Consultants Brace for Greater Scrutiny

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By Paul Menchaca

The U.S. Department of Labor’s proposal to revise the definition of fiduciary under the Employee Retirement Income Security Act could have far-reaching implications for investment consultants that work with defined benefit plans, experts say. But how far reaching the changes might be – and when they might take place – remain unclear.

Adding another layer of uncertainty comes from the recent midterm elections, in which the Republicans regained power in the House and significantly cut into the Democrats’ majority in the Senate. Republicans have vowed to repeal or block part of the sweeping financial reform law signed by President Obama in July, and it’s unclear whether they will also turn their eyes to other aspects of regulatory reform.

In the simplest terms, Labor’s proposal – which it made in October – is an attempt to classify more investment advisors as fiduciaries. It is an effort that stemmed out of the Securities and Exchange Commission’s study, finished in 2005, of 24 pension consultants in which it found wide-ranging conflicts of interest. Among the findings was that many consultants under review had provided products and services to both pension plan advisory clients and money managers on an ongoing basis. Most of those consultants provided only limited disclosure of those competing business lines, and some made no such disclosure at all.

The Department of Labor has oversight of corporate pensions. In a conference call with reporters last month, Phyllis Borzi, assistant labor secretary for the Employee Benefits Security Administration, said that the existing rules had “become barriers” to the department’s capacity for protecting plan participants. “The enforcement activities that the DOL has undertaken, both in our investigations and our litigation over the past three decades, have made it perfectly clear that these arcane rules really interfere with the ability of the department and fiduciaries to understand where the lines are being drawn, and to protect beneficiaries and participants,” Borzi said.

Rich Lynch, chief operating officer of Fi360, a Pittsburgh-based organization that provides fiduciary education, says there is a “grey area” where some consultants argue that they aren’t fiduciaries, while regulators argue otherwise. “When a consultant is required to disclose a conflict of interest, plan sponsors can take the recommendation with eyes open about what they should take into consideration,” Lynch says.
One of the reasons that consultants have been able to argue that they aren’t fiduciaries is because the five-part test that determines whether a consultant is actually a fiduciary is difficult to pass. According to Fi360, this test stipulates that a consultant must (1) provide advice or recommendations (2) on a regular basis (3) pursuant to mutual agreement or understanding; and (4) the advice serves as the primary basis for investment decisions for the plan; and (5) the advice is individualized to the needs of the plan. Under the Labor proposal, it will no longer be required that advice is given on a regular basis; a mutual agreement or understanding will no longer have to be in place; and the advice will not have to be the primary basis for investments decisions by the plan. There is no deadline for when the public comments will be closed, and even if the change is approved, it will probably take some time to phase it in.

Paul Klauder, v.p. and managing director for the retirement market in SEI’s institutional group, says he “applauds the position” of the Labor Department because it will make consultants more accountable for advice they are giving. He notes that in a traditional search a consultant will cull a list down of potential managers and then give his or her perspective and recommendation to the plan sponsor. If there is later negligence on the part of the selected manager, the consultant would not take blame if he or she (or their firm) is not a fiduciary.

“In the new model, he could be liable,” Klauder says. “It raises the bar for the amount of due diligence that consultants use in their business.”

SEI has spent over $10 million on the due diligence process and has more than 105 people dedicated to selecting investment managers, according to Klauder. Labor’s proposal calls into question whether many smaller consulting firms will have the financial resources to cover similar costs.

“I think there could be contraction” across the consulting industry, Klauder says. By definition, it will mean more tech dollars and resources, and boutique and regional consultants will need to figure out if they can be profitable with that.”

Lynch says that the best way for a consultant to eliminate a conflict of interest is to obviously cut ties with the party in question. But if you can’t get rid of the conflict, the best thing a consultant can do is to properly manage the conflict. What this means, according to Lynch, is “proper disclosure” – which entails more than putting a note at the bottom of the performance report informing the plan sponsor of the conflict. Instead, he says, there should be a conversation in which all questions are answered, and then have the client consent to it.

Even still, this may not be enough to save a consultant’s job with the plan sponsor. “[The conflict of interest] could create a seed of doubt and the plan sponsor might say, ‘Maybe we shouldn’t take the chance,’” Lynch says.