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Investment Consultants and Institutional Corruption

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Harvard University

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Abstract

Analyses of the financial crisis of 2007-2009 and the continuing effects of a difficult investing environment have largely focused on factors such as the roles of failed and complex financial products, inadequate credit rating agencies, and ineffective government regulators. Nearly unexamined, however, is a key group of actors in the financial landscape, investment consultants. Investment consultants stand as gatekeepers between large investors, such as private and public retirement funds, and those from “Wall Street” who design and sell financial products. Investment consultants hired by these asset owners practically control many investment decisions. Yet, as a whole the profession failed to protect asset owners in the recent financial crisis and has yet to engage in serious self-examination. Much of the reason for the failure can be traced to institutional corruption, which takes the form of conflicts of interest, dependencies, and pay-to-play activity. In addition, a claimed ability to accurately predict the financial future, an ambiguous legal landscape, and a tainted financial environment provide a fertile soil for institutional corruption. This institutional corruption erodes the confidence and effectiveness of the retirement and investment systems today. While not proposing a comprehensive system of reform, this article illuminates a way forward for those in the industry who have the desire to address and implement necessary corrective activity.

Keywords:

Institutional Corruption, Investment consultants, Fiduciary duty, Wall Street, Money managers, Self-dealing, Retirement crisis, Modern Portfolio Theory, Defined benefit pensions, Multi-employer plans, Taft-Hartley plans, Department of Labor, Securities and Exchange Commission, Conflict of interest, Cognitive capture, “Dinner risk”

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Table of Contents

Introduction

Foreword—A Short Story

Who Protects Investors?

What is Institutional Corruption?

The Landscape—Funds, Trustees, and the Advisors They Employ

What do Investment Consultants Do or Not Do?

Classic Institutional Corruption and Investment Consultants

Unique—or Maybe Not so Unique—Forms of Institutional Corruption

What Is To Be Done?

Introduction

Over seventy-five years ago, President Franklin Roosevelt signed the Social Security Act.¹ For a nation in the throes of change and facing a difficult economic landscape, the Act represented the recognition of the hardship of an old age without income, and the importance to the nation of the financial health of its older citizens.²

Since the implementation of Social Security, additional measures have been developed to ensure a safe and secure retirement, including work based methods of providing for retirement income and the promotion of individual solutions. Yet in this age of austerity, demographic changes, political dysfunction, poor investment returns, and Wall Street malfeasance, extraordinary pressure is being applied to the concept of a financially secure retirement. The country is bracing for a “retirement crisis.”³ Only two-thirds of Americans have any savings for retirement, and of those, most have less than \$25,000 in total non-home assets.

While declining in importance, traditional pensions, often called “defined benefit funds,” continue to play a prominent role in the retirement universe. Today nearly four trillion dollars is held in defined benefit pension funds in this country, on behalf of men and women for their retirement.⁴ Amassed by these hard working

¹ *Social Security Act*, 42 U.S.C. Ch. 7 (1935).

² In signing the Act, Roosevelt said:

“Today a hope of many years' standing is in large part fulfilled. The civilization of the past hundred years, with its startling industrial changes, has tended more and more to make life insecure. Young people have come to wonder what would be their lot when they came to old age. . . . We can never insure one hundred percent of the population against one hundred percent of the hazards and vicissitudes of life, but we have tried to frame a law which will give some measure of protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age. This law, too, represents a cornerstone in a structure which is being built but is by no means complete. . . . It will act as a protection to future Administrations against the necessity of going deeply into debt to furnish relief to the needy. . . . It is, in short, a law that will take care of human needs and at the same time provide for the United States an economic structure of vastly greater soundness.” President Franklin D. Roosevelt, “Statement on Signing the Social Security Act,” August 14, 1935, reproduced by the American Presidency Project, <http://www.presidency.ucsb.edu/ws/index.php?pid=14916>. The Act included a number of other important provisions, including the beginning of unemployment compensation insurance.

³ Kelly Green and Vipal Monga, “Workers Saving Too Little to Retire,” *Wall Street Journal*, March 19, 2013, http://online.wsj.com/article/SB10001424127887323639604578368823406398606.html?mod=WSJ_hps_L_EFTTopStories. For an extraordinary history of the 401(k) industry, the complicity of the financial media, and the connection of this form of retirement to the present difficult financial period, see Helaine Olen, *Pound Foolish: Exposing the Dark Side of the Personal Finance Industry* (Portfolio Hardcover, 2012).

⁴ This paper cannot examine retirement issues from top to bottom; there are simply too many questions to be approached. There are too many kinds of vehicles in which retirement assets are held and too many laws and agencies that apply to retirement activities. Further, contested and complex policy questions abound. Thus, this paper attempts to focus on a keystone piece of the institutionally corrupt edifice, the role of investment

Americans through their deferred wages, the funds and the benefits that come from them represent a social promise that when their working days are done, these Americans will be able to live in financial dignity. Yet middle class wages that were diverted to benefit funds are drying up, and past retirement promises to workers are being shamed as harmful “legacy costs.” Politicians run on platforms touting opposition to “Cadillac” benefits for public employees, and their positions are often well received by many private sector workers unaware of the ripple effect of such actions on their own retirement nest eggs. Healthy and widespread investment returns, touted as a pain-free funding mechanism for the building of retirement savings, have proved a chimera: the 2000s are now known as the “lost decade” of investments; investment portfolios took a severe beating in the financial crash of 2008 and have yet to fully recover; and the theory of investment, Modern Portfolio Theory (MPT), that guides most professional investment decisions, has proven flawed.⁵

Given this tableau, issues of trust, in the defined benefit funds that hold retirement assets and in those men and women who administer and advise the institutions, could not be more important. These funds, like the huge California Public Employees’ Retirement System and the New York State Teachers’ Retirement System, play an outsized role in the retirement field, given the billions of dollars that each hold in assets. Yet confidence in them is often lacking. The highly publicized investment failings of these large funds have given heart to those who believe that the system of defined benefit plans has outlived its usefulness.⁶

consultants. Further, to make the examination more manageable, the focus here will be on investment consultants who serve defined benefit funds, especially those which cover public employees at the state and local levels and those that are known as Taft-Hartley or multiemployer funds. These funds, along with single employer funds, constitute the vast majority of defined benefit funds today. While it is true that the number of American workers who are covered by defined benefit plans is falling, the issues found in them are ones that apply to all who have investments dedicated to retirement.

⁵ Modern Portfolio Theory, developed around forty years ago, promised a scientific and mathematical way to balance financial risk and reward. It has given trustees, financial advisors, and their lawyers a false sense of security. “Perhaps the most remarkable feature of these ideas is the indomitable power of their influence on investment decisions, even though the theories failed to survive a battery of empirical testing. Peter L. Bernstein, *Capital Ideas Evolving*, (John Wiley & Sons, 2007), xviii; see also, Peter L. Bernstein, *Capital Ideas: The Improbable Origins of Modern Wall Street*, (John J. Wiley & Sons, 2005).

⁶ Defined benefit retirement funds, simply stated, are managed pools of money structured to provide retirees with specified periodic (generally monthly) benefits based on a predetermined formula based on the employee’s earnings history, tenure of service and age, not on individual investment returns. They are contrasted to defined contribution funds in which employees contribute specified amounts of money from compensation, but provide no guarantee of what will be available for the person at time of retirement. In each case, money is invested and investment returns hopefully contribute to the benefits which can be received. The fundamental difference between the two classes of funds is that in defined benefit funds, the ability to

These retirement issues are being played out in the midst of a time of extraordinary financial events. News of outright fraud in finance cascades through the system. We live in an age of “too big to fail” banks, a revolving door between Wall Street and regulatory oversight positions in government, an extraordinary litany of dishonesty and avarice in the financial sector, and the shocking unwillingness or inability of prosecutors to hold financial charlatans liable for their crimes.⁷

But less noticed is the sea of institutional corruption in which the entire retirement system, other than Social Security, swims today. If this institutional corruption—practices that while not illegal under current law have a distorting and destructive effect on the institutions in question—could be recognized and eliminated, the retirement savings system would be much healthier. Restored trust could banish some of the cynicism that infects the retirement system, and many would receive a much healthier and brighter retirement.

Renewal of trust in the retirement system can begin with those who are paid to be the advisors to the trustees of retirement funds—investment consultants. In the galaxy of professionals who make their living from these funds, consultants occupy a unique role. Consultants are the prime advisors to trustees who administer these funds as to how to produce sufficient and sustainable investment returns, and they occupy the firewall space between investors and their money managers. As such, investment consultants are the center in this investment constellation.⁸

honor the financial promises made is a collective risk; in defined contribution funds, the risk is solely borne by the individual.

⁷ See Gregg Fields, “What Institutional Corruption Shares with Obscenity,” Edmond J. Safra Lab Working Papers, No. 6, April 18, 2013, available at <http://ssrn.com/abstract=2252033>. Consider this quote from a recent story by Michael Lewis, who worked on Wall Street some years ago and has done some of the best reporting on the financial crisis. In reviewing a recent book, *Why I Left Goldman Sachs*, Lewis wrote the following: “Goldman Sachs, [Wall Street’s] most admired firm conspired to flood the financial system with worthless securities, then set itself up to profit from betting against those very same securities, and in the bargain helped to precipitate a world historic financial crisis that cost millions of people their jobs and convulsed our political system. . . . They were then permitted to pay politicians to prevent laws being passed to change their business, and bribe public officials (with the implicit promise of future employment) to neuter the laws that were passed—so that they might continue to behave in more or less the same way that brought ruin on us all.” Michael Lewis, “The Trouble with Wall Street,” *New Republic*, February 4, 2013, <http://www.newrepublic.com/article/112209/michael-lewis-goldman-sachs#>.

⁸ Investment consultants operate in other retirement arenas as well, including in defined contributions plans and 401(k)s where much of this industry gives advice to individuals. Evidence of serious problems in this area is mounting. The analysis featured herein has applicability in all fields in which investment consultants operate, though situations vary.

Billing themselves as champions of retirement assets and guides to those responsible for investing in them, this profession generally has failed to shield trustees from harmful financial manipulation or to produce sufficient and sustainable investment returns.⁹ The industry continues to cling to a broken financial theory and abdicates its role as the gatekeeper for those to whom it sells its services. In addition, it remains true today that, as Jennifer Cooper—the former director of the Houston Firefighters’ Relief and Retirement Fund—counseled a decade ago, “the industry is riddled with conflicts.”¹⁰ Data from Cooper’s Diligence Review Corporation, published in 2012, found that only ten percent of managed assets in the United States adhere to the highest ethical standards, and that nearly one half of all such assets are advised by investment consulting companies who have advisory red flags, meaning that the company “has a systemic culture of breaking the law,” or has “operational weaknesses that allowed a regulatory violation to occur.”¹¹ According to a journalist who has written about Cooper’s study, however, “critics also say that what Diligence perceives as potential conflicts are commonly accepted practices throughout the industry.”¹²

It is time for these conflicts to be identified, examined, and eliminated. Such actions could pave the way for a consulting profession that can truly serve the needs of those who are responsible for benefit funds.

⁹ As when one examines any large area, there are individual exceptions to the general analysis contained herein. Attention to the system of finance today is required; it is not a question of individuals. But it is also true, as Lessig wrote, “For while we respond appropriately to evil, we don’t respond well to good souls who do harm. We don’t identify the harm well. We don’t act to stop it. Indeed, even when we see the harm clearly, we deny its most obvious source. We can’t imagine this decent soul has caused it. So we scour the scene for the obviously corrupt or evil one, as if only the evil could be responsible for great harm.” Lawrence Lessig, *Republic, Lost: How Money Corrupts Congress – and a Plan to Stop It*, (Hatchet Book Group, 2011), 37.

¹⁰ Janice Revell, “Are Your Savings Safe? The Seamy Side of Pension Funds: A Consultant is Supposed to Be a Pension Manager’s Best Friend. But Just How Two-Faced is Your Fund’s Pal?” *Fortune*, August 12, 2002, http://money.cnn.com/magazines/fortune/fortune_archive/2002/08/12/327043/index.htm.

¹¹ See <http://www.diligencereviewcorp.com> and Charles Passy, “An Ethics Test Your Adviser Might Not Pass,” *SmartMoney.com*, September 6, 2012, <http://www.smartmoney.com/invest/stocks/an-ethics-test-your-adviser-might-not-pass-1346970102755>.

