

GREY COURT

March 31, 2004

The SEC Inquiry into Pension Consultants

Dear Clients and Friends:

In December of 2003, the SEC sent a 12-page letter to a group of well-known investment consulting firms primarily serving the pension plan industry. (We will refer to those firms as “pension consultants.”) The letter requested massive amounts of data about the level of independence of the firms, whether their advice to pension funds might have been compromised by payments from money managers, and similar matters. The deadline for responding was January 12, 2004.

Greycourt does not market its services to pension plans, we have no direct pension plan clients,¹ and we were obviously not among the firms that received the SEC’s letter. However, the services we provide our clients resemble those offered by pension consultants in terms of advice about asset allocation, manager selection, and performance monitoring. Moreover, we had the pension consulting model very much in mind when we introduced our open architecture services – specifically, it was a model we wished to avoid.

We think the SEC’s concerns are valid and that investors of all kinds, as well as advisors to those investors, can learn a great deal by understanding the nature of the inquiry. In addition, recent mainstream press coverage² may have raised questions in the minds of many investors about the quality and independence of the advice they are receiving. Hence this letter.

¹ On a few occasions Greycourt has been engaged by families or endowed institutions who have pension plans embedded somewhere in their asset base.

² Mary Williams Walsh, “Concerns Raised Over Consultants to Pension Funds,” *New York Times* (March 21, 2004), p. 1.

Who are the subject's of the SEC inquiry?

The Commission has not made public the names of the firms that received its letter, and some firms have declined to comment about the inquiry. Nonetheless, press reports make it clear that a number of the major pension consultants are involved, including Callan Associates, CRA Rogers Casey, Frank Russell Co., Mercer Investment Consulting, Segal Advisors, Strategic Investment Solutions, Summit Strategies Group, Watson Wyatt, Wilshire Associates, and so on.³

What information is the Commission seeking?

Greycourt has not seen a copy of the Commission's letter, but industry press coverage has suggested that the SEC is interested mainly in "practices with respect to advice regarding the selection of investment advisers to manage plan assets; selection of other service providers such as administrators, custodians, investment research firms and broker-dealers; and services other than investment consulting provided to plan sponsors, investment advisers and mutual funds."⁴

In other words, the SEC is concerned that money managers and other vendors to pension plans are being recommended by pension consultants based on payments from the vendors to the consultants, rather than because they are best-suited to the pension plans' needs. This kind of conflict of interest goes to the very heart of the integrity of the investment advisory business, and to the trust that investors can have in their advisors.

Why is the SEC acting now?

Most of the practices the Commission is looking into have bedeviled the pension consulting community for decades. Hence, it is interesting to wonder out loud why the SEC is moving now, and why, if the practices are so malign, the Commission didn't act many years ago.

³ See, e.g., Barry B. Burr, "Consultants Under the Gun with SEC Probe," *Pensions & Investments* (January 12, 2004), p. 1, 25; Arden Dale, "SEC Looks at Pension-Fund Advisers," *Dow Jones Newswires* (February 11, 2004); Mary Williams Walsh, *op. cit.*, note 2; John Wasik, "Pension Consultants Need to Come Clean on Conflicts," *Bloomberg.com* (February 23, 2004).

⁴ Quoted in Arden Dale, *ibid.*

We are speculating, of course, but we believe that there are three answers to this question:

- ◆ First, during the very long Bull Market that persisted from 1982 until 2000, even investors with poor or conflicted advice experienced reasonably good outcomes in absolute terms (though not, of course, in relative terms). It was only when the very difficult markets of 2000 – 2002 came along that the fault lines in the pension consulting business became obvious. Many pension funds lost hundreds of millions of dollars during this period, and states, municipalities and corporations found themselves in the unwonted position of having to make huge contributions to their pension plans. Conflicted advice caused losses to be larger than they would otherwise have been (just as conflicted advice had caused gains to be smaller than they would otherwise have been in earlier years), and the howls of protest from mayors, state legislators and corporate executives and shareholders were hard for the Commission to ignore.
- ◆ The prominence of the folks whose oxen had been gored also made it difficult for the SEC to turn a deaf ear. While pension plan trustees – themselves deeply implicated in the conflicts (see below) – might have been willing to look the other way, state legislators who had to vote to contribute cash to under-funded pension plans were demanding action.
- ◆ Finally, some of the practices that led, at least indirectly, to losses are relatively new. Only in recent years, for example, have pension consultants brought in truly marquee talent (Bill Clinton, for example) to their conferences in an attempt to distract pension plan trustees from the conflicts of interest that were eating away at their assets.⁵

What practices is the SEC concerned about?

