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A legal update from Dechert's Employee Benefits and Executive Compensation and Financial Services Groups

SEC Examines Conflicts of Interest and Disclosure for Pension Consultants

A report issued by the Securities and Exchange Commission ("SEC") on May 16 announced the results of the examination of 24 pension consultants registered with the SEC as investment advisers, concerning their compliance with securities laws involving conflicts of interest and disclosure. It reflects the SEC's concern that many conflicts of interest are not being properly disclosed. The report was intended not only to assist in consultants' compliance with the Investment Advisers Act of 1940 ("Advisers Act"), but also to educate pension plan trustees and other plan fiduciaries about the issues raised in the report.¹

The report highlights the need for pension consultants that are registered as investment advisers to revisit disclosure provided to clients to assure that all potential conflicts of interest are adequately disclosed, and to revisit compliance policies and procedures to assure that they adequately address all potential conflicts of interest.

Significant findings of the report include the following:

- A majority of consultants to pension plans also receive compensation from money managers that comprises a significant part of their revenue (e.g. from courses and software offered to money managers for a fee). There are indications that at least some consultants are more inclined to recommend money managers who purchase such products.

- A majority of pension consultants have affiliated broker-dealers or relationships with unaffiliated broker-dealers that can raise issues where a portion of the brokerage commissions paid by a plan are used to pay a consultant's fee.

The SEC report mentions that a plan may not be receiving "best execution," may be overpaying its pension consultant, or may be advised to engage in a more active trading strategy as a result of these relationships. Significantly, consultants receive referral fees from the broker-dealer that are not disclosed to the pension plan client.

- Many pension consultants have affiliates that also provide services to pension plan clients, giving rise to conflict of interest and disclosure issues. For example, when a consultant acts as a pension advisor and a broker-dealer representative, conflicts of interest may arise if disclosure is not made that the consultant may be compensated based on the volume of transactions executed by the pension plan. Similar conflicts exist where the consultant recommends the services of its affiliates to its pension plan clients without disclosure.
- Pension plan clients do not receive disclosures sufficient for them to be able to understand the conflicts that exist in situations where the consultants provide services and products to the money managers they are recommending to the pension plans.

¹ Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), plan fiduciaries must act prudently in selecting and monitoring service providers.

- Many pension consultants do not believe they have any fiduciary duties to their clients under ERISA or the Advisers Act.²
- Many pension consultants do not maintain procedures concerning how they prevent or manage conflicts of interest in their activities or governing disclosure of conflicts to clients.
- Many money managers who have relationships with pension consultants do not disclose these relationships to their pension plan clients.

As a result of the examinations, the SEC concluded that pension consultants need to enhance their compliance policies and procedures to ensure compliance with their fiduciary duties to their pension plan clients under the Advisers Act.³ On June 1, the SEC and the Department of Labor issued a joint guidance statement⁴ for plan fiduciaries which consists of a set of questions that plan fiduciaries can use to evaluate their plan consultants and the objectivity of advice provided by such consultants. The specific questions include the following:

- Whether the pension consultant is registered with the SEC or a state securities regulator and whether the consultant has provided all required disclosures?
- Whether the pension consultant or a related company has a relationship with money managers

² The SEC warned in its announcement of the report that “[a]lthough investment advisers owe their clients a fiduciary obligation—including to adequately disclose all material conflicts of interest—some pension consultants appear to have erroneously concluded that they are not fiduciaries to their clients.”

³ The SEC suggested that these policies and procedures might include: (1) policies and procedures to ensure that the consultant’s advisory activities are insulated from its other business activities in order to eliminate or mitigate conflicts of interest in its advisory activities (e.g. policies concerning the identification and monitoring of money managers and mutual funds recommended to a pension plan to prevent the money managers’ or mutual funds’ other relationships with the consultant from affecting the consultant’s duties to the plan); (2) policies and procedures that adequately disclose all conflicts of interest arising from a consultant’s relationship with both the pension plan to which it is rendering advice and the money manager and mutual funds that it recommends or monitors; and (3) policies and procedures to prevent or disclose all other material conflicts of interest.

⁴ “Selecting and Monitoring Pension Consultants - Tips for Plan Fiduciaries,” SEC Release 2005-81.

that it recommends, considers or otherwise mentions to the plan?

- Whether the pension consultant or a related company receives payments from money managers it recommends, considers, or otherwise mentions to the plan?
- Whether the pension consultant has any policies or procedures to address such conflicts of interest?
- If the pension consultant allows plans to pay its consulting fees using brokerage commissions, whether the pension consultant monitors the amount of commissions and alerts plans when fees have been paid in full and what steps the pension consultant takes to ensure the plan receives the best execution for its securities trades?
- Whether the pension consultant has any arrangements with broker-dealers pursuant to which the consultant or a related company will benefit if money managers place trades for their clients with such broker-dealers?
- Whether, if hired, the pension consultant will acknowledge in writing that it has a fiduciary obligation as an investment adviser to the plan while providing consulting services?
- Whether the pension consultant considers itself a fiduciary under ERISA with respect to its recommendations to the plan?
- What percentage of the pension consultant’s plan clients utilize money managers, investment funds, brokerage services and other service providers from whom the consultant receives fees?

The guidance statement cautions that if the consultant is a fiduciary under ERISA and receives fees from third parties as a result of their recommendations, a prohibited transaction under ERISA occurs unless the fees are used for the benefit of the plan (e.g. an offset against the consulting fees charged to the plan), or there is a relevant exemption.

It is important to note that ERISA requires a plan fiduciary to act prudently and in the best interests of the plan and its participants. In light of the DOL’s guidance, plan fiduciaries should contact their pension consultants and request that they respond to those questions recommended by the DOL in addition to any

other questions that may be relevant to the particular plan's relationship with the pension consultant. Answers to this questionnaire should be carefully reviewed, and any remaining uncertainty clarified so that appropriate action may be taken.

For example, based on the answers received, a plan fiduciary may need to consider whether a plan's relationship with a pension consultant should be continued and, if not, what remedial action may be necessary or appropriate to properly protect the plan's interests. If the answers to this questionnaire are satisfactory, the plan fiduciary will have received additional assurance that the retention of the consultant was and continues to be free of potential conflicts of interest that could "taint" the consultant's advice to the plan. In either event, records of the due diligence process followed and any related action taken with respect to this issue should be maintained.

Moreover, it is recommended that the plan's compliance processes and procedures be updated to include an annual review of these relationships, and that the plan obtain contractual protections to ensure that each pension consultant will comply with the SEC's disclosure requirements. Finally, new consultants should not be retained without first ensuring that any potential conflicts have been fully disclosed.

The full text of the guidance statement can be found on the SEC (<http://www.sec.gov/investor/pubs/sponsortips.htm>) and DOL (<http://www.dol.gov/ebsa>) websites.

The SEC's staff findings can be found at <http://www.sec.gov/news/studies/pensionexamstudy.pdf>.

Practice group contacts

If you have questions regarding the information in this legal update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/employeebenefits or www.dechert.com/financialservices.

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