

# 2018 Fee Report and Other Compliance Matters



*Competitive Process: Fiduciary Duty, Basic  
Principles and Consultant Selection*

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BOOK **2**

## Fiduciary Duty Chapter 32 and 840 CMR 1.01

“A board member shall discharge all of his/her duties solely in the interest of members and their beneficiaries, and”

## Exclusive Purpose

- 1) For the exclusive purpose of:
    - a) providing benefits to members and their beneficiaries; and
    - b) defraying reasonable expenses of administering the system
- Loyalty – Not just honesty
  - Impartiality – fairness to all members and beneficiaries—no favoritism
  - Avoid Conflicts
  - Expend systems assets reasonably and properly

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## Prudent Expert

2) “With the care, skill, **prudence and diligence** under the circumstances then prevailing that **a prudent person acting in a like capacity and familiar with such matters** would use in the conduct of an enterprise of like character and with like aims.”

- Care, Skill, Prudence, Diligence
- Hire competent necessary experts/specialists and staff
- Monitor experts/specialists and staff

## Laws, Rules and Regulations

3) In accordance with the Massachusetts General Laws, the rules and regulations promulgated by the Commission, and rules and regulations adopted by the Board and approved by the Commission.

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## Recent — OCH Ziff — Foreign Corrupt Practices Act

- In 2007, Och-Ziff used an agent to pay a bribe of \$3 million to high ranking Libyan government officials to secure \$300 million of LIA funds for Och-Ziff. Also, an Och-Ziff employee **paid \$400,000 from investor funds** to its Libyan agent, the agent would then use those funds to pay bribes to benefit a Libyan property development project in which \$40 million of Och-Ziff funds had been invested (SEC, 2016).
- In 2007 and 2008, Och-Ziff gave a loan of more than \$86 million (**more than \$10 million from investor funds**) to one of its South African partners, an African mining-focused fund. Och-Ziff's employees deliberately ignored the fact millions would go to the bribery of foreign government officials, illicit payments to middlemen, the personal benefit of business partners, and expenditures irrelevant to investment (SEC, 2016).
- In 2008, Och-Ziff gave **a loan of about \$124 million from investor funds** to an entity affiliated with an infamous Israeli businessman, Dan Gertler (Geiger, Robinson, Weinberg and Hurtado, 2016), who had close connections with DRC government officials at the highest levels and became Och-Ziff's partner in the DRC to purchase mining assets there. Gertler used a substantial amount of the money to bribe high-ranking DRC officials with the aim of securing mining assets for both himself and Och-Ziff (SEC, 2016).
- In 2010 and 2011, Och-Ziff **took \$130 million of investor funds** and then loaned the funds to another entity also controlled by Gertler. Och-Ziff allowed him to take \$84.1 million without any restrictions or supervision. Och and Frank knew he would use the money to bribe important DRC officials, and were aware of the corruption allegations against Gertler (SEC, 2016).
- In 2011, Och-Ziff created another Africa-focused fund in a London-based oil exploration company. The fund purchased shares from Och-Ziff's South African partner, who then paid more than \$1 million to a consultant. The latter used the funds to bribe Guinean government officials. Both Och-Ziff and its two employees were willfully blind as to the high probability the consultant would use the funds for bribery (SEC, 2016).

## OCH - Ziff (Continued)

- Och-Ziff used not its own capital, but funds which investors gave Och-Ziff to invest to fund the above corrupt transactions. The SEC repeatedly insisted the CEO and CFO of Och-Ziff knew investor funds were being used to pay bribes (SEC, 2016).
- As for Daniel Och, the SEC accused him of involvement in the corrupt transactions, as he had final decision-making power over all private investments by Och-Ziff. This authority meant he could decide whether to allow the above transactions. He also personally approved transactions (4) and (5) (SEC, 2016).
- Joel M. Frank was in a similar position. He was responsible for controlling Och-Ziff's internal accounting system, and he approved the expenditure of Och-Ziff funds in the above improper or corrupt transactions (SEC, 2016).
- The SEC also stressed that although neither Och nor Frank had actual knowledge that bribes would be paid through the above transactions, they were still liable for the bribery because of their executive positions and the power and responsibility which came with the posts (SEC, 2016)

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## OCH - Ziff (*Continued*)

