RVK Investment Perspectives
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MANAGING INVESTMENT CONSULTANT CONFLICTS OF INTEREST

Overview

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Successful management of institutional investment portfolios requires unbiased advice from multiple individuals and third parties. Key advisors include investment board/committee members, investment staff, investment consultants, fund managers, and custodians. Despite a robust regulatory infrastructure in the US, securities laws do not preclude investment consultants from operating with a variety of conflicts of interest, which may compromise their objectivity. Current laws simply require the disclosure of such conflicts, leaving investors with the final say on acceptability.

When RVK was founded in 1985, one of our primary objectives was to deliver independent, fiduciary investment advice and help clients navigate conflicts of interest throughout the financial services industry. Over our 30+ year history, we are proud to have stayed true to this objective — to this day, our transparent, advisory-only business model remains the cornerstone of our strategy to mitigate conflicts of interest. We also credit other firms that have remained true to the same principals. However, over the past decade or so, we have observed changes in the investment consulting profession, which we believe threaten to increase the occurrence of conflicts of interest.

In response to this trend, our paper presents what we believe to be a useful analytical framework for evaluating and mitigating investment consultant conflicts of interest. An important note about our framework is that we broadly define "conflicts of interest" as intentional behaviors and unintentional biases that negatively impact an investment consultant's advice. This definition enabled us to address investment consultant behaviors, such as unconscious behavioral biases, which may not be considered "conflicted" from a legal perspective, but can be harmful to investors nonetheless.

We also credit individuals and organizations that contributed indirectly to this paper, as we drew upon existing compliance, ethics, and behavioral economics research. Our hope is that investors will use this paper to reduce their exposure to conflicts and thereby improve investment performance. Furthermore, by raising awareness of these issues, we hope to encourage others in our profession to proactively reduce the incidence of conflicts of interest.

Investment Consultant Conflicts of Interest

According to a February 2016 study by the CFA Institute, management of conflicts of interest is important to investors, and they value upfront conversations about this issue. Specifically, the two most important expectations are that firms "act in an ethical manner in all [our] interactions" and "fully disclose fees and other costs."[1] Despite these expectations, a 2017 global study on the Future State of the Investment Profession showed that 56% of investment professionals believe clients today are often sold inappropriate products.[2] Even within organizations that are regarded highly for their integrity,

[1] From Trust to Loyalty: What Investors Want. CFA Institute. (February 2016): page 13.
[2] Future State of the Investment Profession: Pursuing Better Outcomes—for the End Investor, the Industry, and Society. CFA Institute. (April 2017)

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the ever-present financial incentives in the investment industry necessitates constant vigilance and continuous improvement. Complicating this issue further is the number of ways in which investment consultants can violate their ethical, contractual, and legal obligations to prioritize client interests above their own. Given the importance and complexity of this issue, we spent considerable time pondering an effective discussion framework. After much debate, we settled on a framework that consists of two dimensions. The first specifies whether a conflicted act constitutes a legal or contractual violation (as opposed to acts that are legal, but may be self-serving). The second dimension describes whether the act was intentional or unintentional. **Figure 1** shows the resulting two-by-two matrix. Also provided in the matrix are examples of potential conflicts that may fall in each quadrant.[3]

Two interesting observations stand out in this matrix. First is the fact that acts in the "Legal, but Self-Serving" quadrant are legal if accompanied with proper disclosure. As such, many of these actions are considered to be acceptable business practices, but nonetheless create conflicts of interest that need to be monitored. The second observation is that there are many "self-serving" acts that are not only legal, but also likely to be unintentional and unconscious. This amplifies the prevention challenge – if a consultant is unaware that they are acting in a conflicted manner, how is it possible for investors to be aware?

Figure 1: Investment Consultant Conflicts of Interest Framework

Consultant Intent[5]	Violation of Legal/Contractual Obligations[4]: No	Violation of Legal/Contractual Obligations[4]: Yes
Intentional	**Legal, but Self-Serving** • Recommending conflicted products • Generating revenue from competing and/or non-fiduciary services • Operating affiliated business lines that accept commission dollars or engaging in revenue sharing agreements • Permissive gifts/entertainment policies • Sales-heavy compensation models • Lack of transparency with regard to fees or known organizational weaknesses	**Intentional Violations** • Bribes for placement of funds • Preferential treatment accessing over-subscribed investments • Undisclosed financial interest in recommended investments • Collusion between a fiduciary and 3rd party provider – "don't fire me, and I won't fire you" • Misleading performance reporting • Front-running with personal account trades
Unintentional/ Unconscious	**Unintentional Biases** • Cognitive and emotional biases that negatively influence recommendations • Selling additional products, services and/or projects of questionable value	**Unintentional Violations** • Same as above, but the consultant is unaware of the illegality or unethical nature of the action[6]

[3] While many examples of conflicts are included in these quadrants, the notations are not intended to capture every example.

