

## NEWS RELEASE



## FOUNDATION FOR FIDUCIARY STUDIES

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## FOR IMMEDIATE RELEASE

### Guide to SEC Probe of Consultant Pay-to-Play Schemes

*Understanding fee and disclosure issues*

**Pittsburgh, PA, January 16, 2004**—The **Foundation for Fiduciary Studies** has prepared the following guide to assist members of the press and other interested parties in understanding the complex issues associated with the SEC probe on the consultant “pay-to-play” schemes.

The overwhelming majority of the nation’s pension plans, foundations, endowments, private trusts, and wealthy families are advised by investment consultants. The SEC has begun an investigation to determine whether certain investment consulting firms have engaged in inadequately disclosed “pay-to-play” schemes, whereby investment consultants are receiving millions, if not tens of millions of dollars, from the very same money managers the investment consultant has been retained to evaluate and monitor.

#### “Pay-to-play”

The term speaks for itself. As it pertains to investment consultants, it involves selling “services” to money managers, which typically include:

1. Conferences, institutes, or forums where the money managers are invited to Tycoish-type events attended by either the consultant’s blue-chip client list, and/or the consultant’s analysts who are responsible for preparing the “objective” reports on the very same money managers.
2. Performance measurement reports, whereby the consultant prepares reports on the performance of the money manager’s products.

3. Performance measurement software, that enables the money manager to prepare their own performance reports.
4. Training, marketing, and sales support of the money manager's staff.

The investment consultant is required by SEC regulations to disclose the fact that such "services" are being provided. The basis for the SEC probe, however, is the determination as to whether the actual dollar amounts received by the investment consultant, disclosed or not, have unduly tainted the independence and objectivity of the investment consultant.

### **Breach of Fiduciary Responsibility**

An investment consultant is a fiduciary, and therefore has certain duties and responsibilities defined by legislation, regulations, and case law. "Pay-to-play" schemes potentially cause four fiduciary breaches:

1. **The duty to have investment decisions delegated to a "prudent expert."** Evidence suggests that there is a strong correlation between money managers participating in the consultant's pay-to-play schemes and the same money managers being suggested to clients. The scheme taints the results of any money manager search, and raises the question as to whether a particular money manager was recommended because it was in the best interests of the client or the investment consultant.
2. **The duty to control and account for investment expenses.** The "pay-to-play" consultant typically will not aggressively negotiate money manager fees. There is a disincentive for the consultant, hopeful that a portion of the money manager's lucrative fees will be used to pay for the investment consultant's "services."
3. **The duty to monitor.** The lost opportunity costs associated with holding onto an underperforming money manager probably represents the greatest damage. There is strong evidence to suggest that investment consultants are reluctant to suggest the timely removal of money managers that are participating in the consultant's "pay-to-play" scheme.
4. **The duty to avoid prohibited transactions.** In the case of qualified retirement plans under ERISA §406(b) (Employee Retirement Income and Security Act), a fiduciary (such as the investment consultant) is prohibited from using its position to be paid additional amounts.

The lost opportunity costs associated with these breaches could easily reach the hundreds of millions of dollars for the typical multibillion-dollar pension plan. In the case of public pension plans, the negative impact could easily result in an underfunding status of the pension plan, requiring either an increase in taxes, and/or a reduction in retirement benefits.

## Probable Outcome

The SEC is likely to follow the same script it used with Morgan Stanley. The SEC complaint against Morgan Stanley concerned the firm's "Partners List"—mutual fund firms that either paid cash or used "soft dollars" to maintain a "preferred" status at Morgan Stanley. Morgan Stanley neither admitted nor denied wrongdoing and paid a settlement of \$50 million.

Comparable action is warranted with the investment consultant pay-to-play schemes. Consulting firms should be required to disgorge all "pay-to-play" revenues for the past five years; eliminate altogether the provision of "services" to money managers; and, formally define detailed fiduciary practice standards of care for its consultants.

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*About the **Foundation for Fiduciary Studies (Foundation)**: The **Foundation** was established in 2000 for the purpose of defining the practices that detail a prudent process for investment fiduciaries. The **Foundation** is part of the trilogy of organizations focused solely on the subject of investment fiduciary responsibility that make up the unincorporated entity, **Fiduciary 360** ([www.fi360.com](http://www.fi360.com)). The other associated organizations include the **Center for Fiduciary Studies**, which is associated with the **University of Pittsburgh Joseph M. Katz Graduate School of Business**; and **Fiduciary Analytics**, which develops Web-based tools based on the fiduciary practices for investment decision-makers.*

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