- Och-Ziff pleaded guilty in a Federal District Court in Brooklyn to one count of conspiracy. Settlements were entered into to settle the civil as well as criminal charges against Och-Ziff, Daniel Och, and Joel M. Frank (Stevenson, 2016). They were all charged under the Foreign Corrupt Practices Act (FCPA) in the U.S. (SEC, 2016).
- Och-Ziff paid a \$413 million fine as part of a deferred-prosecution agreement. Apart from monetary compensation, the agreement requires Och-Ziff to hire an independent monitor, and the criminal charges will only be dismissed if the company complies with the terms of the agreement and does not violate any other laws over the course of three years, from 2017 to 2019 (SEC, 2016).
- Daniel Och had to pay a \$2.2 million fine as an admission for lack of control and oversight of his own company. He was also charged with four counts of bribery, which will be dismissed if Och-Ziff complies with the agreement terms. Joel M. Frank also had to settle charges against him of allowing executives to ignore red flags.

## Post Mortem

- Och Ziff has changed its name to Sculptor Capital Management
- June 2019 Sculptor received SEC approval to raise money after being prohibited from doing so as part of the case
- Investors in a Canadian mining company seeking at least \$150 million and possibly as much as \$1.8 billion in compensation
  - Held rights to an undeveloped mine in the DRC
  - Company lost those rights after \$100 million in bribes paid to government officials

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## Oglala Sioux Tribal Bonds (2013 - 2016)

- \$43 million stolen from pension funds (Michelin Retirement Plan; Birmingham Water Works Pension Plan; Chicago Transit Retiree Health Trust)
  - Convinced Native American Tribal Corporation (WLCC) to issue bonds supposedly to purchase an annuity
  - Purchased investment advisory firms (Hughes Capital and Atlantic Asset Management) who then bought the WLCC bonds for pension client accounts
  - No annuity was purchased with the proceeds
  - Proceeds of the bond sales (pension fund monies) were diverted to the use of conspirators to acquire entities, shore up existing companies, pay back debts, compensate scheme participants, buy real estate or make other personal investments

## Oglala (*Continued*)

- John Galanis, Devon Archer, and Bevan Cooney were each convicted of conspiracy to commit securities fraud and securities fraud. U.S. District Judge Ronnie Abrams in Manhattan ruled that the evidence at the trial had not shown that Devon Archer knew that the bond issue was fraudulent, or that he received any personal benefit from it. Abrams said she was “left with an unwavering concern that Archer is innocent of the crimes charged.”

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## Red Flags

- Often Hedge Funds, Real Estate, Alternative Investments
- One Key Figure
- Prominent - Politically Connected/Claim of Political Connection
- Secretive Valuation - “Model” Portfolio
- “Socially Responsible Investing/Native American Initiative”
- Lack of Transparency
- Third Party Payments

## Prudent Expert

- Hire competent and qualified staff and experts
- Monitor employees, consultants, managers and other service providers
- Become and Remain Knowledgeable

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## Vendor Selection

- There is no more challenging responsibility for Retirement Board members than that of prudently selecting investment consultants, managers and custodians. Under the provisions of Chapter 32 Boards rely on the advice of consultants, delegate direct investment of assets to money managers and depend on custodians to account for investment activity.
- The potential problems that could arise from mismanaging investments underscores the need to act as a prudent expert would in selecting monitoring and retaining these vendors.

## Competitive Process

- Open - Public Notice; Reasonable Time - Section 23B
- Objective - Pre-established, objective and relevant criteria
- Fair
- RFP - Section 23B
- Processing
- Record Keeping - Minutes; Procurement File - Section 23B

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## Role of Consultant

- Board may employ the services of a consultant (fiduciary duty – prudent expert; other institutional investors)
- Consultant must be retained as a result of a “23B” Process
- Section 23B (h) (i) - “The retirement board or its consultant retained under this chapter shall be responsible for the initial evaluation of the proposals. The retirement board or its consultant retained under this chapter shall prepare initial evaluations based solely on the criteria set forth in the request for proposals.”
- “If the initial evaluation is conducted by the consultant retained under this chapter the consultant shall review all initial evaluations with the retirement board and provide to each member of the retirement board the initial evaluation of each proposal.”

