Why and How Executives Should Reclaim Their Investment Decision-Making Power

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Abstract Brief

Decisions regarding the selection of investment service providers and management of certain fiduciary duties were previously straightforward, even rote responsibilities for the executive class. Well-established investment firms provided a blanket of security for corporations and foundations, with implications of co-responsibility, accountability and trustworthiness. Now, in an era of Sarbanes Oxley and a period of insecurity ushered in by the massive Madoff scandal, the burden of trust has shifted. In-house corporate and foundation investment committees – not third-party investment advisors – must own the responsibility of insuring the efficacy of not only what, but how fiduciary decisions are made. This article addresses why and how executives should take heed of new processes for ethical decision-making and evaluation of investment service providers in an unchartered economic and financial climate.

Definition Spotlight: Fiduciary

A fiduciary is…

a) any executive or committee within a corporation who makes decisions regarding the company's retirement plan on behalf of the company's employees.
b) any executive within a foundation or endowment that serves as a trustee to the designated institution.

The Dissolution of Trust: Upping the Ante for Investment Execs

Less than a decade ago, "trust" was a go-to descriptor for corporations and executives seeking to allay personal or public concerns regarding corporate investment decisions or employees' financial futures. CEOs trusted well-reputed investment firms to deliver on their promises of exponential returns. Foundations and charitable institutions trusted investment advisors to offer unbiased counsel in the management of their money. Executive committees trusted that their employees' retirement savings were safely invested in those options with maximized long-term benefits.

That was before the financial maladies of Madoff, The Stanford Group and others quickly squashed the notion of unqualified trust in investment service providers, and shifted the burden of investment awareness squarely back onto the shoulders of the executive class.

In the Sarbanes Oxley and Madoff age, "trust us" doesn't work anymore – not for investment firm service providers, and certainly not for executives who are responsible for their employees' financial well-being. Fiduciaries – those executives within a corporation or foundation who make decisions regarding a company's retirement plan or donors' contributions – must be proactive to disarm the veils that disguise some investment firms as trustworthy partners in corporate financial responsibility. If financial missteps are uncovered, the executives and committees who chose the investment firms – not the investment firms themselves – will pay the (theoretical and literal) price.

The Veils of Trustworthiness: Keeping Executive Decision-Making at Bay

Investment firms' three veils of trustworthiness – the veil of complexity, the veil of conflicts, and the veil of authenticity – provide seemingly unbiased rationale of why executives should entrust their highest burden of responsibility (that of their employees' financial futures) to investment service providers, who appear more knowledgeable and experienced in fiduciary law and process.

With these veils in place, many executives and committees dubbed with the responsibility of overseeing their employees' pension plans and foundation's assets are unknowingly abdicating their fiduciary duties to investment advisors, money managers and other third-party vendors that do not have the same responsibilities to uphold by law. As such, vendors can (and do) invent their own standards for "safeguarding" and "growing" wealth for employees to whom they have no legal accountability. Fiduciary executives and committees partner with these vendors under their guise of trustworthiness and responsibility, when, in fact, these partnerships can strip executives of their decision-making power, and place them – inadvertently or not – in the line of fire if and when consequences are sought for ethical or financial failure.

This paper will uncover how many service providers' veils of trustworthiness place corporate and foundation fiduciaries at risk. It will also provide executives with concrete approaches for reclaiming prudent decision-making processes in their emergence as ethical leaders in a new era of fiduciary responsibility.

The Veil of Complexity

The esoteric nature of fiduciary laws and regulations provides investment service providers with a distinct advantage when selling their services to corporate or foundation fiduciary committees. Of the most cerebral CEOs and executive committee members, only a small percentage of that elite class (specifically, those who have had training or education relating to pension laws like ERISA or foundation statutes like UPMIFA) are able to fully comprehend the jargon and legal implications relating to managing

other peoples' money, the selection of various plans, and the responsibilities they must maintain on behalf of their employees or donors. Investment service providers leverage this position to make an (easy) argument to foundation executives and pension plan committees of why they should "leave it to the pros."

