

THE FOLEY ADVISER

June 2005

SEC STAFF RELEASES REPORT OF EXAMINATIONS OF PENSION CONSULTANTS; SEC AND DEPARTMENT OF LABOR PUBLISH TIPS FOR PLAN FIDUCIARIES

A recently released staff report of the Office of Compliance Inspections and Examinations (“OCIE”) of the Securities and Exchange Commission (“SEC”) calls for pension consultants to adopt enhanced compliance policies and procedures to ensure that such pension consultants are meeting their fiduciary obligations to their clients. The report and its conclusions stem from an examination conducted by OCIE of 24 pension consultants during the period from January 1, 2002 to November 30, 2003. All of the pension consultants examined were also investment advisers registered under the Investment Advisers Act of 1940 (the “Act”).

As legal background for the report, the OCIE summarized basic law governing investment advisers under the Act: investment advisers owe a fiduciary duty to their clients. This duty requires that they provide clients disinterested advice and disclose all material facts to clients. Typically, such basic disclosure about an investment adviser is made through Part II of the Form ADV. In addition to the disclosure required by Form ADV, conflicts of interest that are material only to a particular client must be disclosed. The new “Chief Compliance Officer Rule” (Rule 206(4)-7 under the Act) requires registered advisers to appoint a Chief Compliance Officer and adopt written policies and procedures to address their fiduciary and regulatory obligations to their clients.

The OCIE examinations were conducted in response to questions about the independence of the advice that pension consultants provide and the extent of their disclosures regarding conflicts of interest. There were concerns that the advice provided by pension consultants could be influenced by their other business relationships. More specifically, there was a concern that pension consultants either select or steer clients toward certain money managers because of other business relationships.

The examinations focused on three specific areas: (1) the services and products provided to both those clients who are pension plans and those that are money managers or mutual funds; (2) the payment method used to pay for the services provided by the pension consultant; and (3) the disclosure provided to clients by the pension consultants.

The OCIE found that more than half of the pension consultants (or their affiliates) who were reviewed as part of the examination provided ongoing services and products to both money managers and pension plan advisory clients. The OCIE also found that a majority of those examined either had affiliated broker-dealers, allowing the pension consultants to receive payments through “commission recapture,” or relationships with unaffiliated broker-dealers, which in many of the cases examined appeared to be undisclosed to clients.

The staff report indicated that, because of insufficient data, the staff had been unable to determine whether recommendations made by pension consultants were “skewed” to benefit certain money managers. However, the report did find that relationships between pension consultants and their affiliates who also provide services to pension plans (such as investment management or brokerage) may create a conflict of interest, and that these issues have not been fully addressed by pension consultants.

The report found that many money managers had relationships with multiple consultants and that they purchased overlapping products from such consultants. The report noted that many money managers did not disclose their relationships with consultants to their pension plan clients to whom the money managers are recommended by such consultants.

The report also indicated that many of those pension consultants examined did not believe they owed a fiduciary duty to their clients because they had taken the necessary actions not to be considered a “Fiduciary” for purposes of ERISA. The report stated that many consultants “ignore or are not aware of their fiduciary obligations” under the Act.

From these findings, the staff concluded that pension consultants should enhance their policies and procedures regarding compliance. The report reiterates the SEC’s statements in the release accompanying adoption of the “Chief Compliance Officer Rule” regarding the need to evaluate risks and conflicts “in light of the firm’s particular operations.” The report also provided the following specific examples of the policies and procedures that might be relevant given the activities of pension consultants:

- § policies and procedures that separate the consultant’s advisory activities from the other business activities conducted by the firm with the goal of either eliminating or mitigating conflicts of interest;
- § policies and procedures that would make certain that all disclosures necessary to fulfill the consultant’s fiduciary obligations are made, particularly with respect to conflicts of interest arising from relationships between the consultant and the managers or funds it recommends; and
- § policies and procedures to prevent and disclose conflicts of interest with respect to the use of brokerage commissions, gifts, gratuities and other items provided to clients or received from money managers.

In response to the findings in the report, on June 1, 2005, the U.S. Department of Labor and the SEC published “Selecting and Monitoring Pension Consultants: Tips for Plan Fiduciaries.” The tips are available at www.dol.gov/ebsa and www.sec.gov/investors/pubs/sponsortips.htm.

Investment advisers with questions about any of these matters should contact Peter Rosenblum or Jeffrey Collins in Foley Hoag’s Investment Management Group at (617) 832-1000.