## 23B/Fiduciary Duty

- In procurement the provisions of Chapter 32, Sections 23B set forth specific requirements that must be followed. **These mandates are in addition to the duty to comply with the fiduciary standards noted above.**
- Thus one could meet the letter of the law as set forth in Section 23B but still violate the Prudent Expert Rule by not acting “with the care, skill, prudence and diligence ... that a prudent person acting in a like capacity and familiar with such matters would use...”

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## 23B/Fiduciary Duty (*Continued*)

- Section 23B does not address each and every element of the competitive process. For example it leaves to the each board member's judgment how to determine if a prospective vendor has achieved a "Highly Advantageous" rating. Simply because the statute is silent does not give the board member license to base his or her decision on arbitrary and capricious considerations, extraneous factors, or personal bias
- Section 23B is also silent as to whether the Board should conduct in person interviews with some or all of the prospective vendors. It is incomprehensible that a Judge or a Jury when confronted with a claim of violation of fiduciary duty in the context of losses to the system would find that a Board member and a Board that failed to directly interview the vendor whose acts or omissions caused the loss had complied with the **Prudent Expert Rule**.

## Consultant RFP

- How to insure that the Board and each Board member has met the fiduciary standard of a **"Prudent Expert"** in making the selection of an investment consultant?
- Many of the principles outlined also apply to the selection of other service providers

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## General Information

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - The length of time the respondent has been in business
    - The ownership structure
    - The history of the principals
    - The identity of affiliates (broker-dealers, money managers, distributors etc.)
    - Recent changes in ownership
    - Future plans and ability to serve the retirement board as those plans are implemented

## Quality Control

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - The number of consultants in the firm
    - Average number of clients assigned per consultant
    - The maximum number of clients allowed per consultant
    - The existing client base
      - list of clients
      - size of assets
      - how long the consultant has been retained each client

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## Personnel Experience

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - Number of personnel who are Chartered Financial Analysts
    - Experience of the personnel:
      - Institutional experience in public funds administration
      - Management in various asset classes (equity, fixed income, cash, real estate, private equity and hedge funds)
      - Trading (equities, bonds)

## Primary Consultant

- A **“Prudent Expert”** would:
  - Review information pertaining to the lead consultant and team that would be assigned to the retirement board:
    - Biography
    - Names of all clients
    - Nature of service/relationship

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## Consultant Team

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - Identity of the principal assistant to the Primary Consultant and others expected to service the account
    - The role of the principal assistant and other staff
    - The identity of clients that principal and other staff serve and the nature of those relationships

## Client History

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - Clients gained in the last five years - asset size of the fund
    - Clients lost in the last five years:
      - Size of the fund
      - Reason (s) for losing the account

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## Firm Commitment to Adopting Evolving Technology

- A **“Prudent Expert”** would:
  - Review information pertaining to the firms:
    - Commitment to stay abreast of systems and technological advances and to implement those advances

## Litigation History

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - History of litigation involving the firm, its principal/owners/officers
    - History of regulatory action involving the firm, its principal/owners/officers
      - SEC litigation
      - SEC Administrative action
      - State securities action
      - Criminal charges
      - **“Google” the firm and its principals**

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## Code of Ethics/Insurance

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - Code (s) of Ethics that principals and staff subscribe to
    - Levels of insurance coverage and insurance carriers for:
      - Errors and omissions
      - Fiduciary liability
      - Professional liability

## Performance, Performance Measurement & Portfolio Analytics

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - The content of all standard performance reports
    - The format of all performance reports
    - Compliance with industry standards (AIMR Performance Presentation Standards)
    - Availability of reports after quarter end
    - Customization of report content and format

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## Performance, Performance Measurement & Portfolio Analytics *(Cont'd)*

- A **“Prudent Expert”** would:
  - Review samples of the firm’s performance reports
  - Assess the firm’s data base including:
    - The size
    - Composition
    - % of public funds
    - % of private funds
    - Method of compiling data

## Added Capabilities

- A **“Prudent Expert”** would:
  - Determine the ability of the firm to evaluate other investment related activity aside from manger/fund performance:
    - Securities lending
    - Trading costs

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## Client Investment Returns

- A **“Prudent Expert”** would:
  - Review the investment returns of firm clients over several periods:
    - 3 best performing full service clients over last three year period, five year period and 10 year period
    - 3 worst performing full service clients over the last three year period, five year period and 10 year period