Lori A. Richards, director of the SEC's Office of Compliance, Inspections and Examinations, has pointed out that the Commission's inquiry is still in progress and that no conclusions have yet been drawn. However, there is no mystery about the kinds of activities that ought to concern the regulators, as they have been the subject of widespread press coverage (see, e.g., note 3):

⁵ Other luminaries who have appeared at pension consultant conferences recently include retired General Norman Schwarzkopf, Colin Powell (before he became Secretary of State), political strategist Mary Matalin, former New York Comptroller H. Carl McCall, and former Israeli Prime Minister Ehud Barak. Mary Williams Walsh, *op. cit.*, note 2, p. 16.

- ◆ Believe it or not, some consultants are engaged in the most egregious and straightforward type of “pay-to-play:” money managers pay the consultants to recommend them to clients.⁶ Although not (yet) illegal, one would have thought this practice would have died of shame long ago.
- ◆ Many pension consultants require their money managers to pay for the consultants’ marketing activities. The most common examples are the many conferences sponsored by pension consultants. These conferences have little purpose beyond advertising the consultants’ (and money managers’) services and cementing relationships between the consultants and the trustees who are supposed to be looking out for their plan participants’ interests (but who are clearly looking elsewhere). The conferences are paid for not by the consultants, and not by the plan trustees (through registration fees), but by the money managers the consultants are recommending.
- ◆ Many pension consultants have broker/dealer affiliates. By channeling client trades through these affiliates, the consultants supplement their incomes, sometimes very substantially.⁷ Exactly how this practice comports with the requirement to obtain best execution is a mystery to many people, including us.
- ◆ Many pension consultants are engaged in businesses other than providing investment advisory services to their clients. Most of these businesses involve selling services to – surprise, surprise! – money management firms.⁸ While the consultants claim that the managers are always told that buying services won’t necessarily lead to being recommended to clients,⁹ money managers might very well believe that if they *don’t* buy the services, they will *never* be recommended.
- ◆ Many consultants actually compete with money managers for business by having their own asset management arms. These asset management units

⁶ Sometimes the payment takes the form of sharing investment advisory fees that would otherwise be paid to the manager – wrap accounts usually work this way.

⁷ The New York *Times* cites one case in which UBS PaineWebber misled the city of Nashville into such an arrangement, which ended up costing the city \$60 million. UBS eventually paid \$10 million to the city as part of a settlement agreement. Mary Williams Walsh, *op. cit.*, note 2, p. 16.

⁸ These services typically involve selling advice to money managers about how to market their products, or perhaps selling strategic planning advice to money managers.

⁹ The New York Times cites the case of a Hawaii pension fund that learned that 14 of 16 managers recommended by Callan Associates were paying Callan for marketing advice and other services.

typically market funds of funds products, in which the consultant bundles several managers into one product.¹⁰ Exactly how the consultants decide when to recommend an outside money manager and when to recommend their own products is a deep mystery.

- ◆ Many consultants have cozy relationships with managers, especially alternative managers like private equity partnerships. Consultants often serve on the advisory boards of PE firms. A close look at such consultants almost always reveals that their clients have suspiciously high exposures to PE.¹¹
- ◆ Pension consultants spend huge sums of money (sometimes their own, most times that of money managers) entertaining pension plan trustees and employees. This entertainment occurs at conferences held in fashionable locations, at sporting events where tickets are hard to come by (the Masters gold tournament, the NCAA basketball tournament), and via direct gifts at holidays.
- ◆ Public pension plans are controlled by elected officials who appoint all or most of the trustees. Those trustees then decide which pension consultant to engage. Consultants who wish to be considered had best be prominently listed among the financial supporters of the officials who appoint the trustees. Consultants who wish to remain engaged had best respond enthusiastically when the arm is put on them for additional contributions. This is the original pay-to-play problem, and it remains amazingly widespread.

Why reform is important

Let's take a moment to reflect on why it is so important to reform the pension consulting business. A few pension funds, it is true, are prodigious in size, heavily staffed with experienced investment professionals, and altogether well able to fend for themselves. Those funds, however, are the exception, not the rule. Most pension funds are unstaffed or have modest staffs with little investment experience. Trustees are often retired teachers, firefighters, bus drivers, or political appointees selected for their political loyalty, not their investment knowledge.

¹⁰ Until recently, Wilshire Associates consolidated both its asset management and consulting units under one executive. After the SEC inquiry was launched, Wilshire separated these two units and the executive left the firm.