With the combination of complicated laws, technical terminology, and the complex analyses of various investment plans on behalf of their workforce and donor groups, executives and investment committees often willingly give up control of these decisions to a team of "trusted" investment partners, who can include:

- **Investment advisors,** who often claim to provide "independent" due diligence on appropriate investment options in the process of selecting the "right" plan for employee retirement plan participants;
- **Recordkeeping organizations**, who undertake the process-laden role of administering the retirement plan participants' accounts on behalf of the company;
- **Custodians or directed trustees**, who say they ensure the safe-keeping of plan participants' assets and donors' contributions; and
- **Money managers**, who actually select the specific securities for retirement plans and foundations, including mutual funds, target date funds, separate accounts, and alternative investments such as hedge funds.

The difference between this "fiduciary vendor supply chain" and a typical vendor supply chain is how executives are able to evaluate and select these vendors. An ordinary vendor would be vetted on several levels – not the least of which would be on capability, pricing, quality and integrity. But for the fiduciary vendor supply chain, these typical rules of evaluation do not, and cannot, apply.

The complicated nature of vendors' service offerings and pricing models, as well as the disproportionate emphasis they place on projected returns, dilutes the executive team's ability to examine the traits that really count – namely, whether the vendor charges reasonable (and transparent) fees for their services, whether they maintain conflicts of interest (and thus more pricing complexity) with other vendors in their supply chain, and whether they define fiduciary duty based on actual legal statutes or their own invented terms. This leaves the corporate or foundation executive team susceptible to potential fee gouging, or worse, inadvertent neglect of its fiduciary duties.

AT-A-GLANCE: Veil of Complexity

The issue? Without proper training, fiduciary law and responsibility are too complex for corporate or foundation investment committees to understand, leaving open the opportunity for investment service providers (members of the "fiduciary vendor supply chain") to take advantage of executive committees' less-informed position.

The danger? Corporate or foundation executives may relinquish fiduciary decision-making control to investment vendors who may be abusing their position – including overcharging fees or misrepresenting the executives' responsibilities under law (so as to protect themselves from further investigation).

The Veil of Conflicts

One of the most pervasive functions of the executive class is to maximize cost efficiencies, wherever possible and pragmatic, for a company or foundation. Investment service providers work to accommodate this need by offering many fiduciary supply chain services in a bundled, one-stop-shop package for executive investment committees. From investment advice, to record-keeping, to custodial duties and money management, all of these business units are often offered under one common ownership or company (also known as conflicts of interest). The vendor's enticing claims made to executive teams regarding "bundle approach" benefits include:

- gaining cost efficiencies,
- relying on only one vendor to supervise and coordinate all of the fiduciary supply chain activities, and
- enabling one service provider to be intimately acquainted with the intricacies of the company's plan or a foundation's objectives.

To further confound the bundle situation, there are no laws within the U.S. pension system that prohibit investment vendors from offering multiple services under one

AT-A-GLANCE: Veil of Conflicts

The issue? Without laws governing investment vendors' bundling of services, fiduciary executives and committees may select one vendor for multiple investment, administration, and custodial activities, without fully evaluating or understanding the risks of that model.

The danger? Vendors with conflicts of interest may be hiding fees within numerous reports that make it difficult or impossible for fiduciary committees or executives to find fee inconsistencies or overcharges.

roof – and no laws that require corporate executives to avoid investment vendors with these conflicts of interest. So, if investment firms claim to provide efficiencies under this model, and there are no laws against it, why should executives care?

First, while there are no laws prohibiting foundation or corporate executives from working with investment vendors who provide multiple services, there are laws that require executives to evaluate these vendors' conflicts of interest. Foundation or corporate fiduciaries who avoid even a superficial review of these conflicts of interest subject themselves and their personal assets to great risk under law.

Additionally, a careful review of these vendor conflicts of interest might reveal astonishing overpricing for services that have been hidden by the mirage of "efficiencies" the vendor represented to exist. While investment service providers are required to report their fees, often times they do not offer one consolidated report for all of the various business segments, making it virtually impossible for executives to make an informed evaluation of those fees.

The Veil of Authenticity

Many investment service providers represent themselves to be genuine, devoted partners to retirement plan sponsors and foundations – from their brands, to their marketing presentations, to their detailed, regular updates to clients. By all accounts, it appears that these vendors' efforts are focused on helping their clients' retirement plans and foundations to be successful. Unfortunately, while corporate and foundation fiduciaries may interpret that investment vendors are acting in their company's best interest, some vendors are authentic in one thing, and one thing only: their desire to be profitable.