## Asset Allocation

- A **“Prudent Expert”** would:
  - Review the firm’s approach to asset allocation:
    - How the firm consults with clients and presents asset allocation issues regarding the total portfolio
    - Assess the ability of the firm to work within existing policy guidelines, investment objectives and range constraints
    - How does the firm research the assumptions used and method of developing asset allocation models
    - To what extent does the firm rely on an outside vendor in the asset allocation process

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## Asset Allocation *(Continued)*

- A **“Prudent Expert”** would:
  - Assess how the firm involves the Board and staff in determining the economic climate and asset return assumptions used in the development of an asset allocation
  - Assess how the firm measures the risk tolerance of clients
  - Assess how the firm addresses biases of clients that may impact the asset allocation and/or manager selection process
  - Review the time frame used in the asset allocation model and frequency of reviews
  - Review how the firm adapts the model to changing economic circumstances

## Manager Search Process/Asset Allocation Implementation

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - The firm’s manager data base and search process
    - How a manager is included in that data base
    - The impact of performance, portfolio review and asset allocation changes on manager turnover
    - The consistency of firm recommendations

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## Experience With Screens

- A **“Prudent Expert”** would:
  - Assess the experience of the firm in assisting clients in the development and/or evaluation of:
    - Social or country screens such as evaluating a portfolio for holdings in tobacco companies
    - Economically targeted investments or other social programs

## Manager Review

- A **“Prudent Expert”** would:
  - Review information pertaining to:
    - The firm’s role in implementing manager transitions
    - The firm’s role in adjusting strategic asset allocation targets
    - How and when the firm conducts due diligence reviews

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## Alternative Investments

- A **“Prudent Expert”** would:
  - Assess the firm’s view of the role of alternative investments within a portfolio
  - Assess the use of alternative investments in client portfolios
  - Assess how the firm aids the client in the design, implementation and monitoring of an alternative investment program
  - Determine the firm’s commitment of staff to this asset class

## Real Estate

- A **“Prudent Expert”** would:
  - Assess the firm’s view of the role of real estate investments within a portfolio
  - Assess the use of real estate investments in client portfolios
  - Assess how the firm aids the client in the design, implementation and monitoring of an real estate investment program
  - Determine the firm’s commitment of staff to this asset class

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## Passive Investment

- A **“Prudent Expert”** would:
  - Review the firm’s approach to passive investing (index funds)
  - Review the number of active managers retained by clients with a similar amount of assets
    - Review the styles and market cap ranges assigned to each of these managers

## Disclosures

- A **“Prudent Expert”** would:
  - Assess whether there are conflicts of interest, ethical problems or past behavior that raises concerns about the firms
  - Apply the lessons of the Och-Ziff, Ogala Sioux, CFM, Madoff and other cases in making that assessment
  - Review information pertaining to:
    - How the firm, its principals and affiliate generate revenue
      - % of revenue from consulting services, money management, services to money managers

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## Disclosures *(Continued)*

- A **“Prudent Expert”** would:
  - Assess whether the firm, its principals or any affiliate:
    - Own a money management firm or have an interest in such a firm (Galanis)
    - Own a broker-dealer or have an interest in such a firm
    - Own or have an interest in any other organization
    - That sells services to institutional investors and/or SEC registered investment advisors

## Legal Proceedings

- A **“Prudent Expert”** would:
  - Determine if the firm, its principals or any affiliate have:
    - Been the focus of a non-routine SEC inquiry or investigation or similar inquiry or investigation from any federal, state or self-regulatory body
    - Been a party to litigation concerning fiduciary responsibility or other investment related matters
    - Had a claim submitted to the firm’s errors and omissions, fiduciary liability and/or fidelity bond insurance carrier

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## Fee Schedule

- A **“Prudent Expert”** would:
  - Ask for consistent, comparable fee information in order to make an informed comparison between respondents
  - Mandate that the service provider provide the lowest price that it charges (Most Favored Nation)
  - Mandate that service provider agree to amend fee if the lowest price charges changes over the course agreement

## Warning

- Board members must understand:
  - Questions about the process by which a service provider was selected will only arise:
    - In the context of a serious loss or legal violation
    - At a time when public officials, the media and even system members will be assigning blame
    - Explaining how the loss occurred will be difficult
    - Unless the selection was made in accordance with principals and procedures that would be followed by a **“Prudent Expert”** the loss itself may only be the beginning of your troubles

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**COMMONWEALTH OF MASSACHUSETTS**

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