¹² *Ibid.*

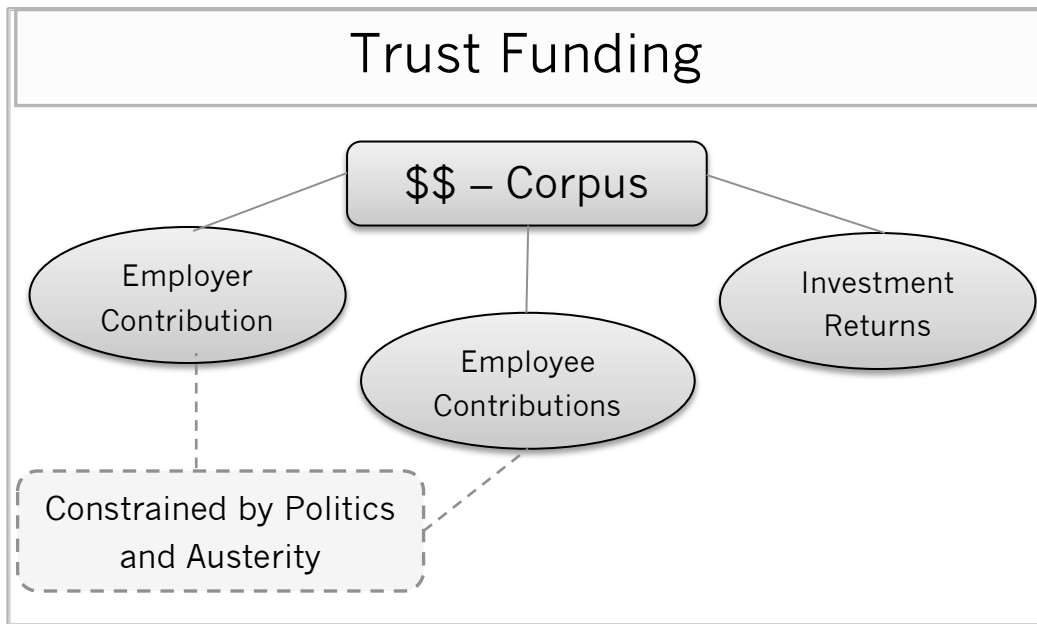


Figure 1

Foreword – A Short Story

In the late spring of 2012, the leader of a Southern construction union asked me to accompany him to a quarterly meeting of a small defined benefit pension fund in which several hundred of the members of his union participated. Some of his members were retired and receiving monthly benefit checks, and some were working and contributing to the fund in order to receive benefits in the future. As one who has served as a lawyer for funds such as these for many years, I was asked to attend this meeting with him to help the union leader understand whether or not he should be comfortable keeping his members in this fund.

The meeting was held in a square, beige, one-story building that sat on a busy street corner. This newish squat structure, surrounded by live oak trees, sat across from a lovely antebellum mansion. Upon entering the building we were greeted by the staff members of the fund. Their attitude was not surprising. As was the custom, before the actual meeting began female fund staff brought out large steaming metal containers of local cuisine from a nearby restaurant. A luscious lunch of Gulf delights including oysters and jambalaya was served. At the meal, we were joined by a small stream of trustees of the fund as they came in—local building trade union officials and representatives from local building contracting

companies. Also joining us were “service providers”—professionals, from the accounting, legal, and investment communities, who serve and make their living from funds such as these. As usual, the professionals, male and female, were dressed in suits, while the trustees—those who legally have the power and responsibility in these funds—were dressed more casually.

This was a meeting of a “Taft-Hartley” pension fund, one of the many types of legal entities that hold accumulated benefit money for workers.¹³ These particular funds, set up pursuant to a section of the National Labor Relations Act enacted over sixty years ago, must by law have equal voting power of labor and management on the governing Board of Trustees. Further regulated by a sweeping federal statute known as the Employee Retirement and Income Security Act of 1974 (ERISA), they operate under a particular set of laws, regulations, cultural habits, investment narratives, and political realities.¹⁴

These funds hold quarterly meetings, like the one we were attending, in which their trustees come together to oversee the activities of the fund. Financial and benefit matters are reviewed and decided upon. The health of the fund is discussed. Appeals may be heard from members who believe they are aggrieved by benefit decisions made by the trustees. Federal filings, required by the Department of Labor (DOL) and the Internal Revenue Service (IRS), are approved. And, in what often takes up half or more of the meeting, investments are discussed.¹⁵

At the conclusion of our delicious lunch, the meeting began. What is interesting for our purposes here is the investment section of the meeting. Funds like these are under tremendous financial pressure now, as wages are stagnant and hours worked

¹³ Authorized by the Taft-Hartley amendments to the National Labor Relations Act, multi-employer pension and other benefit plans involving unionized employers take the form of a trust, with trustee power shared equally between labor and management. 29 USC 186(c)(5). For over a half century, these benefit plans have provided benefits to a specific portion of working America—laborers, covered by collective bargaining agreements, who are employed by various employers within one industry, such as mobile construction workers.

¹⁴ Employee Retirement and Income Security Act, 29 U.S.C. Chapter 18, Section 1001 et seq. (1974).

¹⁵ Benefit funds such as these receive the money they use to pay retirement benefits from two major sources. First, money is contributed by participating employers pursuant to an agreement between the union and the companies. Like most job-related benefits, the money seems to come from the employer, but is really a part of the pay package received by the employee. In fact, the wages and benefit payments—including money for pension, health care, training, and occasionally other benefits—is often negotiated as a single amount and then often divided between the benefit payments and those amounts that go “on the check,” as wages. The second source of money is investment returns on the money accumulated in the fund.

by those workers contributing to the fund are falling. Each working member must support a greater and greater load for the retired workers who are receiving pension benefits. The result is that there is massive pressure on the investment of the money held by the funds to pick up the slack. But unfortunately, given that the last decade is known appropriately as the “lost decade” in terms of investment performance, funds like these are struggling.

Three investment professionals were present for the investment section of the meeting. One, the investment consultant, was typical for those in that profession. He is the intermediary between the trustees and those who sell financial products for their portfolio to them. A personable fellow, he had worked with the fund for many years.

Two well-coiffed money managers were in attendance as well. The fund had invested a portion of its money with each of their companies, and these men were here to explain the performance of these investments since the last quarterly meeting.

The first money manager, who came from Charlotte, began his presentation. His firm, one that manages stocks for the fund, had a “proprietary” trading system. In his explanation, he used a variety of phrases which I, even given my experience in the area, had never heard before. At first I assumed that they were obscure but important “terms of art,” but after a few minutes of his presentation, I realized that these terms were ones that his firm used to differentiate their financial products from others; they were simply sales terms. I doubt if anyone else in the meeting realized this or understood these terms any better than I did.

This money manager, like most who serve these funds, compared his returns to a benchmark. A benchmark is a financial comparison used to see if the manager is doing as well as his peers, those who invest in similar financial “styles.” Usually chosen by the manager so that he can decide where his goal line is, a benchmark is agreed to by the investment consultant and probably voted on by the trustees. As often happens, this money manager brought a very slick and colorful book for the trustees to review. It contained all manner of charts and mind-numbing numbers.

Books such as these often allow managers to hide mistakes, as the novelist Patricia Cornwell recently testified, “in plain view.”¹⁶

The second money manager had flown down from the North. His firm sells largely to Taft-Hartley funds. He handed out his pretty books, which we all flipped through. His pitch was pleasant, well-honed, and extremely friendly. He told us that the investment strategy of his firm means that they have no cares as to which stocks they own. They do only “quantitative” analysis, looking not at the fundamental qualities of the stocks, but only at certain numbers that represent the movement and other mathematical characteristics of the price of the stocks. He was quite proud that his stock pickers are not swayed by any knowledge about the underlying stocks themselves.

I looked at his book. His return numbers were dreadful and his comparison to his benchmark was shocking. He had missed his benchmark over the last three to five years, a “market cycle” in the parlance of investment consultants. And he had missed it over the last year, and six months, and three months. I asked him if I was reading it right. I was, he acknowledged. In response, this person worked to bond with the trustees who had been hiring his company for all this time. “We are all in this together,” he seemed to say.¹⁷

After both money managers left, the investment consultant said a few words. I asked him why the fund has a manager who has such woeful returns. Why would an investment consultant, who has a fiduciary duty to the fund, recommend that trustees continue to employ this company? The investment consultant spouted some stock phrases. He then told us that there was no way that this manager

¹⁶ Cornwell sued her former investment manager/consultant for theft and fraud. In her questioning by the attorney for the defendant, Cornwell was confronted with the fact that she had been provided with two financial reports that allegedly showed the failed investment strategies. The attorney for the defendant told her, “There’s absolutely no effort to hide this,” to which Cornwell replied, “It’s what I call hiding something in plain view.” Peter Schworm, “Patricia Cornwell Testifies in Suit vs. Her Accounting Firm,” *Boston Globe*, February 7, 2013, <http://bostonglobe.com/metro/2013/02/07/crime-novelist-patricia-cornwell-takes-stand-suit-against-former-accounting-firm/pWQiuZdMkJeHagiO8L3CEJ/story.html>. At the conclusion of the trial, the jury awarded Ms. Cornwell and her fellow plaintiffs over \$50 million dollars in damages.

¹⁷ John Kenneth Galbraith recognized this interplay in finance. “Shared error has also a well-protected role. It is no longer a personal matter. The financial world sustains a large, active, well-rewarded community based on compelled but seemingly sophisticated ignorance.” John Kenneth Galbraith, *The Economics of Innocent Fraud: Truth for our Time* (Houghton-Mifflin Company, 2004), 40.

should be fired, as when their investment performance is down is the best time to keep them. He literally said, “What goes down must go up.”¹⁸

In fact, this is a common but faulty precept among investment consultants. Recently investment consultants from a well-respected company wrote the following: “Many investors have been conditioned to terminate investment managers when they underperform. It is very important to realize that when a manager is terminated during a period of underperformance, not only will the negative performance be “locked in,” but there is also no chance of the investor reaping the benefits of that manager when it regains its edge.”¹⁹

Unwilling to admit the mistakes they may have made in choosing a manager, or recommending the continued employment of those with a terrible track record, today’s investment consultants often poorly serve the trustees who employ them. Yet, unlike the funds they serve, they seemingly always prosper financially.

We had seen enough and we left. In these days of uncertainty for workers who believed that their hard work would guarantee them a pension sufficient to live out their “golden years” at a financially level status, we had seen an all too typical performance by investment managers, and by the investment consultant—the gatekeeper of the fund.²⁰ This scene is played out every work day in this country, in funds large and small. Because of the failures by this class of professionals, investment returns have been unable to play the role that is required to protect the retirement benefits of American men and women. Why have the professionals failed?²¹

The answer is institutional corruption.

¹⁸ An experienced fund lawyer I interviewed for this paper told me a similar story. The investment consultant at a trust meeting the lawyer attended was asked by a trustee why the consultant was not recommending the discharge of an underperforming manager who was losing money for their fund. The manager needed time to recoup the losses, the consultant said. The fund should fire the manager, he continued, as soon as the manager got his losses back. Why the consultant believed positive performance always follows negative performance in the financial world was not made clear; of course, it does not.

¹⁹ Dave O'Donovan, Jason Bailin, CFA, and Nick Catanese, “When Not to Fire a Money Manager: A Consultant’s Perspective,” *Financial Advisor*, February 6, 2012. <http://www.fa-mag.com/news/when-not-to-fire-a-money-manager-a-consultants-perspective-9591.html>.

²⁰ While this was not a “secret” meeting, given that I attended the meeting as part of my legal representation of a client, it seems prudent to shield the names of the fund, city and attendees.

²¹ A word about the standpoint from which I write is appropriate here. In this field, I serve concurrently as an academic, a legal advisor, and as an actor. See footnote 1. Thus, the practices described herein are generally ones which I have specifically observed, and on which I am currently studying and sometimes working as an actor to affect.

Who Protects Investors?

Few can doubt that when the history of the present period is written, future generations will be amazed at the amount of corruption in today's financial system, especially at the highest levels. The colorful stories of greed and theft will startle. Our grandchildren's grandchildren will marvel at how our society allowed such malfeasance to occur.

The current regulatory system certainly seems to think about how to defend participants in financial transactions from corruption. In order to shield investors, including pension funds, from bad behavior of actors, our financial system employs a variety of structures. They include government regulators at global, national, and state levels, such as the Securities and Exchange Commission (SEC) and federal Department of Labor (DOL); private third-party ratings agencies, such as Moody's and Standard and Poor's; and financial service providers hired directly by investors, such as investment consultants. In spite of these protections, few would doubt that they have failed in the recent period in shielding investors from the avaricious and self-serving activities of the financial industry.²²

The first line of defense should be government regulators.²³ Conservative jurist and academic Richard Posner has written: "Banks can be made safe by regulation, but that is not their natural state, and so if regulation is removed they may careen out of control."²⁴ However, government regulators of finance, past and present, are widely acknowledged to be ineffectual at best and handmaidens for the financial bad actors at worst. A recent study by the Project on Governmental Oversight, using public data, found that over four hundred former SEC employees filed nearly two thousand disclosure statements revealing that they planned to represent a private-sector client with SEC business from 2001 to 2010.²⁵ Significantly, it was

²² Fundamentally, of course, the responsibility and fiduciary duty for the proper management of, and investment activity in, funds belongs to the trustees. Trustees' ability to confront the problems outlined here is growing, in spite of numerous hurdles. One example of collaborative work in this area is the Trustee Leadership Forum for Retirement Security, a part of the Hauser Center at Harvard University. See <http://hausercenter.org/iri/about/tlf>.

²³ The virtues of self-regulation continue to be preached in this arena, as in others. But few disinterested observers are convinced of the efficacy of this approach.

²⁴ Richard A. Posner, *The Crisis of Capitalist Democracy* (Harvard University Press, 2010), 251; also Lessig, *Republic, Lost*, 78).

²⁵ "The SEC's Revolving Door," Project on Governmental Oversight, <http://www.pogo.org/our-work/reports/sec-revolving-door.html>.

revealed in the confirmation hearing of Treasury Secretary Jack Lew that Lew's 2006 employment agreement with his former employer Citigroup gave him a large financial bonus if he left the company for a top U.S. government job.²⁶ Such arrangements are problematic for effective governmental regulation, to be sure.