[4] We recognize that many examples do not represent legal or contractual violations in all circumstances. Our objective is to simply list examples that have the potential to constitute such a violation, but we do not attempt to capture every example.

[5] Many examples listed can be both intentional and unintentional. We attempted to categorize examples according to the type of intent that we believe to be common. It is important to note the dotted line that separates each quadrant is intended to represent the fact that the legality and intent of conflicted acts is contextual. Many examples listed in one quadrant could easily be placed in another quadrant under a different set of circumstances.

[6] Lack of awareness is not an excuse for engaging in improper conduct; it is simply an explanation for the purposes of categorizing different types of conflicts.

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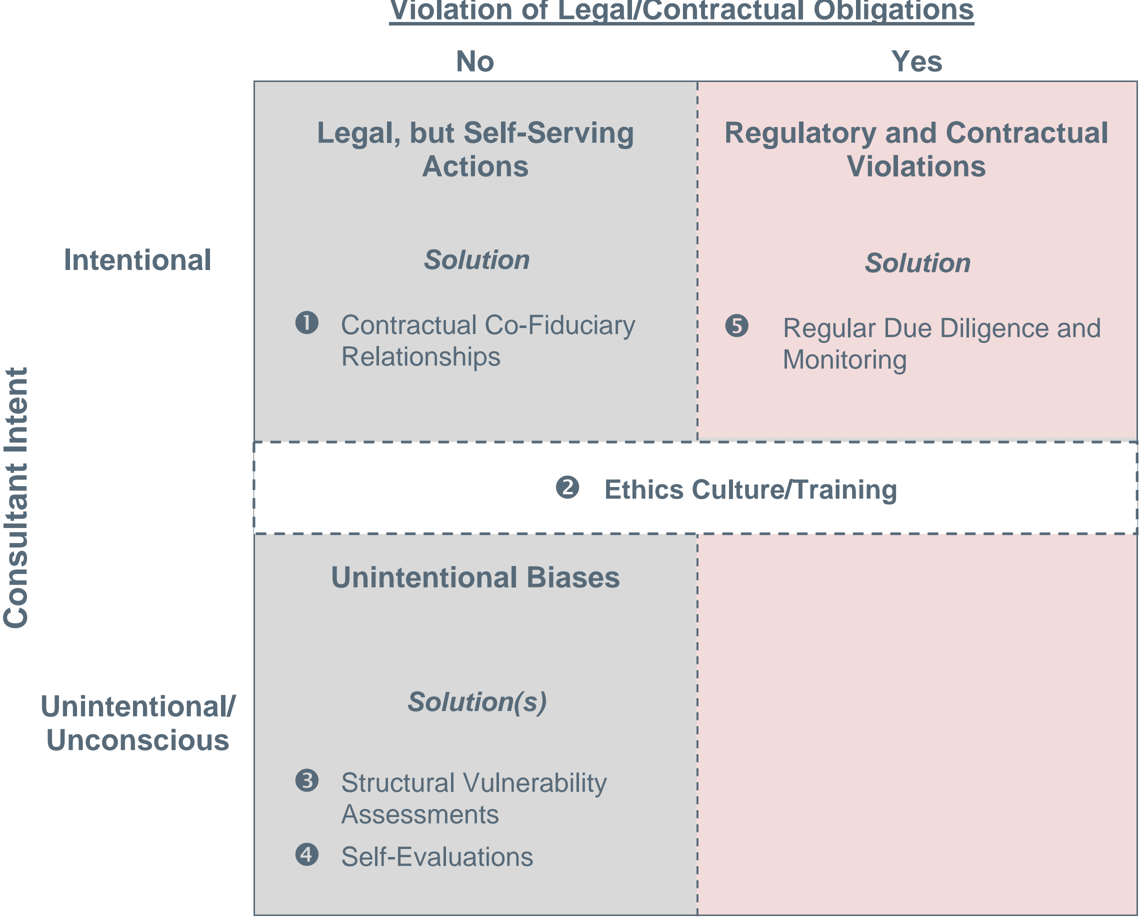
Conflicts of Interest Mitigation