Being profitable does not necessarily exist to the exclusion of being ethical and representing clients' interests, but U.S. pension and trust laws blur this line of profitability vs. ethics to an even fainter shade of gray. For retirement plan sponsors and foundations, fiduciary laws require that they adhere to a strict set of processes relating to the management of their employees' retirement plans and donors' accounts. For investment service providers (or vendors), no laws burden them with a fiduciary duty that is equal to that of their clients. Hence, there is a fundamental misalignment of interests at play: Most pension executives and foundation trustees care greatly about doing the right thing and adhering to the laws governing their fiduciary duty. Vendors legally have the latitude to care greatly only about money, if they so choose.

Proof can be found among the many vendors that do not disclose the misalignment of interests at the outset of their servicing arrangements with pension sponsors and foundations. Rather, some investment service providers claim they care about helping clients uphold their fiduciary duty – some even bold enough to claim they will adopt the fiduciary burden on behalf of their clients (which is impossible under law). The danger of this misalignment of interests is apparent: investment service providers can suggest or claim virtually anything to earn fiduciary executives' trust and business. It is not they who will be called to task if fiduciary obligations are not upheld.

As noted above, this misalignment can lead to dangerous misinterpretations of fiduciary responsibility. Consider the investment service provider's quarterly marketing presentation to its fiduciary committee, in which the vendor spends most of the time focusing on new investment trends, the latest investment options, and the phenomenal returns the company charted for the previous year. While vendors spend time on the flashy world of investing, they imply that the committee's fiduciary responsibility is to ensure profitable returns for their employees' retirement plan or foundation's assets, which is simply not the case.

AT-A-GLANCE: Veil of Authenticity

The issue? A misalignment of service providers' goals (to be profitable) and foundation or corporate executives' goals (to adhere to sound fiduciary practices) permits vendors to say anything to garner executives' trust and business.

The danger? Investment service providers could be misrepresenting their responsibilities to executive committees and fiduciaries, leaving the corporate or foundation executive susceptible to legal and ethical remuneration.

In fact, a committee's fiduciary responsibility by law is to ensure that all of the processes surrounding the retirement plan or foundation are proper and intact. That means evaluating service providers, ensuring reasonableness of fees related to the plan, and guarding against unjust conflicts of interest. The committee, while being fully accountable to the plan's process and functionality, has virtually no legal responsibility regarding the investment returns on the plan. Misalignment of interests is quickly translated into a risky misinterpretation of fiduciary duty, leaving the investment committee vulnerable and completely unaware of its true responsibility under law.

Lifting the Veils: Reclaiming Fiduciary Decision-Making Power
How do fiduciary executives take back the power of making their most impactful decisions – those of financial safekeeping – on behalf of their employees? To make a powerful difference as fiduciaries, corporate and foundation executives must uncover the service provider veils that disguise misguided investment practices as responsible partnership.

All three of the investment vendor veils addressed in this paper tap into those imperatives executives seek to be successful in their roles – the need to delegate to trusted advisors who are experts in their field (*veil of complexity*), the need to seek efficiencies (*veil of conflicts*), and the need to feel informed (*veil of authenticity*). For executives and investment committees without an acute awareness of their specific role as fiduciaries, investment vendors are ideally positioned to take advantage of these fiduciaries seeking a seemingly quick and efficient "fix" to their retirement plan or foundation responsibilities.

Below are concrete ways fiduciary executives can take back their decision-making authority, and protect the future of their employees and their personal reputations:

1. **Get training**. Retirement plan officials or trustee boards should implement a training that covers all levels of their relevant fiduciary duties. Training programs can range from one-day classroom sessions, to Internet training that can be completed as time permits. Some programs also offer certification. At a minimum, training topics should include:

    - vendor selection and monitoring;
    - determining reasonableness of fees from service providers;
    - evaluating conflicts of interest; and
    - differentiating effective governance and abdication of duty.

2. **Conduct a review**. Hire a qualified, independent, third-party firm to conduct a review of your investment committee's practices. The independent firm should evaluate the roles and responsibilities of all parties, written policies and procedures for reviewing conflicts of interest, the investment policy, and how to measure the success of the plan. Once an evaluation of current practices is complete, the independent firm can assist in upgrading the committee's practices as needed, and undertake the responsibility of ongoing monitoring of committee practices and vendor compliance.