The Institute for the Fiduciary Standards, an organization of academics and investment professionals, argues that effective regulation has declined in the last four years. In response, the group has formulated a "Fiduciary Standard," which calls on the DOL and SEC to close the "regulatory gap" and apply a consistent fiduciary standard to all who render investment advice.²⁷

To be fair, there are many fine regulators, and the DOL and SEC have recognized issues involving investment consultants. But lobbyists for the financial industry wield significant power. Their lobbying and the institutional corruption found in the relationship between lobbyists and politicians has stymied regulators' ability to implement useful provisions of the Dodd-Frank Act, the most important piece of post-crash financial legislation.²⁸ Systemic and narrative hurdles exist as well. Much of the investment business, including that of investment consultants, is premised on an economic model of sales. Sales businesses do not mesh well with conceptions of fiduciary duty in a "caveat emptor" world.²⁹ Further, those who oppose protections for investors overseen by strong regulators rely on current ideological trends that denigrate government and regulation. As John Kenneth Galbraith wrote, "out of the pecuniary and political pressures and fashions of the time, economics and larger economic and political systems cultivate their own

²⁶ Jonathan Weil, "Citigroup's Man Goes to the Treasury Department," *Bloomberg View*, February 21, 2013, <http://www.bloomberg.com/news/2013-02-21/citigroup-s-man-goes-to-the-treasury-department.html>.

²⁷ http://www.thefiduciaryinstitute.org/wp-content/uploads/2012/11/Declaration_Large1.pdf

²⁸ While many have written of the failure of regulators and regulations, the foremost chronicles have come from Matt Taibbi in *Rolling Stone* magazine. For example, see, Matt Taibbi, "The Real Housewives of Wall Street," *Rolling Stone*, April 28, 2011, <http://www.rollingstone.com/politics/news/the-real-housewives-of-wall-street-look-whos-cashing-in-on-the-bailout-20110411>. Taibbi wrote of why the most important congressional action taken after the 2008 crash, the Dodd-Frank Act, has, in the main, yet to be implemented or enforced. "While it's incredibly difficult to get a regulatory reform passed, it's far easier—and more profitable to politicians—to kill it. Creating legislation is a tough process. But watering down legislation? Strangling it with lawsuits and comment letters and blue-ribbon committees? Not so tough, it turns out. . . . Real people—even committed professionals—get tired of running through mazes of motions and countermotions, or reading thousands of pages about swaps-execution facilities and NRSROs. They will fight through it for five days, or maybe even six, but on the seventh they will watch a baseball game, or Tanked, instead of diving into that morass of hellish acronyms one more time. But money never gets tired. It never gets frustrated." Matt Taibbi, "The Slow, Painful Death of Dodd-Frank," *Rolling Stone*, May 24, 2012, 87. Also see Fields, "What Institutional Corruption," *op.cit.*

²⁹ See Donald C. Langevoort, "Psychological Perspectives on the Fiduciary Business," 91.3 *Boston University Law Review* (2011): 995–1010.

version of truth.”³⁰ Thus, actions by “too big to fail” banks and unhelpful financial professionals are supported according to an account in which, as Lawrence Lessig has written in a different context, “these ‘versions’ are still experienced as ‘versions of the truth,’ not outright fraud.”³¹ And, these “versions” constrain the ability of government regulators to act.

The second group that investors should be able to rely on is the independent rating agencies. The rules of many funds allow money to be placed only with financial products that have achieved a certain positive rating from these agencies. If the rating falls below a certain level, the financial instrument must be sold. These rating agencies claim to vet different forms of financial products, in a system that can be relied upon by investors with capital to buy complex financial products. With their promises of comprehensive financial analysis and precise examination of financial instruments, the pronouncements of these raters are used by all manner of investors.

The raters failed in the 2008 crisis, however, giving superior ratings to flawed financial products. In spite of their assurances of impartiality and incorruptibility, a look at the business model of these rating companies gives one pause.³² Raters are paid by the financial companies they rate. The rating companies compete for business from the issuers of financial products, and issuers are often able to shop among raters to get the best deal. Lawyers have taken note recently of these failures, and raters are increasingly facing allegations of liability for losses suffered by investors and regulators who claim the raters maintained schemes to defraud the investors in order to increase their profits. On February 4, 2013, the U.S. Government and a number of states sued the largest credit rating agency, Standard & Poor’s (S&P), alleging that the firm falsely represented that its credit ratings on complex securities “were objective, independent,” and “uninfluenced by any conflicts of interest.”³³ The allegation of the governments is that this rating agency maintained a top credit rating on certain securities purchased by investors,

³⁰ Galbraith, *Economics of Innocent Fraud*, 2.

³¹ Lessig, *Republic, Lost*, 82.

³² Malcolm S. Salter, “Short-Termism At Its Worst: How Short-Termism Invites Corruption... and What to Do About It,” Edmond J. Safra Lab Working Papers, No. 5, April 11, 2013. <http://ssrn.com/abstract=2247545>.

³³ See Jeannette Neumann, “U.S. May Seek \$5 Billion From S&P,” *Wall Street Journal*, February 5, 2013, http://online.wsj.com/article/SB10001424127887324445904578285802822704578.html?mod=WSJ_hps_LEFTTopStories.

including many mortgage bonds, even though it knew the housing market was cratering at the time, a situation sure to affect the value of the bonds. The complaint alleges that S&P deliberately understated the risks in order to preserve and increase its sales. At the same time, S&P constantly insisted that its ratings were objective and accurate. S&P's unwillingness to be honest about the situation, even as it marketed its advice as being objective, independent, and free from conflict of interest, arose because such a move would affect S&P's profitability and its ability to secure new business from the issuers of these securities.

Finally, funds and investors hire investment consultants to advise and protect them from the maelstrom of the financial markets, and to plot a course that produces financial return with only a modicum of risk. While much has been written about regulators and credit rating agencies, much less attention has been paid to this class of financial professional. There are a number of reasons for this, including the rambling nature of the industry, a lack of centralized and aggressive government regulation attributable to ferocious lobbying by consultants and a lack of funding, an extraordinary complexity in the financial arena as a whole, and a feeling of helplessness by investors, given the levels of greed and corruption that seem to be endemic to the system.³⁴

This group of financial professionals is seen by investors as the experts standing between them and the vagaries of the financial system writ large. Like their lawyers in the courtroom, clients count on the consultants to “represent” their interests. And like lawyers, consultants are expected to translate mysterious professional terms for clients, like “alpha,” “beta,” and “risk parity,” and numerous others that carry exotic meanings. Like other professionals, consultants are expected to act solely in the interest of those clients. If lawyers breach this duty, a stringent system of correction for malpractice, enforced both in court and by independent bodies of overseers is present. No such system exists for consultants who commit their own form of malpractice.

No one can doubt that investment consultants who take their job seriously have had a difficult environment to work in. The CFA Institute, the most august body in

³⁴ Jennifer Coopers adds that, other than trustees, no actors in the system have an economic incentive to say anything but good things about investment consultants. For money managers, there is no advantage to saying anything bad about investment consultants, at least in public, as consultants generally have the power to block any financial manager from being able to present their wares to trustees.

which investment consultants are likely to be members, recognizes that the “absence of appropriate ethical culture at financial services firms has been the biggest contributor to the lack of trust in the finance industry.”³⁵

What is most surprising is that in spite of the trust placed in these consultants, many trustees are counseled by them to continue to do business with all manner of financial institutions that have been found guilty of cheating customers, self-dealing, financing terrorism and the like. Given this, the protectors they directly hire, investment consultants, have yet to fulfill their fiduciary responsibility to these trustees.³⁶ Some even argue that these consultants sometimes seem to be conspiring against trustees, in favor of their brethren within the financial system.

I interviewed Bill Sokol, a renowned trust fund lawyer from Oakland, California, on this point. Sokol believes that instead of “gatekeepers,” some consultants have become “jailors.” Today, he says, many investment consultants keep trustees outside the gate—making sure trustees have minimal opportunity to ask questions of managers, unmediated by consultant “spin.” Sokol tells of being in meeting after meeting in which well-meaning trustees asked piercing and fundamental questions of managers, only to be interrupted by consultants who kept the managers from answering. He tells of a trustee who asked an investment manager, “how can you

³⁵ See Amanda White, CFA Institute Survey Reveals Ethical Vacuum Leads to Lack of Trust, Top 1000 Funds, January 11, 2013, <http://www.top1000funds.com/analysis/2013/01/11/cfa-institute-survey-reveals-ethical-vacuum-leads-to-lack-of-trust/>. White, a financial journalist who reported the findings, wrote that, “Matt Orsagh, director of capital markets policy at CFA Institute, says to restore integrity in global markets, change must come from within and that ethical culture within financial firms needs to be addressed to solve systemic problems that led to fiscal crisis.” The entire global survey with over 6000 responses from CFA Institute members can be seen at http://www.cfainstitute.org/ethics/Documents/global_market_sentiment_survey_report.pdf.

³⁶ Nearly all consultants have a fiduciary duty to their clients, yet the scope and source of the duty are often the subject of dispute; one result is that the Department of Labor continues to labor under a cloud as it attempts to counter consultant malfeasance because of this contested terrain. One source of duty for consultants can be found here, quoting a 2005 SEC report: “the Investment Advisers Act of 1940 (“Advisers Act”) (Section 202(a)(11)) defines an adviser as any person who, for compensation, engages in the business of advising others as to the value of securities or the advisability of investing in securities, or who promulgates analyses or reports concerning securities. A person that advises as to the selection or retention of an investment manager is considered an investment adviser under Section 202(a) (11). (See Advisers Act Rel. No. 1092 (Oct. 8, 1987). Rules under the Advisers Act require that the pension consultants to plans have an aggregate value of at least \$50,000,000 to register with the Commission (Rule 203A-2(b)).” “The Advisers Act ‘reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship, as well as a congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment adviser—consciously or unconsciously—to render advice which is not disinterested.’ . . . An adviser owes its clients . . . an affirmative obligation ‘to employ reasonable care to avoid misleading clients.’” Thus, the Advisers Act, in recognition of the adviser’s fiduciary duty, requires advisers to provide disinterested advice, and to ensure this, requires advisers to disclose material facts. Whether an adviser’s relationships with other parties create a material conflict of interest depends on the facts and circumstances. “Staff Report Concerning Examinations of Select Pension Consultants,” U.S. Securities and Exchange Commission, May 16, 2005, <http://www.sec.gov/news/studies/pensionexamstudy.pdf>.

say you are not market timers when your portfolio turns over more than 100% in a single year?”³⁷ The consultant jumped in and said, “No, you have to understand that when we buy this Fund, it is for the long term, we will keep it for years as long as its returns are consistent.” This answer from the consultant, coming in such a complex area, completely misinterprets, misdirects, and cuts off any more dialogue on the fact that many investment managers often engage in financial speculation.³⁸

What is Institutional Corruption?

This paper utilizes the lens of institution corruption when looking at investment consultants, using the insights of the work of the Edmond J. Safra Center for Ethics, Professor Lawrence Lessig, and those of his intellectual antecedents, including John Kenneth Galbraith.

Lessig’s work is useful in providing intellectual guidance for examining dysfunctional institutions and the narratives and dependencies that characterize them. In his book *Republic, Lost*, Lessig posits two kinds of harmful corruption. The first type is venal or criminal corruption.³⁹ This kind of corruption is easily identified when found, though often hard to find if covered up. While this corruption is quite harmful, and often debilitating to the institution in which it occurs, society has long recognized the danger and has set up all types of mechanisms—law and law enforcement especially—to ferret it out and punish it.

Certainly newspapers have been full of stories about this type of corruption in the financial sphere. And, while many criticize the lack of enforcement,⁴⁰ a number of lawyers and governmental agencies are currently active in battling this type of corruption.

³⁷ In financial jargon, “market timing” is considered to be a sure way to lose money, but knowing when to buy or sell stocks or bonds is considered the hallmark of a good investment manager.

³⁸ Further, the statement is a fundamental category mistake, confusing the action of the investment manager and the action of the Board of Trustees, which are in two different arenas.

³⁹ Lessig, *Republic, Lost*, page 233-235.

⁴⁰ See e.g. Gregg Fields, “The Banker Had No Face: Assessing Institutional vs. Managerial Responsibility in Mortgage Fraud Lawsuits,” Edmond J. Safra Lab blog post, Oct. 11, 2012. <http://www.ethics.harvard.edu/lab/blog/252-the-banker-had-no-face-assessing-institutional-vs-managerial-responsibility-in-mortgage-fraud-lawsuits>.

A second type of corruption exists—institutional corruption. Not technically illegal, this corruption is a systemic economy of influence that weakens the effectiveness and the trust of an important institution. This “institutional corruption” is, as Lessig argues, “much more virulent, if much less crude” than venal corruption.⁴¹ Institutional corruption is often seen in the relationship between lobbyists and lawmakers, and that of pharmaceutical companies and medical professionals.

When considering the presence of institutional corruption and investment consultants, two major themes appear. The first involves misalignment of interests between investors and consultants, showing up in conflicts of interests and financially self-serving actions by these advisors. John Kenneth Galbraith, often called America’s greatest economist, called the world of finance a “well-recognized area of innocent fraud”⁴² “[I]t is my conclusion,” he wrote, “that reality is more obscured by social or habitual preference and personal or group pecuniary advantage in economics and politics than in any other subject.”⁴³ Examples will be outlined in detail below.