The 2017 CFA Institute report covering conflicts of interest includes global survey results that found only 11% of investment professionals believe finance has a positive impact on society today, but that 51% believe that it could have a more profound positive impact with stronger principles.[7] One way to build stronger principles is by asking tough questions and taking practical steps to materially reduce potential occurrences of conflicts of interest, as underscored in the report's discussion on "purposeful capitalism."[8] To this point, understanding the full scope of potential conflicts of interest in an investment consulting relationship is an invaluable first step for investors. While effective mitigation remains a daunting task, there are several practical steps that we believe investors can take. In the remainder of this paper, we describe several effective tactics that we have observed during our 30+ years serving as investment consultants. In **Figure 2**, we have organized these tactics according to the type of conflict that each addresses in our framework.

Figure 2: Solutions to Protect Against Investment Consultant Conflicts of Interest



[7] Purposeful Capitalism is one of four future scenarios derived from the interaction of finance-specific forces and known megatrends that are currently expected to disrupt our ecosystem, including aging demographics, tech-empowered individuals and organizations, economic imbalances, government footprints and resource management. Future State of the Investment Profession: Pursuing Better Outcomes—for the End Investor, the Industry, and Society. CFA Institute. (April 2017).

[8] Ibid

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Tactics to Reduce Legal and Intentional Self-Serving Actions

The first group of conflicts in our framework are potentially damaging, but can be addressed effectively. These conflicts involve self-serving actions by consultants that are both legal and intentional. Fortunately, we have identified and described a relatively simple defense against these conflicts. This tactic is described below.

➊ **Contractual Co-Fiduciary Relationships** – In **Figure 1**, conflicts of interest that violate legal or contractual obligations are shaded in red, while those that are legal, but remain biased toward investment consultants' self-interest are shaded in gray. If there is one single act that can reduce the probability that investment consultants will engage in conflicted behavior, it is to require the consultant to serve as a fiduciary to the client's plan(s). This single designation moves all of the actions categorized as "Legal, but Self-Serving" into the category of "Legal/Contractual Violations." While this action does not eliminate the potential urge to prioritize self-interest over client interest, it raises the penalties for such actions and thus serves as a powerful deterrent. For institutions concerned about conflicts of interest, demanding a fiduciary standard of care should be a non-negotiable provision. The language in **Figure 3** is extracted from a sample investment consultant contract and can be used to accomplish this objective.

Figure 3: Sample Fiduciary Standard of Care Contract Language

<ABC Consultant> Standard of Care

a. ***<ABC Consultant>*** *acknowledges that it is a fiduciary under this Agreement and as a fiduciary, it will discharge each of its duties and exercise each of its powers with the care, skill, prudence, and diligence under the circumstances that a prudent investor acting in like capacity and familiar with such matters would use in the conduct of any enterprise of like character with like aims.*

b. ***<ABC Consultant>*** *will discharge its duties hereunder with respect to the Client solely in the interest of the Client.* ***<ABC Consultant>*** *will not, knowingly, in any capacity, represent or act on behalf of a party whose interest is directly adverse to the Client in any transaction involving the Client.* ***<ABC Consultant>*** *will not receive any consideration for its personal account from any party dealing with the Client in connection with a transaction involving the assets of the Client.*

c. ***<ABC Consultant>*** *will comply with all applicable laws and regulations in the performance of its duties under this Agreement.*

d. *If the Client is an employee benefit plan subject to the Employee Retirement Income Security Act of 1974 ("ERISA"),* ***<ABC Consultant>*** *will serve as a fiduciary, as defined by ERISA, with respect to plan assets.*

It is important to note that this is not a failsafe solution. Exemptions can be embedded in contractual language, and there are many subtle conflicts of interest that may occur legally despite this provision. Nevertheless, we believe that this tactic is a valuable first step if only to force potential consultants to reveal the extent to which they are willing to commit to conflict of interest mitigation.

