising plan sponsors are inconsequential to these firms; the exponentially greater surreptitious compensation available to unscrupulous firms is the prize. "Independent" consultants that do not offer brokerage and other services to money managers are forced to compete on the basis of stated fees with consultants who can afford to offer a reduced fee due to the undisclosed compensation they derive from investment managers. Pensions historically have been unwilling to pay higher stated consulting fees for truly independent advice.

Here's how the fee game is played. The consultant bids as low a stated annual fee as necessary to land the pension client. Some firms (notably consultants within wirehouses) even offer to provide the service for free. Once selected as a "gatekeeper" to the pension, the consultant can demand a "toll" or "kickback" from anyone seeking to offer investment advisory services to the fund client. Managers are only too eager to use client commissions to reward a consultant for bringing a large institutional account. Even conference fees approaching $60,000 or marketing consulting fees of $75,000 paid out of the manager's own pocket are a small price to pay for advisory fees that may amount to millions annually. The kick-backs from managers frequently dwarf the annual consulting fee paid by the pension that is disclosed to the client. In certain cases that we have investigated, a consultant may earn millions in brokerage and other compensation from investment managers of a pension that pays only $100,000 or less in an explicitly stated annual consulting retainer.

OUR INVESTIGATIONS HAVE SHOWN THAT NO PARTY EXERTS AS GREAT AN INFLUENCE ON THE OVERALL SUCCESS OF A PENSION THAT A CONSULTANT WHO PROVIDES SOUND ASSET ALLOCATION, MANAGER SELECTION AND OTHER ADVICE

As has been reported, the SEC's Office of Compliance and Inspections has recently asked some of the leading consulting firms to provide information regarding the consulting services they offer and the revenues related to those services. The goal is to identify and quantify conflicts of interest that may be harmful to pensions. We suggested this approach to the SEC because we have found that consultants, when subjected to conflicts, universally attempt to keep this information from their pension clients. Even when these consultants provide information regarding their alternative sources of income and conflicts of interest, as, for example, when required in a Request for Proposals ("RFPs"), the information provided in the response is generally incomplete and misleading. In completing RFPs, consultants respond to questions with marketing statements that may not be legally complete. For example, a firm may claim to have "sold" its affiliated brokerage when, in reality, the economic benefits of owning the broker-dealer have been retained.

If the SEC's current inquiry into pension consulting "pay-to-play" schemes results in meaningful disclosure of conflicts of interest, including, most importantly, quantification of conflicting sources of revenue and pensions demand an end to such abuses, then firms may be forced to honestly price the consulting services they provide. The price of pension consulting services, as reflected in expressly stated fees disclosed to the client could (and we would argue should) easily double. We believe a good consultant is worth his weight in gold and is probably as difficult to find as gold. Our investigations have shown that no party exerts as great an influence on the overall success of a pension that a consultant who provides sound asset allocation, manager selection and other advice. On the other hand, a corrupt or inept consultant can cost a pension billions. While fees will almost certainly increase, overall compensation

derived from pensions by consultants subject to conflicts of interest will dramatically decline. For example, the annual retainer may increase from $100,000 to $200,000 but the $1 million in brokerage paid to the consultant's affiliate by investment managers will largely disappear.

Why should pensions care that consultants earn millions in surreptitious compensation from managers, if that results in pensions paying lower stated consulting fees? Because the cost of a corrupt consultant ultimately is borne by plan and can be enormous – far greater than even the undisclosed compensation earned by the consultant. The consultant keeps the kick-backs paid by the manager for allowing the manager to handle pension assets, but the fund is taking all the risk. When managers are selected, not on the merits but based upon "pay to play," underperformance ensues, and it's the fund that suffers. Undisclosed compensation paid to pension consultants results in real, quantifiable harm. We are not concerned with theoretical breaches of fiduciary duty when we draw attention to these longstanding practices.