But there is a further source of corruption in this arena, the problematic nature of the narrative that supports current conceptions of investment consultants, which has been highlighted by Galbraith, among others. These financial professionals claim that they have a superior ability to predict the financial future and guide investors to the proper path in that future based on this knowledge. They don’t. In 1997, reviewing the history of financial predictions, William Sherden found the following: economists’ predictions are no better than guesses; government economists’ predictions are often worse than guesses; long-term accuracy is impossible; turning points cannot be predicted; no specific forecasters are better than the rest of pack; no forecaster was more expert with specific statistics; no one ideological orientation was better; consensus forecasts do not improve accuracy;

⁴¹ Lessig writes that it is “not a corruption caused by a gaggle of evil souls. On the contrary, a corruption practiced by decent people, people we should respect, people working extremely hard to do what they believe is right.” Lessig, *Republic, Lost*, 8. It is “not the aggregate of many smaller cases of quid pro quo [as is often seen in the first type of] corruption. The two may overlap, but they are not coextensive.” *Ibid.*, 231. For a further elaboration of this aspect of institutional corruption theory see Lawrence Lessig, “Institutional Corruptions,” Edmond J. Safra Lab Working Papers, No. 1, March 15, 2013. <http://ssrn.com/abstract=2233582>

⁴² Galbraith, *Economics of Innocent Fraud*, at 39. Galbraith described the “world of finance” as including “banking, corporate finance, the securities markets, the mutual funds, organized financial guidance and advice.” He also recognized that much of the fraud in this area is “legally less than innocent.” *Ibid.*

⁴³ *Ibid.*, ix.

psychological bias distorts forecasters and their forecasts; increased sophistication does not improve accuracy; and that over the years, predictions have not gotten better.⁴⁴ Yet the investment consultant industry still bases its asset allocation advice on future prophecies.⁴⁵

And, like John Maynard Keynes before him, John Kenneth Galbraith recognized the potential for harm in these claims of accurate predictions:

[T]hose employed or self-employed who tell of the future financial performance of an industry or firm given the unpredictable but controlling influence of the larger economy, do not know and normally do not know that they do not know. Predictions from a financial firm, Wall Street economist or financial adviser as to the economic prospect for a corporation—recession, scheduled recovery or a continuing economic boom—are thought to reflect economic and financial expertise. And there is no easy denial of an expert's foresight. Past accidental success and an ample display of charts, equations and self-confidence affirm depth of perception. Thus the fraud. Correction awaits.⁴⁶

With this backdrop, it is useful to return to *Republic, Lost*, where Lessig examined the financial crisis of 2008. He argues in his chapter, "Why Isn't Our Financial System Safe," that any analysis claiming the 2008 crisis was based on "irrationality" or that "somehow, and inexplicably, everyone just became insanely greedy—irrationally borrowing more than they could repay, irrationally lending more than was prudent, irrationally ignoring the warning of impending doom," is a "criminally incomplete understanding of the disaster."⁴⁷ In fact, the "core driver in

⁴⁴ William Sherden, *The Fortune Sellers: The Big Business of Buying and Selling Predictions* (John Wiley & Sons, 1997). For a comparison of Sherden's findings to financial matters today, see, Paul B. Farrell, "Dow 17,000 Main Streets Lambs Led to the Slaughter," *MarketWatch.com*, February 13, 2013, <http://www.marketwatch.com/story/dow-17000-main-street-lambs-led-to-the-slaughter-2013-02-13>.

⁴⁵ The SEC, in its "Beginners' Guide to Asset Allocation, Diversification, and Rebalancing," states, "Asset allocation involves dividing an investment portfolio among different asset categories, such as stocks, bonds, and cash." U.S. Securities and Exchange Commission, <http://www.sec.gov/investor/pubs/assetallocation.htm>. Of course, this argument can be taken too far. We all take actions in uncertain areas based on what we think is going to happen in the future; and this action is often based on analysis of how certain actions performed in the past. The difference for investment consultants is that for many, their business seems based on their ability to accurately and consistently predict the future.

⁴⁶ Galbraith, *Economics of Innocent Fraud*, 40-41. For a description of the idea of Keynes in this area see, Paul Davidson, *John Maynard Keynes* (Palgrave Macmillan, 2007), 31-35.

⁴⁷ Lessig, *Republic, Lost*, at 67.

this story was not craziness. It was rationality. The behavior we saw—from borrowers to lenders to Wall Street to government officials—was perfectly rational, for each of them considered separately. It was irrational only for the system as a whole.”⁴⁸

This argument, that institutional corruption engenders seeming “rational” actions that produce “irrational results,” is at the heart of this analysis.

The Landscape—Funds, Trustees and the Advisors They Employ

In order to understand institutional corruption in this area and to be able to confront it, one must first understand the general structure of benefit funds.

Benefit trust funds hold money for beneficiaries. In the case of pension benefit funds, they hold money to provide retirement income for workers. While legal “ownership” seems to be with the beneficiaries—those persons who will receive a pension, for example—it is a different group of people, the trustees, who control the assets. Since the invention of this concept of “trusts” over one thousand years ago, it has been clear that the ultimate responsibility for the success of each fund in meeting its mission ultimately resides with trustees.⁴⁹

⁴⁸ Lessig, *Republic, Lost*, at 68. For an explanation from a former Wall Street insider that proves this point, see, Chris Arnade, “Why It’s Smart to Be Reckless on Wall Street,” *Scientific American Blogs*, February 27, 2013, <http://blogs.scientificamerican.com/guest-blog/2013/02/27/why-its-smart-to-be-reckless-on-wall-street>.

⁴⁹ For more on this history, see, Jay Youngdahl, “The Time has come for a Sustainable Theory of Fiduciary Duty in Investment,” *Hofstra Labor and Employment Law Journal* 29 (2011): 115.

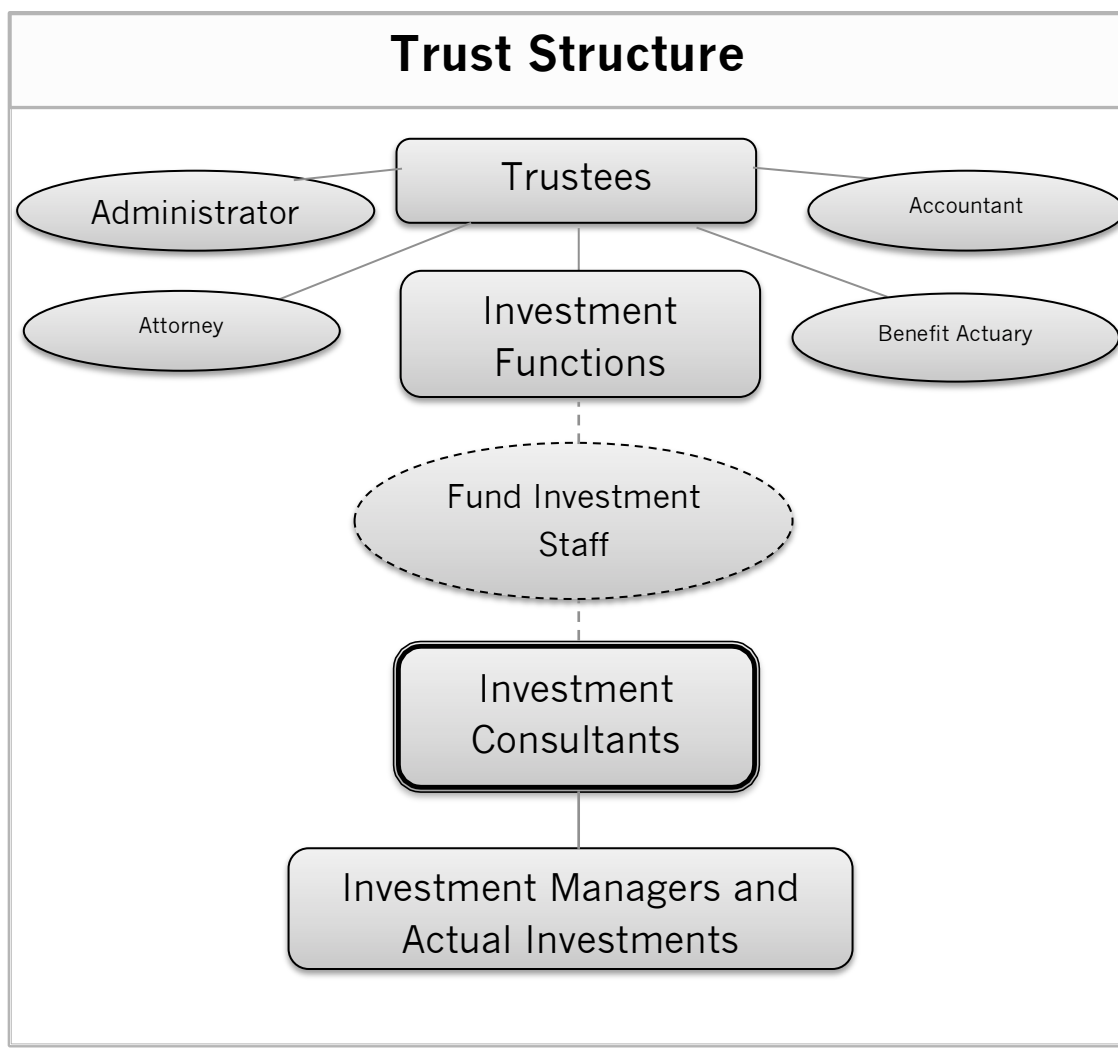


Figure 2

Further, in order to ensure that these trustees look out for the beneficiaries and not for themselves, it has long been the case that trustees owe a fiduciary duty to the participants in the fund.⁵⁰ Most of this strict duty emanates from common sense propositions about how one should look after another in a trusting relationship. The

⁵⁰ Persons operating in a number of different spheres must adhere to fiduciary duties, yet the scope and meaning of such duties vary widely, often resulting in definitional ambiguity. As an example, corporate directors are subject to fiduciary duties, but the duties to which they are subject are less demanding than those found in the trust context. The fiduciary duties of corporate directors, for example, allow for significantly more flexibility than those which apply to benefit fund trustees, as "[a]cts which might well be considered breaches of trust as to other fiduciaries have not always been so regarded in cases of corporate officers or directors." *Paddock v. Siemoneit*, 218 S.W.2d 428, 432 (Tex. 1949). The result of these definitional difficulties is that any discussion of fiduciary duty must begin with an understanding of the description and demands of the particular legal form in which the duty arises.

legal responsibility of a fiduciary includes the foundational duties of loyalty and impartiality. A review of this reasonable responsibility reveals that it is one of the firmest duties in American society. The classic statement on the nature of this standard came from the American jurist Benjamin Cardozo: a trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this, there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the “disintegrating erosion” of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”⁵¹

The duty, while legal in nature, is built on a firm ethical/moral foundation. As Maryam Kouchaki and her co-authors point out, moral systems involve “values, virtues, norms, practices, identities, institutions, technologies, and evolved psychological mechanisms.”⁵² Further, “the politicization of the issue of retirement security highlights the practical challenges faced by trustees. No major decisions by trustees exist in a vacuum and all must be weighed in a real-time political landscape.”⁵³

Trustees operate within a web of laws and regulations that are extraordinarily vague, such as ERISA, yet which carry within them the specter of personal liability. The apocryphal line that is often repeated in the field is that such lawyers tell trustees that the trustees will be sued and “lose their house” if they violate their fiduciary duty by deviating from the Wall Street model of investment.⁵⁴ The governing legal structure in the United States for most types of plans provides a level of legal protection, a kind of good faith defense, for trustees who rely on the

⁵¹ *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928).

⁵² Maryam Kouchaki et al., “Seeing Green: Mere Exposure to Money Triggers a Business Decision Frame and Unethical Outcomes,” *Organizational Behavior and Human Decision Processes* 121.1 (2013):

⁵³ <http://dx.doi.org/10.1016/j.obhdp.2012.12.002>, quoting Jonathan Haidt and Selin Kesebir, “Morality,” in S. Fiske, & D. Gilbert (eds.) *Handbook of Social Psychology*, 5th Edition (Wiley, 2010).

⁵³ See Mike Musuraca, “Avoiding the Next Financial Crisis, or Notes of a Flawed, Former Fiduciary,” in Tessa Hebb (ed.), *The Next Generation of Responsible Investment* (Springer, 2012), 49-59.

⁵⁴ Steven Lydenberg, “Beyond Risk: Notes Towards a Responsible Investment Theory”, in James Hawley and Andrew Williams (eds.), *Institutional Investors–Risk/Return Tradeoffs and Corporate Governance Failures* (University of Pennsylvania Press, 2011). And, for more on the helpful role of lawyers in this area, see Youngdahl interview at <http://fsinsight.org/insights/detail/conservative-us-legal-culture-slows-progress-of-esg-in-pension-funds>.

opinions of experts.⁵⁵ This is significant for trustees who, in the main, work a full time job *in addition to* their trustee duties. Thus, reliance on professionals is nearly always required. These professionals include lawyers, accountants, actuaries, administrators, and investment consultants. This need for experts is found in many areas of society. Lessig wrote on the result of this need.

None of us are expert—enough. We each may know a great deal about something, but none of us know enough about the wide range of things that we must understand if we’re to understand the issues of government today. For those bits we don’t understand, we rely upon institutions. But whether we trust those institutions will depend upon how they seem to us: how they are crafted, and whether they are built to insulate the actors from the kind of influences we believe might make their decisions untrustworthy. We don’t have a choice about this. We can’t simply decide to know everything about everything, or decide to ignore the things that make us suspicious. We are human. We will respond in human ways. And we will *believe* long before scientists can *prove*. Thus we must build institutions that take into account what we believe, especially when those beliefs limit our ability to trust.⁵⁶

Dependencies on professionals develop in ways that undermine the fiduciary role that investors should play. As Lessig has written, “A dependency develops over time; it sets a pattern of interaction that builds upon itself; it develops a resistance to breaking that pattern; it feeds a need that some find easier to resist than others; satisfying that need creates its own reward; that reward makes giving up the dependency difficult; for some, it makes it impossible.”⁵⁷

Next, uncertainty is especially strong in the investment function.⁵⁸ For example, in making recommendations about how to allocate assets, consultants uniformly rely

⁵⁵ A practitioner in the field of “law and economics,” finds this concern at the core of fiduciary duty. “Stripped of legalistic formalisms and moralizing rhetoric, the function core of the fiduciary obligation is *deterrence*. The agent is induced to act in the best interest of the principal by the threat of after-the-fact liability for failure to have done so.” Robert H. Sitkoff, “The Economic Structure of Fiduciary Law,” *Boston University Law Review* 91.3 (2011): 1043.