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Tactics to Prevent Unintentional, but Self-Serving Acts

Many investment consulting firms provide advice with the best of intentions, but may be unknowingly influenced by self-interest. Many drivers of self-interest are driven by fundamental economic incentives. It is also our observation that the greater the complexity of a business (i.e., the more sources of revenue), the greater likelihood that unintentional and/or unconscious biases may emerge. There are several actions that firms can take to mitigate these types of conflicts. Examples include ethics training,[9] structural vulnerability assessments, and self-evaluations. Each of these tactics is described on the following pages.

❷ **Ethics Culture/Training** – Establishing a culture of integrity is essential for investment consulting firms seeking to mitigate conflicts of interest residing in all four quadrants of our framework. In order to be effective, this culture must reinforce the ethical treatment of clients and fair handling of conflicts of interests. In order to sustain this culture, it must be embedded in management's day-to-day decisions. Unfortunately, given that ethics training is a regulatory requirement, it can be difficult for investors to differentiate firms that simply "check the box" versus those that truly live and breathe their stated ethos.

Fortunately, there are some useful clues that may help. One simple metric is the presence of CFA charterholders on the investment professional staff. While the CFA designation is by no means a guarantee of ethical behavior, it does indicate that professionals have at least undergone intensive education on ethical behavior. As a producer and publisher of thought leadership for the industry, the CFA Institute's commitment to ethics education and the importance of managing conflicts of interest goes well beyond the exam curriculum.[10] Another method is to inquire about the issues addressed in a consultant's ethics and conflicts of interest training sessions and supporting materials, as well as the frequency of such training. Although most investment consulting firms implement a variety of training programs, understanding the content and intensity of the training enables investors to gauge the quality and commitment to such programs.

In summary, we strongly believe that an effective ethics culture and training infrastructure is a critical component of conflict management. While an evaluation of these practices is admittedly subjective, developing a sense of the extent to which these are embedded in a culture can help investors differentiate firms with ethical cultures from those with simple box checking tactics.

❸ **Structural Vulnerability Assessments** – In FINRA's comprehensive 2013 publication, entitled *Report on Conflicts of Interest*, they cited *organizational structure* as a key element that shapes a firm's management of conflicts of interest. The report encourages firms to carefully evaluate and decline to offer products when conflicts are too significant to be mitigated effectively, "even if that avoidance means foregoing an otherwise attractive business opportunity."[11] Over the past several years, some investment consulting firms have taken steps to increase profitability. One profitability enhancement strategy is to create new products and services and encourage consultants to sell them to existing clients. Unfortunately, this also creates an incentive to sell unneeded services, which is precisely what FINRA warned against. This is just one form of "structural vulnerability" that creates pressure for consultants to prioritize self-interest over client interest.

All else being equal, it is our belief that as the number of structural vulnerabilities increases at a firm, the challenges

[9] The type of ethics training that we describe must go beyond simple annual reminders of rules and regulations. Training must be thorough and sincere, and the rules that are discussed must be enforced.

[10] Ethics is an important and challenging component of all three levels of the CFA exam. This is by design to ensure that CFA charterholders not only know what's expected of them in the Code of Ethics/Standards of Professional Conduct, but that they can also identify conflicts and address them in a variety of financial contexts.

[11] Report on Conflicts of Interest. FINRA (October 2013).

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associated with managing the resulting conflicts also increases. Therefore, we believe that a useful exercise is for investors to assemble a comprehensive inventory of a consulting firm's structural vulnerabilities. In order to assist with this task, we have provided a list of common vulnerabilities that we have observed over our 30+ years in investment consulting.[12]

a. **Sale of Conflicted Products** – Generally speaking, fees and margins are more attractive for investment products in comparison to investment consulting services. As such, many investment consulting firms have launched investment products, such as funds of funds, which they sell to their investment consulting clients. Simply disclosing the potential conflict does not change the fact that there remains a financial incentive to recommend these products over the best available product. In some cases, this is not even an issue of bias in the recommendation, as some firms only present their own products to clients.