3. **Reread your service agreement**. A study of your company's existing service agreement with an investment vendor may clarify the vendor's true role as it relates to your committee's fiduciary duty. If your vendor claims in person to be a "plan fiduciary" or "co-fiduciary" for the company, see if that language is in writing and appropriately defined. If it is not, your vendor may have misrepresented their role (and thus, your responsibility), placing you at risk. Contact a qualified, independent fiduciary consultant to discuss alternative service provider options.

4. **Insist that your service providers are certified**. While no laws can protect executives in their selection of service providers for their pension plans, a certification (or lack thereof) can speak volumes about the trustworthiness of your vendor's practices. Those vendors that carry certifications relevant to their type of support service (e.g., ASPPA for pension recordkeepers or CEFEX for investment firms) have been evaluated through a multi-step process that ensures fee solidarity, ethical investment practices, and clear and consistent reporting.

5. **Get insurance on your fiduciary decisions.** To be certain you are fulfilling your legal duty and making the best decisions on behalf of your employees or foundation, seek the partnership of an independent fiduciary advisor. This type of firm (or independent fiduciary) can be an indispensible member of your fiduciary team, ensuring your decisions are sound, and even accepting liability for the guidance it provides. When selecting an independent fiduciary, keep in mind these critical characteristics:
   - The firm should be completely and wholly independent (i.e., it does not provide any other "fiduciary supply chain" services and thus does not benefit from any investment decisions you make);
   - The firm should vow to accept a full transfer of primary fiduciary duty on your behalf (i.e., it maintains full legal accountability for its counsel); and
   - The firm should have specialized competency in the duties expected of primary fiduciaries (i.e., it is certified and recognized for its ethical practices).

Uncovering the Veils: A Case Study

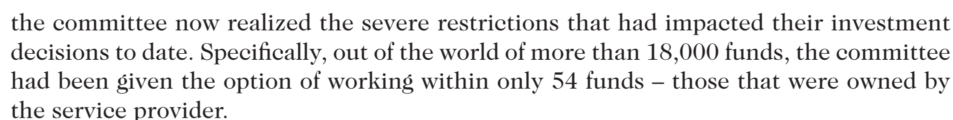
For many years, a large raw materials production company had been working with the same investment service provider for the management and administration of the company's retirement plan. The company had established an internal investment committee to oversee the plan with guidance from its investment vendor.

Like many fiduciary committees, there was significant turnover amongst the committee's members. However, throughout the committee's tenure, the investment service provider demonstrated to committee members that all aspects of the plan were being adequately monitored. Astute mid-level representatives from the service provider would regularly call the committee members with updates. On a quarterly basis, the vendor would send a barrage of in-depth information to the committee that reported on investment returns, pension plan developments, as well as topics that fell outside the scope of pension plans. The committee members would pore over these dense documents for weeks, content with their service provider's thorough reporting style and reliable partnership.

Due to the complexity of the retirement plan details and the persuasiveness of the investment vendor, members of the committee never felt at issue with the service provider or the multiple services the vendor provided for them. This single vendor bundled a number of services for the company, providing investment advice, money management, recordkeeping, and the custody of assets under one umbrella.

Only when more recent committee members began to pose "tough" questions regarding the service provider's business model and approach, did these inquiries lead to an audit of the vendor's practices and a review of the results.

The audit and subsequent analysis revealed an inappropriate business model for the retirement plan service provider, which included rampant conflicts of interest (as the vendor was providing multiple services under one convoluted pricing model) as well as fee overcharging for various pieces of the plan, which had been accumulating for years. In addition, with the vendor's monopoly on the company's investment options,



the committee now realized the severe restrictions that had impacted their investment decisions to date. Specifically, out of the world of more than 18,000 funds, the committee had been given the option of working within only 54 funds – those that were owned by the service provider.

Overpricing in the investment arena alone cost the employees of the company a total of over $30 million in lost value. Close to $250,000 of investable funds was depleted from the company per year, which was being paid to the service provider through duplicate services or surreptitious overcharges.

The company enlisted a third-party fiduciary audit and consulting firm to conduct the audit and assist in implementing subsequent corrective action. The independent fiduciary firm reorganized management of the company's plan by helping it partner with several non-competing investment vendors. The executive committee members also underwent training with their independent fiduciary firm in order to fully understand their legal roles and responsibilities. In the end, the committee members moved forward with a new approach that enabled them to make important, informed decisions on behalf of the company's employee community, and firmly establish their roles as fiduciary leaders.

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