⁵⁶ Lessig, *Republic, Lost*, 41.

⁵⁷ *Ibid.*, 17.

⁵⁸ Recognition of the problematic nature of uncertainty or vagueness in investing was one of the motivating factors for the work of the originators of Modern Portfolio Theory.

on looking at the past performance of asset classes. In choosing managers, they look at past performance of returns. Yet, in spite of this focus on past performance, consultants typically include language like the following in their contracts: “The prior performance of an investment manager is not necessarily indicative of such investment manager future results.”

The legal standard for fiduciary conduct with regard to investments is unconscionably ambiguous. Take the idea of diversification of investments found in Section 404 (a) (1) (c) of ERISA. This general section defines a number of the requirements of the meaning of fiduciary duty in investment, including a requirement that investments be diversified. The relevant language is as follows:

(a) Prudent man standard of care.

(1) Subject to sections 403(c) and (d), 4042, and 4044 [29 USCS §§ 1103(c), (d), 1342, 1344], a fiduciary shall discharge his duties with respect to a plan solely in the interest of the participants and beneficiaries and--

(A) for the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan;

(B) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims;

(C) by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so; and

(D) in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with the provisions of this title and title IV.

The need for diversification outlined in Section 404(a) (1) (c) above has been problematic. It failed, in 2008, to play the role that had been promised by the academic financial establishment. Even the *Wall Street Journal* was forced to admit recently that, “the past decade also has shown that traditional diversification—parceling out your money across U.S. and international stocks and bonds, along with a variety of other assets—can leave investors exposed to the risk of severe losses.”⁵⁹ So, what is a trustee to do? The overall uncertainty of this legal mandate

⁵⁹ Jason Zweig, “A ‘Bucket List’ for Better Diversification,” *The Intelligent Investor*, *Wall Street Journal*, February 8, 2013, http://online.wsj.com/article_email/SB10001424127887324906004578292200253111008-IMyQjAxMTAzMDAwOTEwNDkyWj.html. A similar situation involves fees paid for active management. Financial research makes clear that the “active management of stocks,” in which fees are paid to managers for their expertise, is a sucker’s bet. As a recent piece in a CFA magazine pointed out, in its concern for the reputation of financial professionals, “while 85% of the equity managers studied underperformed the market in nearly all

robs trustees of solid anchoring when they attempt to make decisions, leading to unhelpful reliance on the prognostications of investment consultants.

Finally, trustees operate within a constraining web of culture which my co-author, David Wood, and I documented in a project of participatory action research. This project included the study of a number of contested concepts, including the legal role of a fiduciary, the meaning of investment theory and beliefs, issues of access to information, agency issues and service provider relationships, the role of “expertise,” the dynamics of decision making bodies, and the relative isolation of many trustees and their individual funds.⁶⁰ This culture produces power relationships, and a grid in which, as Steven Lukes has written, “power is at its most effective when it is least observable.” An example of this is the ability to create or enforce “social and political values and institutional practices that limit the scope of the political process to public consideration of only those issues which are comparatively innocuous” to those with whom they are in actual or potential conflict.⁶¹ These “rules of the game” are an institutionalization of norms, including “predominant values, beliefs, rituals, and institutional procedures” that can benefit certain persons or groups—who typically occupy positions of privilege—at the expense of others. Thus, the area has a serious principal-agent problem. Trustees who work with financial professionals are often led to acquire beliefs and form desires that result in their consenting or adapting to being dominated, in coercive and non-coercive settings.⁶²

Given all this, for a trustee on a pension fund to perform her duty in the present environment, she must rely in some sense on professionals, especially investment consultants. She must trust that they will perform their duties. Part of the role of those who carry the trustee responsibility in the retirement arena is to try to decide

relevant time periods, the amount of fees extracted globally for this and other financial-intermediation services is in the range of \$1.5 trillion annually.” Kurt Schacht “Investment Professionals: Are You Earning Your Keep?” CFA Institute – Market Integrity Insights, October 26, 2011, <http://blogs.cfainstitute.org/marketintegrity/2011/10/26/investment-professionals-are-you-earning-your-keep/>. Yet, pursuant to the ERISA guidelines, if other funds and trustees are paying fees for such useless services, they are fulfilling their fiduciary duty. The “prudent investor” does what other investors do. Harmful “lemming” activity is all too often the result.

⁶⁰ See, David Wood and Jay Youngdahl, “Public Pension Fund Trustees and Fund Culture: Responsible Investment and the Trustee Leadership Forum,” Working Paper, Initiative for Responsible Investment, Harvard University (2011), <http://hausercenter.org/iri/wp-content/uploads/2012/05/UNPRI-Youngdahl-Wood-Working-Paper.pdf>.

⁶¹ Steven Lukes, *Power: A Radical View*, (Palgrave Macmillan, 2005) (2nd ed.), 10.

⁶² *Ibid.*, 13.

which financial professionals enhance the value of fund assets and activities and to separate them from those purveyors who seek value for themselves. The men and women who serve the pension and employee benefit funds throughout the world in these capacities are, by and large, a dedicated group trying to help funds produce investment returns. But when these professionals fail this trust, a kind of double failure occurs: first between the consultant and the trustees, and second, because the consultant's violations of trust cause the overall pension fund to become untrustworthy in the eyes of the beneficiaries.

What Do Investment Consultants Do or Not Do?

To understand institutional corruption and investment consultants, it is helpful to understand a little history and look at what consultants say they do.

I.

Many have taken credit for being some of the first to begin the modern investment consulting industry. George Russell of Russell Investments claims to have pioneered the new industry. In 1969 he made a sales call to J.C. Penney to convince them that there was value in “managing money managers.” The company hired him, and thus, he believes, the craft of “strategic pension fund consulting” began.

In the university endowment space, James N. Bailey, of Cambridge Associates, tells a similar story. Beginning in 1973, Bailey—who holds undergraduate, business, and law degrees from Harvard—worked with Harvard Treasurer George Putnam. At that time the Harvard endowment investments consisted of a “balanced fund,” with a mix of stocks, bonds, and cash, which Bailey characterizes as “an undiversified portfolio.” The process that Bailey and others advocated radically changed the investment mix of institutions. The mean asset allocation of the top 20 endowment clients of his firm in 1978 was 61.4% U.S. stocks, 24.5% U.S. bonds, 11.4% cash, and 2.7% “other.” By 2007, the asset pie was divided into over twenty types of assets with exotic titles such as “distressed,” “arbitrage,” and “long/short hedge.” These portfolios demanded payment of large fees to financial professionals. Many of the fees were of “2 and 20” variety—the manager receives two percent each year of the total amount of money pledged or invested, and twenty percent of the profits that hopefully follow, relying on favorable tax treatment and frequently domiciled in

foreign tax havens. Funds using this fee model have been the source of much of the Midas-like wealth of Wall Street. Of course someone has to vet, measure, and oversee these money managers. Voilà—more need for investment consultants such as Mr. Bailey.

A third story comes from someone on the other side of these transactions. Gary Findlay, the longtime and much admired Executive Director of MOSERS (Missouri State Employees' Retirement System), was present as a customer at the inception of the investment consulting industry in the early 1970s.

The genesis of the industry began, according to Findlay, with a simple proposition. Merrill-Lynch brokers were looking for pools of money to which to sell their services. These retail brokers began to approach institutional investors, just as George Russell had approached J.C. Penney. The problem for the brokers was that they had little to offer these investors. Commissions for buying and selling stock were fixed by the SEC at that time, and most funds were not ready for the kind of “endowment” model that Bailey was pitching to Harvard. So, the question from Findlay to the Merrill Lynch brokers was, what could they offer him? Their first idea was performance measurement. The brokers could produce good-looking reports that could help Findlay understand his returns and potentially assist in explanations to trustees and beneficiaries.

Then in 1975, the SEC deregulated commissions and the broker-dealer industry became “cutthroat.” Broker-dealers began to offer additional services to institutional investors in exchange for a guarantee of a certain level of commissions for buying and selling stock.⁶³ Many who pitched investment consulting services could run these trades of their clients through the broker-dealer section of their financial companies, producing revenue for these companies.

The growth of the modern investment consulting industry can also be partially attributed to the growth of Modern Portfolio Theory (MPT). Implementation of the theory demanded an army of advisors to counsel those who controlled large pension funds in the virtues of this new way of thinking. Further, as MPT became

⁶³ One legal observer argues that “the problem is that the brokerage business evolved in the last century as a sales business . . . salesmanship usually comes in the form of ‘advice’ and recommendations given to the customer. So any idea that the brokerage and advisory businesses were conceptually distinct was an illusion from the beginning . . .” Langevoort, “Psychological Perspectives,” *op.cit.* 996.

the paradigm of investing, these investment consultants had new products to sell: asset allocation strategies, which needed to be formalized into Investment Policy Statements. Within these strategies, managers needed to be selected and attention paid to implementation risk, as Cambridge Associates' Bailey described.

But here, Findlay recalls, is where it began to get dicey. Investment consultants began to sell themselves as gatekeepers, the protectors of funds, even as the opportunities for conflicts and misalignment of interests between these consultants and their clients continued to grow. Consultants realized that they could make money from their relationships with money managers. They began providing "training" for these managers. They would instruct them on how to package and sell their products to the funds, trustees, and investment consultants. Of course, if a money manager bought the "training" services of the consultant, the opportunity for that consultant to recommend the manager to a fund had to increase, though no formal quid pro quo existed, at least in the open.

And, as MPT with its need for experts and complex diversification strategies became more widespread and ingrained in law and regulation, the golden age of investment consulting flowered.

II.

What do investment consultants actually do? In a 2005 report, the SEC reviewed the activities of investment consultants. The report described the work that these consultants do.

"Pension consultants" provide advice to pension plans and their trustees with respect to such matters as: (1) identifying investment objectives and restrictions; (2) allocating plan assets to various objectives; (3) selecting money managers to manage plan assets in ways designed to achieve objectives; (4) selecting mutual funds that plan participants can choose as their funding vehicles; (5) monitoring performance of money managers and mutual funds and making recommendations for changes; and (6) selecting other service providers, such as custodians, administrators and broker-dealers. Many pension plans rely heavily on

the expertise and guidance of their pension consultant in helping them to manage pension plan assets.⁶⁴

For one of the funds with which I became familiar, the agreement with the investment consultant describes, in their own words, the following services that are provided to the Fund. “Attendance at Board Meetings; establishment and ongoing review of Investment Policy Statement; establishment and ongoing review of asset allocation policy; review of investment managers; assist in investment manager search and selection; evaluation of investment performance; selection, review and evaluation of custodial services; review and evaluation of brokerage and trading practices; review of proxy voting guidelines; general consultant.”⁶⁵

In performing these services, the agreement continues, the consultant will rely on information “from a wide variety of public and private sources,” but although it is believed that the information is reliable, the consultant stresses that it “cannot verify or guarantee the accuracy or validity of such information or the uniformity of the manner in which such information was prepared.” Thus, the consultant acknowledges that s/he may be providing the trustees with bad information; but that is the system. The agreement continues, the investment consultant “shall not be liable for the conduct or investment performance of any investment manager, investment fund or mutual fund recommended” by the consultant.⁶⁶

The USI Consulting Group, a Goldman Sachs subsidiary that has recently run afoul of the Department of Labor, describes their services:

As your hands-on registered investment advisor, we strive to provide you with the perspective, counsel and support you need to fulfill your fiduciary obligations and help you feel comfortable choosing the best set of investments for your retirement plan(s).

USI Advisors, Inc. can provide you with the following investment advisory services:

⁶⁴ “Staff Report,” U.S. Securities and Exchange Commission, May 16, 2005.

⁶⁵ “Active Investment Consulting Agreement.” Currently in possession of the author.

⁶⁶ Ibid.

Investment monitoring and reporting
Asset/liability studies for pension plans
Retirement plan services and cost analysis
Investment manager searches
Investment policy statement consulting and implementation.⁶⁷

While consultants may do these things, many observe that these tasks do not justify the trust that they are accorded or the fees that they are paid. In response, as to the value of the services of these professionals, in a recent edition of “Rocaton Conversations,” Rocaton Managing Director Michael Luft put his best promotional spin in attempting to hawk their services to the insurance industry that has traditionally only lightly relied on outside investment consultants: “Consulting fees are typically modest compared to the potential impact of investment decisions. However, investment mistakes – or even the opportunity cost of not making certain investment decisions – can be measured in tens or even hundreds of basis points. While hiring an investment consultant does not ensure mistakes won’t happen, it enhances the resources focused on making investment decisions.”⁶⁸

III.