Mitigation Tactics

1. **Open Search Process** – Require an open search process if your investment consultant offers competing products.
2. **Omit Investment Consultant Products from Consideration** – Restrict your consultant from including any of their investment products in searches if avoiding even the perception of conflict of interests is essential.

b. **Other Non-Investment/Affiliated Revenue Streams** – Investment consultants are equipped to assist clients with many investment projects in addition to core service offerings. While these projects can add value, they also create potential conflicts. Even more care is necessary when the services compete with – rather than complement – general consulting. Listed below are five service offerings that can create conflicts of interest.

i. **Acceptance of Referral Fees** – Some investment consulting firms accept referral fees from investment managers and other investment vendors. If these fees are allowable and properly disclosed, they do not violate a consultant's relationship with the client. However, for obvious reasons, referral fees create substantial risk that the consultant will provide clients with recommendations that favor the consultant's financial interests over the client's interests.

ii. **Investment Manager Training Services** – Investment boards and committees often make multi-million dollar decisions involving investment managers and third-party vendors after reviewing a brief finals presentation that may last for an hour or less. Given the brevity of the decision-making process, coupled with the large amount of dollars at stake, investment firms are willing to pay considerable sums of money to improve their win rates. Realizing the value of training investment managers to conduct more effective finals presentations, some investment consulting firms offer "training seminars" to help service providers improve their chances of winning these competitions. Unfortunately, providing such services is ripe for conflicts. The most obvious concern is that investment consulting firms train investment managers on tactics they can use to impress the consultants themselves. In other words, the investment consultant (for a fee) teaches an investment manager to say exactly what the investment consultant needs to hear in order to hire them. A second problem is that the purchase of training services creates a situation in which the firm may provide more favorable reviews of these "paying clients," consciously or unconsciously.

[12] The list we have provided highlights what we believe to be the most significant vulnerabilities. However, this is not intended to be comprehensive. There are other potential vulnerabilities, and investors should not limit themselves to this list when creating inventories.

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iii. **Investment Manager Conferences** – Some investment consulting firms offer fee-based investment manager conferences. The value proposition for investment managers is the opportunity to network with the consulting firm's roster of investment professionals and clients. In exchange, investment managers pay substantial attendance fees. This practice may create an incentive for investment professionals to express favoritism toward investment managers attending these conferences. Favoritism may stem from the fact that the manager is a paying client or it may simply be a function of familiarity bias. Either way, if the favoritism—conscious or unconscious—is based on factors independent of appropriate portfolio construction objectives and performance expectations, it is not in the client's best interest.

iv. **Affiliated businesses** – Many investment consultants operate affiliated business lines. In some cases, these businesses may generate revenue from sources such as commission dollars from investment managers or revenue sharing agreements for the right to be on a platform. This can create enterprise risk and potential conflicts that must be monitored.

Mitigation Tactics

1. **ADV Reviews** – Investors should thoroughly review an investment consultant's Form ADV (short for "Advisor"), which is provided to the SEC, to identify every financial conflict of interest disclosure for the firm and its affiliates. Further, investors should ask clarifying questions, such as how important are revenues derived from investment-related products, investment manager services, or other revenue streams that might conflict with their core services.
2. **Avoid "Conflicted" Projects** – Investors should be wary of projects that may produce outcomes that inherently bias the perspective of a consultant.

c. **Permissive Gift Acceptance Policies** – Acceptance of gifts and favors from investment managers is an all too common practice across the investment industry. Examples include, but are certainly not limited to: accepting tickets to events (such as concerts, sporting events, etc.), allowing vendors to pay for meals during which business is discussed, and accepting free transportation/lodging often associated with conferences. While gifts with substantial financial value clearly have the potential to increase bias toward the gifting entity, even small gifts can subtly shift one's opinion.

Mitigation Tactic

1. **Ensure Proper Gift Acceptance Policies** – Ensure that your investment consultant has a strong policy against the acceptance of gifts from investment managers and other third parties.

d. **Contractual Exceptions to Fiduciary Relationship** – Some investment consulting firms provide a veneer of a fiduciary standard of care. As an example, we have encountered investment advisory firms that offer to serve as a plan fiduciary, but with the stipulation that they will only recommend their firm's funds. This action technically qualifies the firm as a fiduciary; however, by limiting the recommended funds solely to those that are offered by the firm, this exception is clearly not in the client's best interest.

Mitigation Tactic

1. **Avoid Contractual Exceptions to Fiduciary Language** – Ensure that investment consultants contractually agree to serve as fiduciaries without material exceptions.

