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The Gathering Storm In Retirement Funds

By Harvey L. Pitt, Compliance Week Columnist—June 28, 2005

In the broad arena of compliance, no area is fraught with more potential difficulties than asset management. It's axiomatic that any time one group of individuals entrusts property or liquid assets to another, the potential for recriminations runs high. This is especially true with respect to retirement funds, since nothing is more likely to provoke feelings of anger and instability as telling those who've worked a lifetime that money they counted on to care for themselves and their families after they retire has disappeared.

These conflicts also ebb and flow as a result of our cyclical times. Two factors enabled the terrible turmoil in the mutual fund industry to be predicted—flat or declining markets, and Social Security reform. Flat or declining markets always presage *potential* scandals for money managers. Those who earn money based on the *quantity* of assets they manage find that flat or declining markets make it impossible to increase income unless they outperform the markets (difficult if not impossible), sell services to more clients (yielding more assets to manage), or cheat. Human nature being what it is, there'll always be some who cheat rather than increase the fees they're paid the old-fashioned way—by earning them.

Social Security reform, perhaps reflecting Elizabeth Janeway's paradigm of "an idea that simply won't go away," is also a harbinger of potential scandal among money managers. That's because there really are but two fundamental arguments used by those who object to current efforts to change the status quo: Either ordinary folks aren't smart enough to be entrusted with their own assets in volatile markets, or the markets—and those who operate in them—are rigged. The latter ensured that some AG ("Aspiring Governor") was certain to "find" a problem somewhere with money managers.

Of course, no matter how many scandals we seem to produce, we can be certain there'll be more. In the area of retirement funds, the potential for conflicts of interest among money managers is rampant. For example, many money managers have affiliations with broker-dealers, allowing them to recapture a part of a retirement fund's trading commissions. Sometimes, money managers pay others for performance analytics, or to sponsor client conferences. These types of undisclosed conflicts of interest were among those identified in a study published last month by the Securities and Exchange Commission. The SEC looked at 24 retirement fund money managers out of the 1,742 investment advisers registered with it that offer retirement management services. Surprisingly, in some instances these money managers weren't even aware they owed a fiduciary's duties to the retirement funds they managed. If this is representative of the entire industry, it should pose grave concerns to retirement fund trustees.

Retirement fund trustees and boards should examine the performance of the fiduciary agents that manage the retirement funds they sponsor, if for no other reason than that the SEC survey—and the concomitant concerns it raised—effectively demand at least that. Moreover, exposure of the SEC's concerns is sure to attract broad interest from others, particularly state AGs. This is a very political issue, and those who bear responsibility for many of these retirement funds are, themselves, very political. In order to avoid becoming enmeshed in controversy, retirement fund boards should take steps to assure themselves that the people they've hired to manage their employees' funds are performing fiduciary duties as they should be.

The fiduciary obligations owed to a retirement fund ultimately reside with the plan's trustees, usually a company's management or its board of directors. Trustees can certainly delegate some of their responsibilities to others—such as money managers, banks or consultants—but that doesn't relieve them of their fiduciary obligations. Essential to the "art" of delegation are, first, a careful selection process, and second, an effective system to monitor the performance of agents closely. The Department of Labor has warned that fiduciaries who do not follow the basic standards of conduct "may be personally liable to restore any losses to the plan, or to restore any profits made through improper use of the plan's assets resulting from their actions." Individual and corporate stakes are high; indeed, in the current environment, they've never been higher.

As a result, trustees should consider evaluating these areas, among others, on a periodic basis, in order to ferret out—and then address—any problems or issues that may be lurking in their retirement funds:

- **Pay to play.** Money managers are often required to pay fees in order to manage a consultant's clients' funds. These payments can be made directly or through the use of so-called "soft dollars." And yet, soft dollars can conflict with the duty of "best execution," because they generally result in the payment of higher commissions than might otherwise have been available. Currently, some commissions run as low as 1½ cents per share. If a retirement fund is paying higher commissions, and some of those commissions are being paid as soft dollars, a potential problem exists. Low commission costs are an easily identifiable consideration in ascertaining whether a money manager's obligation to obtain best execution has been achieved.
- **Captive trading.** Some money managers, particularly those affiliated with broker-dealers, are required to execute retirement fund trades with captive broker-dealer affiliates. Commissions may serve to offset management fees, or partially satisfy these charges through soft dollars, or augment the management fees identified as such. Issues of best execution are raised by these arrangements, as well as issues about churning and fair compensation.
- **Multiple portfolios.** Many portfolio managers oversee both hedge funds and other types of funds. Each of these products has different fees and demands on personnel and ideas. Money managers should have clear and understandable policies in place to deal with inevitable conflicts over scarce ideas, investment talent, investment opportunities, and other resources. If left to their own devices, the better ideas, people and opportunities will ineluctably flow toward those funds that offer the highest fee potentials. Retirement fund trustees should be satisfied that they aren't the victims of such an arrangement.
- **Codes of ethics.** Every retirement fund needs a formal code of ethics and statement of policy. It should delineate the practices to which money managers are expected to adhere or

activities they are required to avoid. If something's legal, but causes discomfort—such as soft dollars—this is the document in which to preclude those practices. Money managers should recognize their fiduciary obligations to the plan, and periodically certify that they're complying with each and every responsibility imposed upon them.