At the core of the “value proposition” for investment managers is their claim to be able to divine the economic and investment future, and thus to structure an investment portfolio that will be responsive to these scenarios, producing adequate safety of principal and sufficient investment returns. Investment consultants propose “asset allocation strategies” that instruct funds to invest in certain classes of assets in certain percentages of the overall financial pool. Such strategies are often cloaked in exquisite sophistication yet come from simple inputs in simple off-the-shelf software programs. The programs are generally based on historical data covering all sorts of historical periods, which may or may not have a similarity to the present. As Galbraith pointed out, “in the economic and especially the financial

⁶⁷ “Investment Advisory,” USI Consulting Group, www.usicg.com/ias-index.asp.

⁶⁸ Michael Luft, “Insurance: A Consultant’s Value Proposition,” Rocaton, December 2012, <http://www.rocaton.com/files/InsuranceConsulting.pdf>. Or, to put the best face on this argument, Satyajit Das, a former banker, financial author, and commentator, raises the old saw: “Success is always 10% skill and 90% luck but it is unwise to try it without the quotient of skill.” Satyajit Das, “Investment in a Time of Dysfunction,” The Big Picture, Barry Ritholtz, January 3, 2013, <http://www.ritholtz.com/blog/2013/01/investment-in-a-time-of-dysfunction/>.

world, nonetheless, prediction of the unknown and unknowable is a cherished and often well-rewarded occupation. It can be the basis, though often briefly, of a remunerative career. From it comes allegedly informed judgment as to the general economic prospect and that of the individual participating and affected enterprise. The men and women so engaged believe and are believed by others to have knowledge of the unknown; research is thought to create such knowledge.”⁶⁹

Like sports gamblers who check the Las Vegas odds before they make a bet, trustees ask investment consultants at every trust meeting what they think financial returns will be going forward. The consultant always gives an authoritative opinion.⁷⁰

Pundit Tracker, a website that claims it is “Bringing Accountability to the Prediction Industry,” focuses on this problem, handing out grades to the highly paid financial professionals who claim to be able predict the financial future.⁷¹ Jim Cramer, host of CNBC's Mad Money and a co-founder and chairman of TheStreet.com, was receiving a D minus as of February, 2013.

IV.

As in most areas in which institutional corruption exists, moral or ethical considerations would demand less attention if the system was fulfilling its mission.

Investment consultants, however, have been unable to protect trustees from dishonest financial practices, a situation made difficult because of the institutionally corrupting practices found in this arena. In addition, investment consultants have been unable to properly advise trustees on how to deal with the investment challenge trustees face today—how do their portfolios produce a sufficient return to pay for the needed benefits in a timeframe in which additional contributions from employers and employees are difficult to secure? Take two examples:

⁶⁹ Galbraith, *Economics of Innocent Fraud*, 40.

⁷⁰ In this sense, asset allocation decisions are very similar to sports betting. On the recent Super Bowl, bettors placed nearly one hundred million dollars of their money with Las Vegas betting houses. The “house” kept seven million dollars for itself. Reuters, “Ravens’ Super Bowl Win a Boon for Vegas Profit,” Yahoo! News, February 4, 2013, <http://news.yahoo.com/ravens-super-bowl-win-boon-vegas-profit-005045049--nfl.html>. Thus, the fee model is analogous as well.

⁷¹ Pundit Tracker, <http://www.pundittracker.com/categories/view/finance>.

First, as to the role of protection from dishonesty, a current area of concern and litigation involves foreign exchange transactions. Trustees are continually pressed to invest in more non-U.S. financial products. Many funds have well over one-third of their investments in foreign stocks and bonds. Most of these investments are denominated in a currency other than U.S. dollars, so currency conversion is necessary. Governmental regulators and customers have pressed banks over this highly lucrative area of their business, which represented over ten percent of the profits of some large institutions. Numerous lawsuits have been filed against large financial institutions alleging that the banks and large custodian firms that perform these tasks routinely cheated investors on foreign exchange rates.⁷²

Trustees believed that their investment consultants were monitoring this area, as they nearly always recommend some global investments that involve foreign exchange. They were not. When I first heard this, I asked an investment consultant with whom I work if he was on top of this. He said he was not, an answer that shocked me. In order to monitor these transactions, he said, trustees would need to hire a “currency consultant;” he said his firm did not have the expertise to do this, and “neither do our competitors.” Further, he was not concerned about saying in an email to me, “I would have expected that the investment manager community closely monitors this on behalf of their clients’ given the fact that any leakage will detract from their performance. However, it seems as though this may not have been the case.”

When push comes to shove, consultants often refuse to take responsibility, even given the trust they know that trustees place in them. An example can be seen in the allegations of a lawsuit filed in 2012 by The People of the State of California against a money manager bank, Northern Trust, and a well-known investment consultant, Pension Consulting Alliance (PCA).⁷³ Plaintiff attorneys alleged that

⁷² For example, see, Judy Ward, “Custodial Bank Cheated Clients on Foreign Exchange, Lawsuit Alleges,” Institutional Investor, February 16, 2011, <http://www.institutionalinvestor.com/Article/2770496/Trading-Archive/Custodial-Bank-Cheated-Clients-on-Foreign-Exchange-Lawsuit-Alleges.html> and Tim McLaughlin, Fidelity Pushes BNY Mellon for Better Foreign-Exchange Pricing,” *Chicago Tribune*, November 28, 2012, http://articles.chicagotribune.com/2012-11-28/business/sns-rt-us-banks-forex-fidelitybre8ar1es-20121128_1_bny-mellon-foreign-exchange-trades-custody-banks. And for one settlement of claims, see <http://www.ccfsettlement.com/>.

⁷³ Since the original posting of this paper, a representative of PCA contacted me to point out that the named plaintiff is not the Trust Fund, but the People of the State of California; and that legal counsel for the plaintiff in the suit is not LACERS’s own counsel, but the City Attorney for the City of Los Angeles (and private counsel). The representative of PCA is correct in these two assertions and this is reflected in the revised language in this section. (For a media report on the case see, “LACERS lawsuit sparking new concerns about

Northern Trust and PCA made false claims and violated a series of duties that they had to Los Angeles City Employees' Retirement System (LACERS) when the fund engaged in a practice known as "securities lending," which resulted in large losses for the fund.

Securities lending involves the lending of stock owned by an investor to another who wishes to "short" a financial instrument. In recent times, this practice has been promoted by investment professionals to funds as a nearly risk free way to enhance investment returns. In the LACERS case, however, the fund alleges it lost nearly one hundred million dollars because of its securities lending. The complaint alleges that the investment consultant, PCA, collected large fees while acting as the "watchdog" on the transaction. PCA's defense at this point, though cloaked in all manner of legal pleading, is that it did not have an obligation to monitor Northern Trust's actions. It also feels that the legal action is "political." Yet, if their investment consultant is not responsible, LACERS has countered, then who was?

As to the provision of a satisfactory investment return, funds are in trouble today. Many funds are actuarially set to need an investment return of 7-8 percent per year. In the main, this result has not been achieved. The trust in these institutions has been weakened as media and politicians have criticized the inability of funds to meet this benchmark, as the result is a need to to either secure more money from employers and employees or to cut benefits—or both. In response, investment consultants and money managers continue to claim the ability to find investments that will return outsized investment returns. This claim advanced by these professionals, just coincidentally, produces hope, and the most fees. Today this strategy often means buying "alternative investments," such as hedge funds and private equity (leveraged buyouts) from Wall Street's best and brightest. Don Steinbrugge, Chairman of Agecroft Partners, a global consulting and third-party marketing firm for hedge funds, admitted recently that, "this is being driven by the fact that pension funds are forward looking in their investment return assumptions

liability," *Pensions & Investments*, April 30, 2012.

<http://www.pionline.com/article/20120430/PRINTSUB/304309970>.) While this does not appear to be a substantial or material error, especially as PCA has argued in legal documents, and the federal judge agreed, that the pension fund, not The People of the State of California, is the "real party in interest," and that any recovery in the case would substantially go to the trust fund, I am pleased to clarify the plaintiff's identity and counsel. Obviously with respect to the subject matter of this paper, and its potential importance, absolute accuracy, about all facts, however minor, is vitally important. I welcome any other corrections, and/or clarifications others may wish to offer.

when determining their asset allocation. Recent relative performance of a particular asset class has little relevance in their decision making process... What ends up happening is they hire brainless pension consultants who act as gatekeepers, shoving them in 'brand name' funds and these pensions end up getting hosed on fees, with little or no return to show for their allocation. It's what I call the 'alternatives circus' and it's been going on for years.”⁷⁴

Given this world, the task of an honest and hardworking trustee is an extraordinarily difficult one.

Classic Institutional Corruption and Investment Consultants

Institutional corruption involves practices that are usually not strictly illegal, but that have the effect of corrupting the integrity of the process and reducing trust in the institution. What are some examples?

I.

Direct Payments and Gifts from Managers to Consultants

Consultants are responsible for selecting which investment managers are considered by trustees. A decade ago, longtime pension administrators Gary Findlay and Steve Yoakum wrote, “in any environment, any favorable inclination towards a particular management firm has tremendous economic value.”⁷⁵ The SEC has found that “business alliances among pension consultants and money managers can give rise to serious potential conflicts of interest.”⁷⁶ In 1963, the U.S. Supreme Court recognized the obvious as well, noting with concern that when advice to a client might result in financial benefit to the adviser—other than the adviser’s fee—that advice may in some way be tinged with that pecuniary interest,

⁷⁴ Leo Kolivakis, “Hyping Up Hedge Fund Hipsters,” Pension Pulse, November 1, 2012, <http://Pensionpulse.blogspot.com/2012/11/increasing-allocations-to-hedge-fund.html>. For more on this topic, see Youngdahl interview, http://ai-cio.com/channel/MMEDIA/The_Misperception_of_Alternative_Investments.aspx (February, 2012).

⁷⁵ Gary Findlay and M. Steve Yoakum, “In Pursuit of Objectivity in Investment Consulting,” Plan Sponsor, November, 2012, <http://www.plansponsor.com/MagazineArticle.aspx?id=6442460045>.

⁷⁶ “Selecting and Monitoring Pension Consultants—Tips for Plan Fiduciaries,” U.S. Department of Labor Employee Benefits Security Administration Fact Sheet, May 2005, <http://www.dol.gov/ebsa/newsroom/fs053105.html>.

whether consciously or subconsciously motivated.⁷⁷ Recently the *Wall Street Journal* carried a story of a successful money manager for the Tampa Firefighters and Police Officers Pension Fund, Jay Bowen. Bowen, the article found, “shuns investment consultants—who help to vet, select, and monitor money managers . . . “Consultants,” Bowen believes, “have a stranglehold over the industry.”⁷⁸

One way some investment consultants pad their bottom line is to be directly paid by managers, often without the knowledge of the trustees. It is “not uncommon for a consultant to charge a money manager \$200,000 or more for advice on how to impress clients,” Jennifer Cooper wrote in 2002.⁷⁹ These investment consultants get paid by the investment managers to learn how to structure their presentation to the clients of the investment consultants, who are the ones who choose the finalists in the investment manager beauty contest.

A recent investigation by the U.S. Department of Labor's Employee Benefits Security Administration, the section of the U.S. Department of Labor responsible for oversight of this area, found for example that a wholly owned subsidiary of Goldman Sachs Capital Partners Co., USI Advisors, made investments in mutual funds on behalf of ERISA-defined benefit plan clients and received “12b-1” fees from those funds between 2004 and 2010.⁸⁰ This Goldman Sachs subsidiary was recognized by PLANSPONSOR® Magazine as one of the “Most Successful Retirement Plan Advisers” in 2007,” a fact the company prominently displays on its website.

According to the DOL, USI Advisors failed to disclose fully the receipt of these fees and did not use the fees for the benefit of the plans. On August 23, 2012, DOL announced that USI Advisory of Glastonbury, Connecticut had agreed to pay \$1.27 million dollars to thirteen defined benefit pension plans. USI Advisors also will provide to clients a description of all compensation and fees received, in any form,

⁷⁷ See, *S.E.C. v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, at 191-192 (1963).

⁷⁸ Michael Corkery, “Oracle of Tampa is a Rare Breed,” *Wall Street Journal*, March 10, 2013, <http://online.wsj.com/article/SB10001424127887324096404578352390067280044.html>.

⁷⁹ Revell, “Are Your Savings Safe?” Cooper’s initial efforts were met with resistance by the investment consulting industry. In a January 2013 interview with the author, Gary Findlay noted that Cooper was treated poorly and run out of the business for blowing the whistle on unsafe practices. Findlay believes that a coordinated effort of investment consultants and managers to “badmouth” Cooper had the effect of belittling her service of rating the gatekeepers and ending her business.

⁸⁰ A 12b-1 fee is paid by a mutual fund out of fund assets to cover certain expenses. <http://www.dol.gov/opa/media/press/ebsa/EBSA20121753.htm>.

from any source, involving any investment or transaction related to them. According to a statement by Phyllis C. Borzi, Assistant Secretary of Labor for Employee Benefits Security:

If you, as an investment adviser, are a fiduciary under ERISA with respect to plan investments in mutual funds, you cannot use your fiduciary authority to receive an additional fee or to receive compensation from third parties for your own personal account in transactions involving plan assets. We are very pleased that this settlement addresses the problems we identified with USI's practices and restores funds to the plans and their participants.⁸¹

Another way for money managers to influence investment consultants is with gifts and perks—these include small gifts, trips, meals and such. The prevalence of this form of influence led the Department of Labor to issue a regulation in early 2012 requiring disclosure of all direct and indirect compensation received by investment consultants and others.⁸² An example of such a disclosure can be seen in this one posted by a consultant on its website.⁸³

Conference Fees Paid by Managers to Investment Consultants

A long-running problem in the pay-to-play sphere has been conferences run by investment consultants. Consultants sponsor conferences in which trustees and decision-makers for asset owners are wined and dined by the consultant and

⁸¹ “News Release – USI Advisors of Glastonbury, Conn., Agrees to Pay \$1.27 Million to 13 Defined Benefit Pension Plans Following US Labor Department Investigation,” U.S. Department of Labor, August 23, 2012, <http://www.dol.gov/opa/media/press/ebsa/EBSA20121753.htm>.