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❹ **Self-Evaluations** – While every RVK engagement is held to a fiduciary standard of care, we recognize that it is impossible to eliminate all possible conflicts, particularly when it relates to unconscious behavioral biases. Even consultants with the best intentions are vulnerable to biases of which they are often unaware. One way to identify and mitigate conflicts stemming from unconscious biases is to proactively survey investment professionals either formally or informally. By incorporating survey results into ongoing compliance/ethics training, we believe that investment professionals may be able to further reduce potential unconscious/unintended conflicts.

Ironically, the very act of writing this paper inspired us to conduct such a survey. In May 2017, RVK distributed a survey to all investment consultants in the firm in order to measure potential behavioral biases that could produce conflicts of interest. Questions covered different sources of conflicts, such as relationships with investment managers, preferences for non-discretionary business models, and pressures relating to replication of strategies popular with peers. After reviewing these results, we were comforted by the fact that existing safeguards ensured that the most common biases were rated low. However, we also noted that a few items scored in the low to moderate range. In order to improve, we designed an internal training session to build awareness among consultants and brainstorm additional behaviors and tactics to reduce the intensity of these potential conflicts. Specific items on the agenda fell into the categories below. While we acknowledge that conducting an internal survey may not be common practice for all firms, we believe that investors can greatly benefit from the insights of such a survey to evaluate their investment consultant—we have included some sample questions on pages 12–13.

a. **Herd Instinct** – Consultants emphasize strategies that are intended to serve clients well over a long time horizon. However, when these strategies face short-term headwinds, some consultants instinctively feel a strong sense of responsibility. One method to avoid this discomfort is to “follow the herd” and create portfolios that resemble those of peers. The problem with this approach is that peers may have objectives that materially differ from the client’s. Therefore, while following the herd may allow performance to deviate less from peers, it may very well sacrifice long-term performance.

   Mitigation Tactics

   1. **Objectives-Based Asset Allocation** – Firms should encourage consultants to clearly express the importance of basing asset allocation decisions on underlying plan objectives. A client’s strategy may differ from the strategies employed by the majority of peers.
   2. **Client Communication** – Consultants feel less pressure regarding peer comparisons if differences in return/risk expectations are clearly communicated up front. Encouraging consultants to prepare investors for potential market cycles that will produce relative underperformance can reduce client pressure and dissatisfaction when such circumstances arise.
   3. **Group Awareness/Discussion** – Leveraging internal investment committee meetings and formal discussions, investment consulting firms should continuously evaluate the strategies employed by different client types to ensure the consistency and integrity of recommendations.

b. **Familiarity Bias** – Some consultants may feel tempted to recommend known investment managers over less familiar managers. This situation is probably the most difficult to address because it can be both a strength and a weakness. The fact is that often managers with which consultants are most familiar are also the ones that provide the most value. A problem only occurs if consultants recommend known managers out of convenience rather than to best serve a client’s objectives.

   Mitigation Tactic

   1. **Require Multi-Manager Searches** – Require consultants to consider multiple managers to fill mandates regardless of their comfort level with a specific fund.

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c. **Conformity Bias** – One example is how consultants balance what a client or Board wants to hear, with offering objective opinions that may be contrary to client preferences. Some consultants may be tempted to soften opinions in order to avoid creating or contributing to group tension; however, this of course becomes a problem when such deference is not in the client's best interest. A potentially related issue is the creation of variable content performance reporting that may reflect conformity bias in which reporting deliverables include data that may emphasize positive performance attributes but may deemphasize or omit important constructive observations.

Mitigation Tactics

1. **Pre-Meeting Discussions** – Pre-meeting calls to discuss potentially contentious recommendations with committee/board chairs in a less public setting can be an effective way to mitigate this conflict. Such calls provide an opportunity to debate these issues and determine the best approach before discussing at a formal meeting.
2. **Systemic Performance Reporting** – One method to ease pressure to address "positive reporting" bias is to establish a static array of performance metrics that must be reviewed in every meeting. This ensures that performance reviews are consistent and not biased toward only positive indicators.

d. **In-Group Bias** – Success for many investment professionals is more than amassing money, power and status; rather, it is taking pride in one's work. For many investment consultants, this can create a belief in (and potential bias for) the specific business model being employed. For RVK, our philosophy favors the non-discretionary advisory model while others may favor a discretionary model. Our internal survey indicated that we favor our service model versus competing service model that we do not offer. We continue to hold that our business model is attractive for investors seeking to reduce structural conflicts of interest and be mindful that non-discretionary consulting may not be desirable for all clients.