- **Diversification and asset allocation.** Trustees should furnish money managers with reasonable guidelines about allowable concentrations in individual assets and business sectors. They should also provide money managers with instructions about actions they will be required to take in the event some limit is breached, such as immediately selling the offending assets, or immediately notifying the trustees (and awaiting their instructions). Efforts should be made to minimize the number of breaches experienced, and facilitate quick decisions. Restrictions should be placed upon the amount of a company's own stock that can be held in any retirement account, especially 401(k)s.
- **Investment restrictions.** Money-management agreements should specifically identify restricted assets or strategies. To the extent limitations are dependent upon ratings or other criteria, the language should be clear and unambiguous. For example, does a restriction regarding the acquisition of "less than investment grade" assets include those with a Ba1/BBB- rating? These are not issues that can, or should, be left to misinterpretation.
- **Expected returns and benchmarks.** Each permissible investment style—for example, growth, value, fixed income, foreign equities—should be subject to representative benchmarks. Any expected or minimum returns shouldn't conflict with the type of investment involved. It's impossible to guarantee the absence of any negative returns, and yet many money-management agreements require managers to achieve at least money market returns every year. That's just another way of requiring a manager to guarantee the absence of a negative return. If performance benchmarks are utilized, money managers must understand the timing and the consequences of failing to achieve them. So, too, must trustees understand the implications of their money managers' failure to achieve these benchmarks.
- **Performance.** Trustees must monitor performance in order to insure that the fiduciaries that they've hired are fulfilling their duties.
- **Compliance with money-management agreements.** Money managers should periodically affirm their compliance with the operative money-management agreement. In addition, reports should be furnished to the trustees or board evidencing the compensation mangers received and any soft dollars generated and expensed. Any potential breaches of management agreements should be evaluated, assessed, remediated and then subjected to new controls that offer reasonable assurances the problem is not likely to recur.
- **Under- or over-performance.** Significant deviations from articulated style benchmarks should be examined, assessed, and explained. Under- or over-performance may suggest breakdowns have occurred in the money manager's discipline. If left unaddressed, they also may mean the trustees don't understand what their managers are doing.
- **Style drift.** Trustees must watch money managers for style drift. Well-constructed investment policies often contain numerous diversified alternatives that are expected to perform differently in various market environments. This can often decrease the risks that inhere in a particular investment strategy without affecting returns. If money managers deviate from their investment discipline because returns on a particular investment style fall out of favor—as occurred with value investing from 1998-2000—an investment strategy

can become compromised and a fund may wind up overexposed to a particular style. This usually happens just before a particular style falls out of favor and produces poor returns. If trustees wait until they see this phenomenon in the returns achieved, it's surely too late for them to do anything about it.

- **Utilize outside experts.** As regulatory pressures intensify, outside experts can furnish pragmatic expertise managers and boards are able to acquire only over time. The engagement of independent outside experts also evidences the trustees' proactivity. If problems surface—and bad things do happen to good and honestly-managed funds—it will be easier to persuade outsiders that any negative occurrences resulted from an inadvertent omission or mistake, not from an intention to deceive.
- **Get the Facts.** The SEC suggested 11 questions trustees should ask their money managers. These are a good starting point:

    1. Is the manager registered with the SEC or a state securities regulator?
    2. Have the trustees received a copy of the required disclosure documents made by their registered managers?
    3. Does the money manager have business relationships with others to whom the manager recommends clients? If so, what are they?
    4. Does the money manager receive compensation in any form from others for recommending them? If so, what percentage of the manager's revenues do these payments represent?
    5. What are the manager's policies or procedures to prevent or address conflicts of interest or prevent the provision of direct or indirect compensation from being considered in its recommendations?
    6. If the money manager is effectively compensated from fees from the fund's brokerage commissions, how does the money manager ensure that the fund doesn't over-pay?
    7. If the money manager requires captive trading or obtains fees from brokerage commissions, how does it insure the fund receives best execution?
    8. Does the money manager have any arrangements with broker-dealers under which it receives payments generated by the fund's commissions?
    9. Does the money manager acknowledge and understand its fiduciary obligations to the fund?
    10. Does the money manager consider itself a fiduciary under ERISA with respect to its activities on behalf of the fund?
    11. What percentage of the money manager's clients use other service providers who pay fees to the fund's money manager?

    In addition, trustees and directors should consider asking the following questions:

    12. How many different funds and fee structures does the money manager have?
    13. What policies and procedures are in place to allocate trading ideas and personnel?
    14. For the last three years, how many soft dollar commissions did the retirement fund generate and on what were they spent?
    15. Has the money manager advised how the personnel it allocated to the retirement fund ranked against their peers in the PSN Effron database over the last five years?
    16. Has the money manager provided the current holdings of all the investments in the retirement fund ranked from smallest to largest, and by sector?

17. How does the money manager's sector definitions deviate from S&P's sector definitions?
18. What is the beta and alpha on the holdings in the retirement fund?

- **Update Money-Management Agreements.** Money-management agreements should be periodically reviewed and updated to eliminate any confusion regarding the responsibilities and duties of the fund's money managers. Particular attention should be paid to business practices that the fund's trustees want to eliminate or to control more tightly.
- **Verify.** Trustees need to review money managers' compliance and performance on a quarterly basis. Managers and boards should get a quarterly update and an in-depth briefing on an annual basis along with any changes that are proposed or problems that have surfaced.

The sensitive nature of employee pension and retirement funds makes the SEC's report on the conflicts of interest between consultants and money managers both surprising and distressing. It's bound to become a political issue. With planning, and hard work, however, companies can address the issues in advance and minimize the effects on the companies and the plan's trustees. Those that don't get in front of this wave are doomed to be flattened by it.

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