¹¹ At one point, the Louisiana teachers pension fund had 42% of its assets committed to alternative investments, according to the *New York Times*. Mary Williams Walsh, op. cit., note 2, p. 16.

Thus it is true that, legally speaking, pension consultants are only advisors and all important investment decisions are made by the trustees. But the more important reality is that the decisions on which the retirement security of millions of Americans depends are made by pension consultants whose competence and, especially, integrity, are open to question. If we ignore this truth we are elevating a legal formality over the retirement security of millions of working Americans.

How not to reform the pension consulting industry

To its credit, the first instinct of the SEC when it encounters a problem is to deal with it through improved disclosure. This notion, that “sunshine is the best disinfectant,”¹² comports with the free market idea that informed consumers will make better decisions than government regulators. The problem here, as with the mutual fund scandals, is that there are very few consumers around who can be informed in any useful sense of the word. The more disclosure we put in mutual fund prospectuses – which are already virtually unreadable even by professionals – the *less* likely it is that mutual fund investors will read them. And the same phenomenon occurs in the pension fund industry: adding ten more paragraphs on page 68 of the pension consultant’s Form ADV won’t improve the knowledge of most pension fund trustees.

There is another parallel with the mutual fund scandals: the very folks who are supposed to protect consumer interests are the folks who are least likely to do so. With mutual funds it was the mutual fund boards of directors. Notwithstanding the intent of the Investment Company Act of 1940, mutual fund boards serve the interests of the investment advisors to the funds, not the interests of the investors in those funds. Similarly, in the pension industry it is the plan trustees who are supposed to be looking out for the interests of the plan participants. But, notwithstanding the provisions of ERISA, even if those trustees were capable of understanding what was going on (as noted above, most aren’t), they are the very people who have been most compromised by the pension consultants.

Pension consultants claim that their judgment is not affected by the payments they receive from money managers, and plan trustees claim that their judgment is not affected by the boondoggles and gifts they receive from the consultants. Even if

¹² Actually, as disinfectants go, sunshine leaves much to be desired. Otherwise, instead of scrubbing up before operations, surgeons would simply stand out in the sun for a few minutes.

this were mainly true, there would still be an unsavory odor rising out of the pension consulting business that more disclosure won't cover up. What is needed is substantive reform.

What should be done?

Greycourt isn't a player in the pension consulting business, and we don't have enough detailed knowledge of that business to offer concrete suggestions about how the pension consulting mess should be cleaned up. However, the general outlines of what needs to be done to restore confidence in the management of America's public and private pension fund assets are pretty clear:

- ◆ First, the open architecture concept badly needs to be introduced into the pension consulting business. Open architecture requires the elimination of conflicts of interest between advisors and their clients. If the pension consultants were required to operate in an open architecture manner, most of the unsavory practices in the industry would disappear overnight.
- ◆ Second, the regulators should recognize that a bribe is a bribe is a bribe. Pension plan trustees should be prohibited from taking anything of value from pension consultants, and pension consultants should be prohibited from offering anything of value to trustees. Consultants should also be prohibited from making political contributions to the campaigns of government officials that oversee plans they are advising or wish to advise.
- ◆ Finally, we recognize that regulating the practice of pension consultants accepting value from the money managers they recommend is a complex problem. No sooner would the regulators outlaw existing practices than many others would crop up. Moreover, it would be difficult to regulate this issue in the pension consulting industry without undercutting other practices – such as wrap fee accounts – elsewhere in the financial services industry. Here, perhaps, is an area where disclosure can play a role – but it would have to be real disclosure. Taking as an example the “red herring” language of preliminary prospectuses (and the cancer warnings on cigarette packages!), we offer the following disclosure suggestion only partly tongue-in-cheek. Pension consultants who have taken anything of value from a manager they are recommending to a pension fund might be required to state, on the front cover of the recommendation, in red text, something like this:

SOME OR ALL OF THE MANAGERS RECOMMENDED IN THE FOLLOWING MATERIALS HAVE PAID US TO RECOMMEND THEM TO YOU. WE DO NOT BELIEVE THAT THESE PAYMENTS HAVE

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**COMPROMISED OUR JUDGMENT. REASONABLE PEOPLE MAY
DISAGREE WITH THIS VIEW, HOWEVER.**

We hope this overview of the SEC's inquiry into pension consultants has been useful. We will be happy to discuss the matter further with you at your convenience.

With kind regards,

GREYCOURT & CO., INC.