Mitigation Tactic

1. **Limit Scope of Consultant Advice** – The best defense to protect against this type of bias is simply to recognize the differences, merits, and downsides of each model, and limit the involvement of investment consultants when determining an optimal investment advisory model.

Tactics to Prevent Legal or Contractual Violations

Although cases of notable financial crimes dominate the headlines, most financial services firms employ a variety of safeguards to prevent such incidents. In addition, severe penalties from regulatory agencies, such as the SEC and FINRA, provide a powerful deterrent against the more egregious types of conflicts of interest. It is our belief, therefore, that the daily occurrence of legal, but self-serving acts may present the greatest threat to investors. Nevertheless, investors must always remain on guard to protect themselves from legal and contractual violations. In order to provide some practical guidance, we have summarized below and on the following page several elements of a robust due diligence and monitoring program.

❺ **Regular Due Diligence and Monitoring** – The unfortunate reality is that despite many individual firm and legal deterrents, illegal conflicts of interest still occur. While institutional investors cannot scrutinize every act of their own internal staff, much less every financial services provider, there are several high-level tactics that they can use in order to keep a pulse on their investment consultant's culture and practices. Listed below are several activities that may help ensure basic protections. While there are many other activities that may be advisable depending upon the scope of the relationship and the resources available to the investor, this list provides a good starting point.

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a. **Registration with Appropriate Regulatory Agencies** – Investment consulting firms must register with various regulatory agencies depending upon the scope of services provided. For example, all investment consulting service firms to institutions with aggregate assets of more than $200 million must register with the SEC. Consulting firms that may be public companies or have affiliated businesses or other lines of business requiring registration with FINRA or other regulatory agencies.[13] Depending upon the nature of an investment consultant's business, investors should ensure that all of the proper registrations are in place. The absence of an appropriate registration should be considered a non-negotiable issue for institutional investors.

b. **Regular Review of Communications with Regulatory Agencies** – In addition to simply verifying registration with regulatory agencies, investors should ask for and review any regulatory communications, including any SEC deficiency letters. Regulatory communications can reveal ongoing investigations, as well as simple notices, sweep exams pertaining to areas of regulatory focus, and results of periodic examinations that may have uncovered undisclosed conflicts of interest. Deficiency letters specifically are the written culmination of a periodic on-site SEC examination and will be accompanied by the consultant's response to the SEC's written findings. Regular review of communications with regulatory agencies enables investors to respond promptly if potential deficiencies are noted and not sufficiently mitigated.

c. **Review of Annual ADV Filing and Updates** – Each year, investment consulting firms registered with the SEC must submit an annual ADV filing. While this multi-part form can take time to review, developing familiarity with the annual filing and any updates can provide early warnings regarding emerging conflicts of interest. Also, comparing it for consistency with information provided in marketing materials can give institutional investors a good read on transparency.

d. **Conflicts of Interest Policies and Procedures** – Investment consultants that are SEC registrants are required to have a Code of Ethics addressing policies and procedures related to the management of personal conflicts of interest. Robust policies will include guidance on employee roles and responsibilities in identifying conflicts, escalation procedures, and policies for disclosing conflicts of interest to clients. When reviewing policies and procedures, investors should pay close attention to the frequency of updates and the scope and relevance of such policies to the firm. We also encourage careful scrutiny of a firm's gift policy, as the SEC does not have a regulatory cap on this potential area of conflict. Finally, investors should also scrutinize confidentiality practices, charitable contributions, and personal trading policies.

e. **Review of Audited Financial Statements** – Audited financial statements can be an excellent source of information, revealing new revenue streams or financial weaknesses, which could increase incentives to engage in conflicted behavior. When reviewing financial statements, a few red flags to look for include:
   - Qualified opinions from auditors
   - Material differences in revenue streams (especially if they are derived from services that could encourage conflicted behavior)
   - Footnotes that highlight potential conflicts

f. **Background Checks of Individual Consultants** – Contained within all three parts of the ADV filing for SEC registrants – Part 1, Item 11; Part 2A, Item 9; and Part 2B – are varying legal and disciplinary disclosure requirements for the firm and its supervised persons, including any disciplinary action from professional associations, such as the CFA Institute, State Boards of Accountancy, or State Bars. In addition, if a consultant changes its responses to questions pertaining to criminal, regulatory or disciplinary information, a

[13] With limited exceptions, investment consultants in the US with $150 million or more in discretionary assets or $200 million or more in nondiscretionary assets must register with the SEC and filings can be reviewed at www.adviserinfo.sec.gov/IAPD; affiliated broker dealer registrations can be reviewed at www.brokercheck.finra.org; registrations for consultant affiliates doing business in the futures and options markets can be reviewed at www.nfa.futures.org/BasicNet.