⁸² ERISA Section 408(b). See “Final Regulation Relating to Service Provider Disclosures Under Section 408(b)(2)—Fact Sheet,” U.S. Department of Labor, February 2012, <http://www.dol.gov/ebsa/newsroom/fs408b2finalreg.html>.

⁸³ “Gifts, gratuities, and non-monetary compensation: From time to time, third-party vendors (such as product providers, mutual fund companies, broker-dealers, etc.) may provide Segal Rogerscasey (and its affiliates) with non-monetary gifts and gratuities, such as promotional items (i.e., coffee mugs, calendars, or gift baskets), and access to certain industry related conferences and meals associated with those conferences (collectively, “gifts”). Segal Rogerscasey has implemented policies and procedures intended to identify, quantify, and track gifts received by it and its affiliates. Pursuant to rules established by the Department of Labor, Segal Rogerscasey has implemented a policy for allocating the value of a gift among multiple clients, where applicable. Under such policy, where potentially reportable compensation is received by Segal Rogerscasey (including its affiliates) in connection with several clients, Segal Rogerscasey will first divide the fair market value of such gift by the number of individual clients to which such gift is reasonably applicable and then allocate the result to each affected client to determine if it exceeds the de minimis threshold under the Section 408(b) (2) regulation and related and associated guidance. Based on historic trends, Segal Rogerscasey does not expect to receive gifts in excess of the de minimis threshold under the regulations with respect to your Account.” Segal Rogerscasey, “ERISA 408(b)(2) Fee Disclosure Notice,” <http://www.segalrc.com/disclosure-of-compensation/>.

avored money managers seeking access to pension money. The expenses of the conferences come from these payments, required by consultants from money managers who are soliciting business from the consultants and trustees. Charging investment managers a fee for attending conferences has been a major revenue generator for many consultants.⁸⁴ Some even write these conferences into their contracts with funds, in order to make it appear that these are major benefits for trustees of the funds. Investment managers sometimes go to great lengths to disguise the money they make off these conferences, refusing to disclose actual amounts received or providing misleading comparisons.⁸⁵

II.

Bundled Services

Many in the investment consultant industry look longingly on the fee models of investment managers. Investment consultants tend to get paid on a retainer or hourly rate model. Investment managers tend to get paid a percentage of the amount of assets under management. Some investment managers, especially in the area of “alternative investments” such as hedge fund and private equity, receive 2% in advance of money committed by the investor and 20% of any profits that the manager’s investment activity realizes. It is this structure and the ability to minimize tax payment on these fees that has produced the Midas-like wealth on

⁸⁴ Other kinds of harmful “pay-to-play” activities exist in the financial sphere, which bears a family resemblance to “pay-to-play” involving investment consultants. For example, reports of “pay to play” involving middle-men and women illustrate the kinds of problems that arise for those who recommend money managers to trustees. So called “placement agents,” who direct pension fund money to favored financial sales people, have been in the news lately. A recent *Forbes* article reported that, “Agents say they provide valuable screening for public funds that lack the resources to do the job. Critics charge they’re glorified bagmen in a pay-to-play world in which public officials hand assets to money managers willing to contribute to their political campaigns or otherwise enrich them.” Zack Greenburg, “Secret Agent,” *Forbes*, May 23, 2011, <http://www.forbes.com/forbes/2011/0523/features-pensions-glen-sergeon-auditors-secret-agent.html>. Of course, issues of money, politics, and investments are all around us. In California, “critics of political donations to school bond campaigns from companies that profit from the bonds are urging federal regulators to take bolder steps against what they call a ‘pay to play’ practice.” Will Evans, “Feds Urged to Crack Down on Donations to Bond Measures,” *California Watch*, September 21, 2012, <http://californiawatch.org/dailyreport/feds-urged-crack-down-donations-bond-measures-18072>.

⁸⁵ For example, one consultant put this on its website: “Research and Consultant Summit: Segal Advisors acquired the business of Rogerscasey in February 2012. For 18 years, Rogerscasey has sponsored a Research and Consultant Summit and certain investment managers pay to belong to the Summit. The membership entitles representatives to attend two conferences each year and provides access to educational material, whitepapers and research pieces for a fee. The membership is not dependent on, and does not affect or influence the advice, recommendations or other services that we provide. Our compensation represents less than 1/20 of one basis point of the assets under advisement of the firm.” For a list of current members, please contact your client service representative.” Segal Rogerscasey, “ERISA 408(b)(2).” Comparing income received to assets under management is a completely invalid comparison.

Wall Street today. So, investment consultants are often looking for new business opportunities. There is a great temptation for investment consultants to use their gatekeeper status to sell other products to funds and trustees. Investment consulting firms also sometimes provide insurance brokerage, benefit consulting, or broker-dealer services. All are made much easier to sell by the access the firm has from its investment consulting relationship.

While it is not necessarily illegal, many question this practice. The warrior in this area has been Jennifer Cooper, now the head of Diligence Review Corporation. Their recent report examined conflicts in over 150 investment consulting firms, using only publicly available self-reporting of these firms.⁸⁶ The report found that “While the number of firms that have the most significant due diligence concerns is small, we find those firms advise on over half of the pension consulting assets in the US.”

Another example of this issue can be found in the settlement between USI Advisors and the DOL. The DOL statement said:

Under the terms of the settlement, USI Advisors has agreed not to provide bundled investment advisory and actuarial services to any ERISA-covered defined benefit plan client without first entering into a written agreement, contract or letter of understanding that specifies the services provided and whether the company or its affiliates will act as a fiduciary to those plans.⁸⁷

A quick jaunt through the websites of investment consulting firms reveals many illustrations. For example, Mercer, one of the largest investment consulting firms in the country, offers “Private Equity Service Offerings.” Mercer touts services to private equity firms, hedge funds, and venture capital firms. They offer to supply operational management services to these investment managers, including human relations, sales, and compensation management. These firms, of course, may at the same time be asking Mercer to allow them access to Funds and Trustees and

⁸⁶ “2013 Report on US Pension Investment Consultants,” Diligence Review Corp., January 14, 2013, <http://www.diligencereviewcorp.com/2013/01/14/us-pension-investment-consultants-report/>.

⁸⁷ “News Release – USI Advisors,” August 23, 2012.

to recommend the purchase of the services of these private equity magnates to trustees. The conflict is obvious.

To be sure, a number of professions sell bundled services. Law firms in the District of Columbia sell lobbying services to corporate clients, for example. Yet it is difficult to reconcile the sales function in investment consulting firms that sell bundled services with the fiduciary relationship they should maintain with investors. John Bogle of Vanguard Investments, maybe the most important voice counseling attention to fees in the investment arena, has been especially outspoken on this point. Bogle argues that because of changes in the investment landscape, primarily the ferocious sales competition that goes on among the investment professionals who serve fund trustees, the fiduciary duties carried by these professionals has eroded. Bogle writes that the concept that these professionals should act as fiduciaries, with an eye solely focused on the best interests of beneficiaries, “has now been totally discredited.” Speaking of the investment area he knows best, mutual funds, Bogle writes,

Ever since its provisions were enacted into law more than 70 years ago, the federal Investment Company Act of 1940 has demanded that funds be “organized, operated, and managed” in the interest of shareholders rather than fund managers and distributors. But those provisions have been ignored, lost in the dustbin of history. Paradoxically, it was only a short time after the 1940 Act became law that the industry’s culture, balanced in favor of stewardship before that standard was enacted, began to shift soon thereafter toward a balance in favor of salesmanship. In the decades that followed, the interests of fund shareholders became subservient to the interests of fund managers, and the fund industry largely became just another consumer products marketing business.⁸⁸

Investment consultants who work in firms with bundled services face similar pressures and problems.

Bundled services do not always serve consultants well. For example, in 2010 Mercer settled a case brought by the Alaska Retirement Management Board for

⁸⁸ John C. Bogle, “The Clash of the Cultures,” *The Journal of Portfolio Management*, 37.3 (2011): 14-28, at 14, 23.

\$500 million. The Board alleged that Mercer’s actuarial consulting arm, hired by the Board to help them estimate their future liabilities, had made serious mistakes in estimating the amounts of money needed by the Fund, to the tune of \$2.8 billion, and covered up the mistakes.⁸⁹

III.

Trustee Educational Conferences and “Due Diligence” Trips

In spite of the heavy fiduciary duty that they take on and the complicated organizations they must oversee, trustees are generally not paid for their duties. Most hold other jobs, and represent their classification (retiree, active employee, politician, etc.) on the trustee board. A sophisticated “educational” industry has been built up to provide indoctrination opportunities and recreation for these trustees. Investment consultant conferences are one such example. Money managers hold them directly as well.

Investment consultants are not the only group to realize that there is money to be made in trustee “education” and due diligence training. As an example, consider the website of the World Pension Forum.⁹⁰ Founded in 1992 and based in the swanky San Francisco suburb of Tiburon, the “World Pension Forum (formerly Pensions 2000) provides topical, timely and stimulating educational opportunities to experienced fiduciaries of public, corporate, Taft-Hartley pension trusts and endowment funds.” The WPF gushes that their “educational conferences are forums for dynamic debate on issues—for an energetic dialogue on policy and practice—and for lively, informative interchange among trustees, fund managers, asset managers and other decision makers. From a dinner at the Chateau de Versailles and on the Great Wall of China, to a reception at Dublin Castle, our agendas reflect the premise that valuable information is often found after the formalities end.” Testimonials on the site, from asset managers and the trustees to whom they are attempting to market, include kudos for conferences in Paris, Martha’s Vineyard, Dubai, Rio de Janeiro, among other places. One trustee for a religious-based pension fund gushed that he was “Still basking in the glow of our

⁸⁹ Pat Forgey, “Alaska’s Pension Suit Settled for \$500 Million,” *Juneau Empire*, June 13, 2010, http://juneauempire.com/stories/061310/sta_653072396.shtml.

⁹⁰ World Pension Forum, <http://www.worldpensionforum.com>.

recent trip to Prague and St. Petersburg, I want to thank you for extending to Sherry and me the opportunity to be a participant on this fabulous trip.”⁹¹

The presence of such exquisite conferences makes trustees unlikely to wish to rock the boat, or challenge their financial professionals.⁹²

In a similar vein, many consultants preach that investing should not be done without doing “due diligence.” While this seems proper on the surface, I was recently at a conference in which a very solid trustee told of her “due diligence” trip to China. What we mainly heard about, however, was how nice the Great Wall was. Cuba is the present “it” destination.

And, lavish dinners are often provided by investment consultants and financial professionals for trustees. Jennifer Cooper argues that one of the greatest risks in this industry is “dinner risk.” “If there were no free dinners,” she says, “the choice of which financial professional to hire would become more of a competition of ideas and a very different outcome would [be] obtain[ed].”⁹³

The result of these activities is that a dependency is created between the trustees and the consultants.⁹⁴ The consultants tend to validate the perks received by trustees. This validation is important to trustees who wish to take advantage of these activities.

⁹¹ See <http://www.worldpensionforum.com>; <http://www.worldpensionforum.com/about.php>; and <http://www.worldpensionforum.com/testimonials.php>.

⁹² See also Southern States Business Coalition's, “Southern States Alternative Investment Symposium 2013” held at the Ross Bridge Resort, Birmingham, Alabama, March 3 - 6th, 2013, <http://www.ssais2013.com>.

⁹³ Interview with Cooper by the author, January, 2013.

⁹⁴ The dependencies, and the resulting “dependence corruption,” are crucial, for, as Lessig wrote, “[a]n institution can be corrupted... when individuals within that institution become dependent upon an influence that distracts them from the intended purpose of the institution. The distracting dependency corrupts the institution.” Lessig, *Republic, Lost*, 15.

Unique – or Maybe Not So Unique – Forms of Institutional Corruption

I.

Asymmetries, Complexity and Uncertainty—Problems in Finance

Edmond J. Safra Lab Fellow Bill English points out that institutional corruption produces unhelpful “rents” taken by those who benefit, especially when there are “information asymmetries, complexity, and uncertainty.”⁹⁵ English posits that the presence of these three concepts signals an area in which corruption is likely to occur; they could not be more prominent than in the investment arena. Any person who has attempted to manage her or his own finances has experienced the inability to keep up on the information flows, understands the complexity involved, and has most likely felt the effects of uncertainty.

The information asymmetries in this area come mainly from the lack of transparency in finance. As George Bernard Shaw wrote in *Heartbreak House*, “Shall I turn up the light for you? No, give me deeper darkness. Money is not made in the light.” The foreign currency manipulation highlighted above is one such example.

English’s second area is complexity. There is no doubt that one of the complications in reforming the financial arena in pension funds or any type of retirement area is the extraordinary complexity of finances today. The complexity produces a kind of “roll your eyes” landscape that quickly bores the general populace. This complexity comes from two major sources. First, the purpose of finance, historically, has been to provide a system for human business activities to function. These human activities are obviously extraordinarily varied, and thus the financial system by definition will be complex.