In 1997 we arranged financing to acquire pension consulting firms and merge them in what venture capitalists refer to as a "roll-up" strategy. In a "roll-up," firms in a fragmented industry are brought together, economies of scale are realized and hopefully a dominant industry player is created. We met with firms around the country and reviewed their operations, as well as financial statements in our due diligence. We met with some extremely small firms and some of the largest. The size of the firm did not correlate in any way with its profitability. One of the smallest firms we reviewed was, in fact, the most profitable to its owners.

Two significant obstacles arose to our planned consolidation. First, perhaps as a result of the lack of regulation and professional standards in pension consulting, there was considerable debate among practitioners as to the proper approach to providing consulting services. Furthermore, the quantity of the services provided by the firms varied considerably. Pension consulting is an intensely personalized service. There are no credentials required. There are no generally accepted ethical standards. Every firm which whom we met approached the business slightly differently, and each was convinced its approach was most valid.

Second, we discovered that no firm was making much money from consulting! That is, "pure" consulting revenues derived solely from advising pensions were minimal. A typical larger firm at that time might have had $5 million in consulting revenues from pensions, $50 million in brokerage and another $7 million in consulting to managers. Consulting to pensions was the least profitable, most labor-intensive service these firms offered. Brokerage, conference fees and selling products and services to money managers were the treasured business lines. The president of perhaps the largest consulting firm worldwide confided, "Brokerage is where we make our money." The more a firm deviated from the business of providing objective advice to pensions, the more profitable it became. In other words, the more a firm was willing to capitalize on its "gatekeeper" status, exacting "tolls" on money managers eager for a pension account to manage, the more money it made. Indeed, the most profitable firm with whom we met subsequently was criminally prosecuted.

WHAT THE SEC ACTION IS TELLING US IS THAT THE AGENCY HAS SERIOUS CONCERNS ABOUT CONSULTANT CONFLICTS OF INTEREST AND THE RESULTING HARM TO PENSIONS

The SEC's current inquiry into pension consulting should be a call to action to all pensions. What the SEC action is telling us is that the agency has serious concerns about consultant conflicts of interest and the resulting harm to pensions. Pensions, the potential victims here, should TODAY be asking for the very same information their consultants have been asked to provide the SEC. If "pay-to-play" is troubling to a regulator (and we know from the mutual fund scandals the SEC is often the last to act), then it surely merits the attention of the fiduciaries charged with protecting plan assets.

To-date, pensions have not asked for and successfully obtained complete, accurate information from their consultants regarding conflicts. In a June 2002 article entitled "Compelling Pension Consultant Disclosure," we challenged anyone to provide us with the audited financials of a brokerage affiliate of a pension consultant. No one has ever responded to our challenge which, we believe, supports our statement that such financials are among the most closely guarded secrets in the industry. With the SEC now demanding such information, it is harder than ever for fiduciaries to turn a blind eye.

Lastly, we believe the SEC will soon propose a new rule that will require, in part, that pension consultants disclose and quantify conflicts. When information regarding conflicts finally comes to light, we can assure you some consultants and funds are in for a rude awakening. Armed with incriminating information, some funds may revisit past errors regarding matters such as asset allocation and manager selection. It's one thing for a consultant to recommend "active" managers who have significantly underperformed and discourage "indexing," while quite another matter when we learn the consultant's advice may have been tainted by brokerage derived from active managers, whereas indexing would not have similarly enriched the consultant. Honest mistakes may be forgiven; corruption should not be tolerated. ■

About the Author

President of The Benchmark Companies, Edward Ahmed Hamilton ("Ted") Siedle is a federal securities attorney, investment banker, brokerage entrepreneur and writer, who has been named by the Press as the "Sam Spade of money management" and "the nation's most vocal critic of abuses in the money management industry." Ted began his career in law with the SEC's Division of Investment Management, which regulates money managers and mutual funds. After several years of government service in Washington, D.C., Siedle served as Legal Counsel and Director of

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