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prompt update to all three parts is required within 10 business days. Reviewing the background of individual consultants who interact with clients can provide early warning of potential conflicts as well as reveal insight into the firm's culture of compliance. Needless to say, consultants with a record of financial crimes or disciplinary action should raise concerns.

Conclusion

Investment consultants have an obligation to earn their status as trusted advisors. Given the magnitude of the impact of decisions made by institutional investors, consultant advice that is distorted by conflicts of interest can be extremely damaging. Although regulatory agencies provide a first line of defense, relying solely on such entities is not sufficient. Our hope is that investors can use this paper to gain a deeper awareness of the types of conflicts of interest that can influence the judgment and recommendations of financial service providers generally, and investment consultants specifically. It is also our hope that investors can deploy the mitigation tactics outlined in this paper to implement more robust safeguards within their institutions. In the end, it is our belief that refreshing the conflicts of interest conversation will lead to better outcomes for institutional investors and the financial markets by strengthening the value and reputation of the investment consulting profession and creating a more trustworthy consultant/investor relationship.

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Consultant Conflicts of Interest Survey Tool

Firm ________________________________ **Date** __________________________________

Instructions

The following survey outlines a series of questions that investors can pose to their current or prospective investment consultant. The survey is not intended to provide a definitive assessment; it is simply intended to identify areas that may lead to conflicts of interest. Each client must determine the extent to which they are comfortable with the presence of structural vulnerabilities to conflicts of interest at the firm level and among individual consultants.

Structural Vulnerabilities

1. **Does your firm provide training for investment managers on how to improve RFP win-rates?**

   ☐ Yes ☐ No

2. **Does your firm host conferences for investment managers and other service providers?**

   ☐ Yes ☐ No

3. **If yes, does your firm charge a fee for attendance?**

   ☐ Yes ☐ No ☐ N/A

4. **Does your firm accept referral fees from third-party providers (e.g. custodian banks)?**

   ☐ Yes ☐ No

5. **Does your firm offer competing investment products (e.g. hedge funds of funds)?**

   ☐ Yes ☐ No

6. **Does your firm accept gifts (including non-monetary) from investment managers and other third-party providers**?

   ☐ Yes ☐ No

7. **Does your firm contractually agree to assume co-fiduciary status for your plan?**

   ☐ Yes ☐ No

Degree of Individual Consultant Susceptibility to Conflicts of Interest and Behavioral Biases

To what degree is your investment consultant tempted to do the following:

8. **Recommend an investment product offered by my firm that falls within the scope of services for which we were hired to provide independent advice (e.g. recommend my firm's fund of funds product to a general consulting client)?**

   ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

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9. **Accept a meal or gift (such as event tickets, greens fees, parties, free attendance at a conference) that is in excess of that allowed by company policy?**

   ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

10. **Provide preferential treatment to a third-party provider that is also a paid client of another service offered by the firm (e.g. paid conference attendee)?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

11. **Recommend the services of an affiliate of my firm?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

12. **Recommend additional fee-based services of questionable value to my client?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

13. **Recommend a known manager rather than expanding the universe of potential candidates (i.e. familiarity bias)?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

14. **Temper the conviction of my recommendations (i.e. conformity bias) regarding sensitive issues?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

15. **Express a preference for a non-discretionary consulting model as the optimal investment advisory model?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

16. **Express a preference for a discretionary model as the optimal investment advisory model?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

17. **Recommend investment managers in which I personally hold an investment?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

18. **Recommend an asset class due to popularity (i.e. herd instinct) with peers?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

19. **Offer recommendations to larger fee clients prior to lower fee clients?**

    ☐ Extremely Low ☐ Low ☐ Moderate ☐ High ☐ Extremely High ☐N/A

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