But most of the complexity that causes harm, and in which institutional corruption is most likely to breed, is unnecessary and is present solely to provide additional ways for Wall Street to make fees. Today there are over 76,000 financial products on the worldwide market. How can an individual or trustee evaluate them?

⁹⁵ William English, “Ten Theses on Institutional Corruption” Presentation at the Edmond J. Safra Lab Seminar, Harvard University, Cambridge, MA, Sept 26, 2012.

Ways of measurement contribute to the complexity (and uncertainty). The area has a distinct “figures lie and liars figure” aspect to it. Nearly any investment claim can find some numbers to support it. For example, there is no consistent view on the question of what time period to use to see if an investment strategy has worked, the so-called “market cycle.” Thus, financial professionals can use this confusion to claim success in an unwarranted manner.

Academics are especially to blame for this problematic complexity, which has mushroomed in the last forty years as certain finance professors began building finance models that they claimed could predict the financial future. Slowly, their elegant theories have won the day and entire industries have arisen to sell and service these models. Legal theories of fiduciary duty in investment have been altered to respect the supposedly scientific nature of these theories. Yet, like the old saw, these academics and the financial professionals who tout their theories own the yachts, not their customers.⁹⁶

However, in spite of (or maybe because of) the academic and finance professions, uncertainty remains high.⁹⁷ Here again, the failed scientific theory of investment is partially to blame as MPT was intended to be an answer to deal with some of this concern. As Galbraith counseled, such uncertainty will always be here, and with it the need for robust investment consultants untainted by corruption.

Fraud [in the world of finance] begins with a controlling fact, inescapably evident but all but universally ignored. It is that the future economic performance of the economy, the passage from good times to recession or depression and back, cannot be foretold. There are more than ample predictions but no firm knowledge. All contend with a diverse combination of uncertain government action, unknown corporate and

⁹⁶John Bogle, formerly of Vanguard Investment, has pointed out that Modern Portfolio Theory has placed a powerful veneer of objectivity over their predictions. “The modern quantitative and econometric techniques developed in the last generation have given investors and portfolio managers a new sense of confidence in the ability to forecast financial trends and behaviors. By compiling and analyzing historical data, and by building models that take into account current variables, econometricians often try to predict the movement of interest rates, stock prices, inflation, unemployment, and so on. During times of financial euphoria and investor panic, however, these techniques become virtually worthless. The reason is fairly simple: The vast majority of models rest on assumptions about normal and rational financial behavior. But during market manias, logical and analytical minds do not prevail. Such markets are driven more by hubris, elation, fear, pessimism, and the like—emotions that the current models do not, and perhaps cannot, compute” Bogle, “The Clash of the Cultures,” *op.cit.*, 24, quoting (and paraphrasing) Henry Kaufman, *On Money and Markets* (McGraw-Hill, 2001).

⁹⁷ “The one thing we have been certain of is that uncertainty is high!” James Montier, “The 13th Labour of Hercules: Capital Preservation in the Age of Financial Repression,” GMO White Paper, November 29, 2012, 1.

individual behavior and, in the larger world, with peace or war. Also, with unforeseeable technological and other innovation and consumer and investment response. There is the variable effect of exports, imports, capital movements and corporate, public and government reaction thereto. Thus the all-too-evident fact: The combined result of the unknown cannot be known. This is true for the economy as a whole, as also for the specific industry or firm. So the view of the economic future has always been. So it will always be.⁹⁸

But, given that no holistic theory of investment has arisen from investment consultants or academics to rival the comprehensiveness of MPT, trustees have little place to turn.

II.

When You Swim in a Sea of Sharks, You Want The Best Shark By Your Side

Since the financial crisis of 2008, concerns relating to many aspects of this financial structure have been examined in daily press reports and in Hollywood movies. Reports of bad actors in this space are legion. Out-and-out criminal activity has been found and occasionally prosecuted—such as that which was seen in the case of Ponzi-schemer Bernard Madoff—though to a degree found inadequate by many commentators. The *Wall Street Journal* carries a blog entitled, “Corruption Currents,” in which financial companies that trustees continue to employ are often and prominently featured. Trustees must operate in this milieu, as the money they oversee constitutes a large percentage of existing investment assets.

One of the unusual results of, and protective strategies in response to, the lack of trust in the financial system writ large is the belief by many trustees that “when the game is crooked, you need the best crook working for you.” This is a rational belief that I have heard expressed more than once. For example, in many areas of financial services, even with the most mundane activity, such as bank clearing operations, it is impossible to find an institution to work with that has not paid huge fines and does not have a large number of citations on its record—even in this

⁹⁸ Galbraith, *Economics of Innocent Fraud*, 39-40.

time of inadequate regulation. For a trustee to attempt to work only with investment professionals who have not gotten on the wrong side of the regulators would be a full-time job. To be fair, investment consultants face the same conundrum. Thus, many trustees hold their noses and accept that those they work with have interests that are not aligned with the trust. So, they choose the craftiest of the bunch.

Fraud in mortgage lending is often credited with being one of the primary catalysts for the 2008 financial crash. On the investment side, these mortgages were packaged into financial products that were sold to investors, through a process called securitization. This securitization of consumer loans and mortgages produced layer cakes of financial products whose ingredients were quickly forgotten. Pension funds bought billions of dollars of slices of these financial cakes, often on the advice of investment consultants. Yet many of these investments failed or lost significant value when borrowers were unable to repay loans. Recent research shows that the culprits in the story were not indigent borrowers, but “reputable banks” who committed “pervasive” fraud in originating the loans and in securitizing them.⁹⁹ If this is considered a valid asset class, as it has been and continues to be, isn’t it rational for a trustee to choose an investment advisor who has the best relationship with the fraudsters?

A general example of this is the recent scandals with the high profile SAC Capital Advisors. Cascades of insider trading arrests have come to those who work or worked at this company. Yet during the time of the investigations, investors continued to give the firm billions of dollars of investor capital. Citigroup and Blackstone, two of the most powerful financial institutions, continued to counsel their clients to invest with Steven A. Cohen, the head of the company.¹⁰⁰ As with the support they gave Enron, these financial behemoths were quite happy to “forgive rotten ethics for great returns.”

The biggest, most sophisticated investors certainly put an enormous amount of pressure on hedge funds. But almost none of it is about ethics

⁹⁹ Tomasz Piskorski, Amit Seru, and James Witkin, “Asset Quality Misrepresentation by Financial Intermediaries: Evidence from RMBS Market,” Columbia Business School Research Paper No. 13-7, February 13, 2013, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215422.

¹⁰⁰ Given the pressures growing from the continuing nature of the governmental investigation of SAC, this may soon change.

and clean culture. It's about performance. A fund that runs a few ticks lower than its peers for several months running can get put out of business. But investors seem to demonstrate little interest in whether the person is ethical and trustworthy.¹⁰¹

That investment behemoths trade ethics for performance may not be that surprising, as they do not want the ethical spotlight put on them. But for trustees who have a fiduciary duty of the highest order, a different vision is needed.¹⁰²

What Is To Be Done?

This paper argues that institutional corruption is at the heart of the current failures in the financial system and that a focus on investment consultants is an appropriate place to begin. Some argue that the ingrained nature of venality in the financial system is self-evident, and spending time on institutional corruption in finance is a fool's errand.¹⁰³ It is true that the history is grim. Long ago, renowned Americans such as U.S. Supreme Court Justice Louis Brandeis railed about the area.¹⁰⁴ The account of the Congressional investigation into institutional corruption at the time of the 1929 stock market crash and the Great Depression bears disheartening similarities to the reports of 2008.¹⁰⁵ A recent article in the *New York Times* was entitled, "Madoff Aside, Financial Fraud Defies Policing."¹⁰⁶ To quote Samuel Loyd, an Englishman who made his fortune in finance and was considered an authority on money and banking in his time, "No warning can save a people

¹⁰¹ See, Jesse Eisinger, "When Wall Street Investors Favor Performance Over Ethics," *New York Times*, December 12, 2012, <http://dealbook.nytimes.com/2012/12/12/when-wall-street-investors-favor-performance-over-ethics>.

¹⁰² "From the perspective of the economy as a whole, the banks thus took on more risk than was sensible [for the economic system]. . . . Indeed, as Raghuram G. Rajan puts it, 'What is particularly alarming is that the risk taking may well have been in the best ex ante interests of their shareholders.'" Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy* (Princeton University Press, 2010), 152, quoted in Lessig, *Republic, Lost*, 79.

¹⁰³ Further, the recent work of my Edmond J. Safra Lab colleague Maryam Kouchaki and her coauthors found that the mere exposure to money can trigger unethical intentions and behavior. Kouchaki, et al., "Seeing Green" op.cit.

¹⁰⁴ Louis D. Brandeis, *Other People's Money and How the Bankers Use It* (Harper Torch Books, 1914, reprint 1967).

¹⁰⁵ The Pecora Investigation was an inquiry begun on March 4, 1932 by the United States Senate Committee on Banking and Currency to investigate the causes of the Wall Street Crash of 1929. For an account of it, see, Ferdinand Pecora, *Wall Street Under Oath: The Story of Our Modern Money Changers* (Simon and Schuster, 1939).

¹⁰⁶ Jessica Silver-Greenberg and Suzanne Craig, "Madoff Aside, Financial Fraud Defies Policing," *New York Times*, January 6, 2013, <http://dealbook.nytimes.com/2013/01/06/after-madoff-financial-fraud-defies-policing/?emc=eta1>.

determined to grow suddenly rich.”¹⁰⁷ All this makes the financial area problematic by definition.

Perhaps what is most unsettling for this task is that tainted investment consultants appear to go on and on and on, like the Energizer bunny. The pension consulting industry, *Forbes* found, is “eternally sleazy.” As its magazine article from 2009 began, when starting a story about corruption involving some funds in the mid-south,

You might think that being in the business of advising pension funds where to invest and then steering them into Ponzi schemes run by Bernard Madoff and Bayou Group would damage a consultant’s reputation. Or that cheating on federal ethics forms and having regulators bar a cofounder from a supervisory role would hurt business. Or that having its practices described in an independent report as “subject to myriad conflicts of interest” might tarnish its reputation.

Not at Consulting Services Group. Despite suffering all of the above, the Memphis, Tenn. firm is going strong, advising 42 public and private pension funds on how to allocate \$16 billion and which money managers to hire—even while taking money from some of those same managers for steering business their way.¹⁰⁸

Having these bad actors in the chains affects all the operations of the funds, as “the suspicion that some public fund trustees may favor donors with preferential treatment also can tarnish their ability to push the companies in which they invest to adopt better ethical behavior—efforts that are seen increasingly as part of their job.”¹⁰⁹

With “the audacity of hope,” progress is possible. We all know that money corrupts and that in this arena, as the title of the Puff Daddy song said, “It’s all about the Benjamins.” Yet, as in the political arena, another area in which many claim that

¹⁰⁷ Quoted in Das, “Investment in a Time of Dysfunction,” op.cit.

¹⁰⁸ Asher Hawkins and David K. Randall, “Tainted Pension Fund Advice,” *Forbes*, May 20, 2009, <http://www.forbes.com/forbes/2009/0608/100-consulting-services-retirement-tainted-pension-fund-advice.html>.

¹⁰⁹ Eric Laursen, “Bad Behavior,” *Plan Sponsor Magazine*, February 2004, <http://www.plansponsor.com/MagazineArticle.aspx?id=6442455495>.

the monster of institutional corruption cannot be tamed, the passage of time always carries with it an ebb and flow of such activities and reactions to them.

A reimagined investment consulting industry is needed to combat this state of affairs. Given the state of the finance industry and the problems facing today's trustees, there is no other choice. Edmond J. Safra Lab Fellow Bill English has also thought about how best to tackle these problems. Speaking of areas of institutional corruption in general, he argues that, "although legislation is one prominent model of reform, reform can also take place from within institutions (on both a formal and informal level), and this sort of reform is likely better suited to deal with information problems (but more difficult to motivate)." The place to begin is with a newly constructed role for investment consultants.

Investment consultants could be especially useful in a robust system of financial regulation and sustainable investment, as it is now clear that there is a judgment deficit in the financial system that can only be remedied with more individual attention.¹¹⁰ The work of former banker and academic Amar Bhide is important here. He notes that the current narrative has had the effect of harming "decentralized individual judgment and initiative," which "are essential to the success of the modern capitalist economy."

At the same time, rules and centralized systems are needed to bring order and prevent waste. Getting the balance between these two modes of decision making right is a constant struggle. But managers, policy makers, and others are aware of the conflict and have experience managing it. In recent times, though, a new form of centralized control has taken root that is the work not of old-fashioned autocrats, committees, or rule books, but of statistical models and algorithms. This has been especially true in finance, where risk models have replaced the judgments of thousands of individual bankers and investors, to disastrous effect. The problem with the statistical approach is that it cannot adequately account for the uncertainty and idiosyncrasies

¹¹⁰ For more on sustainable investing, see the UNPRI, <http://www.unpri.org>.

inherent in economic decisions. What finance in particular needs is a return to judgment.¹¹¹

Investment consultants can exercise this judgment. They can spearhead a return to common sense in finance and lead a movement to remove all types of corruption from the field. Those who work in this field should be the men and women, who like an honest and uncorrupted sheriff in an old Western movie, protect their town from the outlaws—allowing its citizens to thrive.

Without attention to the problems of their industry, however, the continued profitable existence of investment consultants is likely in doubt, as it should be.

¹¹¹ Amar Bhidé. “The Judgment Deficit,” *Harvard Business Review* 88.9 (2010): 44-53, at 47.



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