

# Conflicts of Interest

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# Conflicts of Interest in Pension Administration

- Potential for abuse is very high
- Serious repercussions for older populations if there are financial losses
- Undermines public confidence



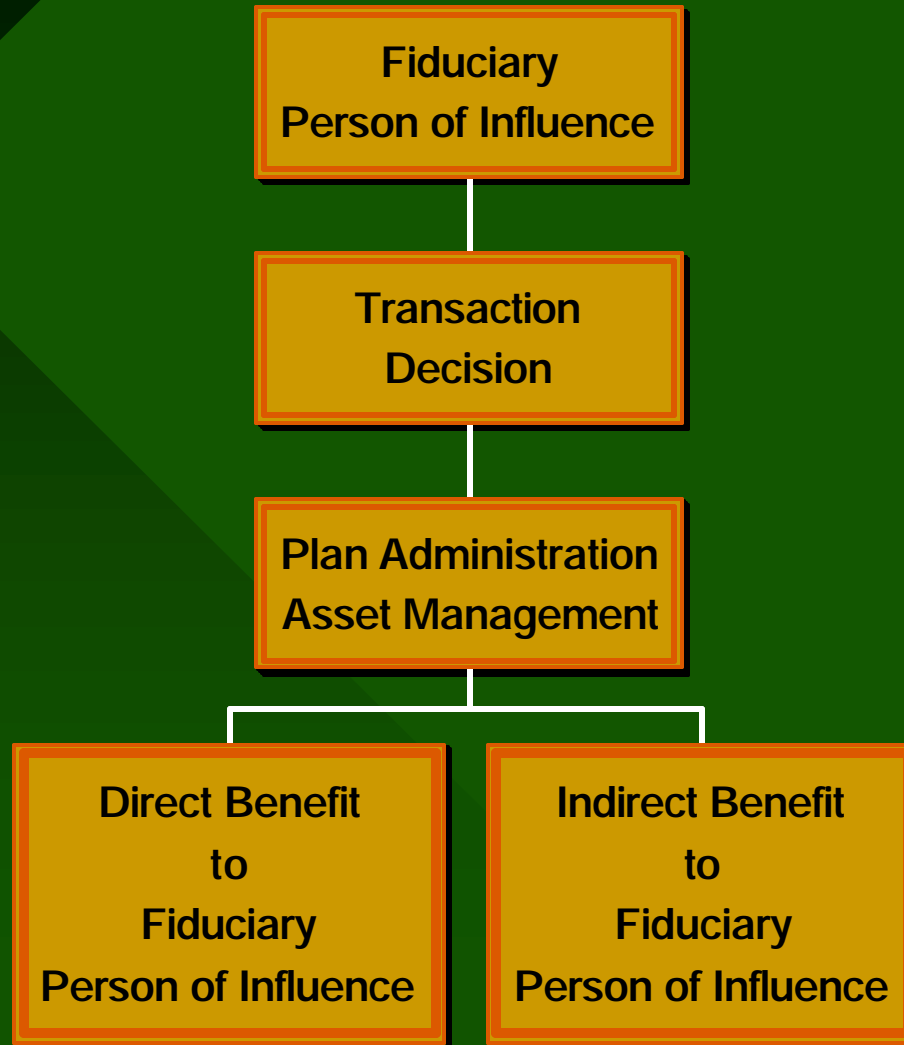
# Overview of Presentation

- Conflict of Interest defined
- Examples of conflict situations
- Current rules and regulations
- Preventative measures
- Methods of detection

# Definition

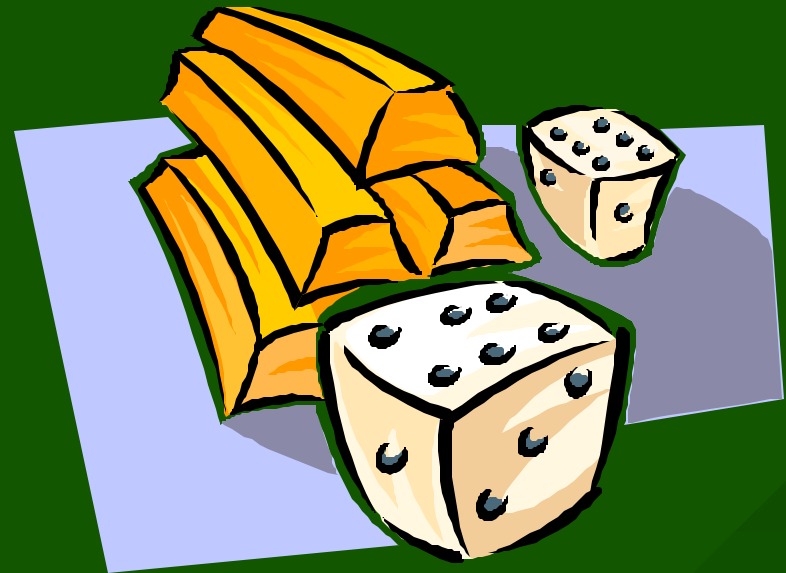
- Any transaction or decision by a fiduciary or person of influence to a pension plan, involving the administration or management of the plan or its assets, whereby that decision or transaction benefits the fiduciary or person of influence either directly or indirectly.
- Must there be a detriment to the plan?

# Elements of a Conflict



# Fiduciaries

- Trustees
- Directors/officers
- Plan Administrators
- Asset Managers

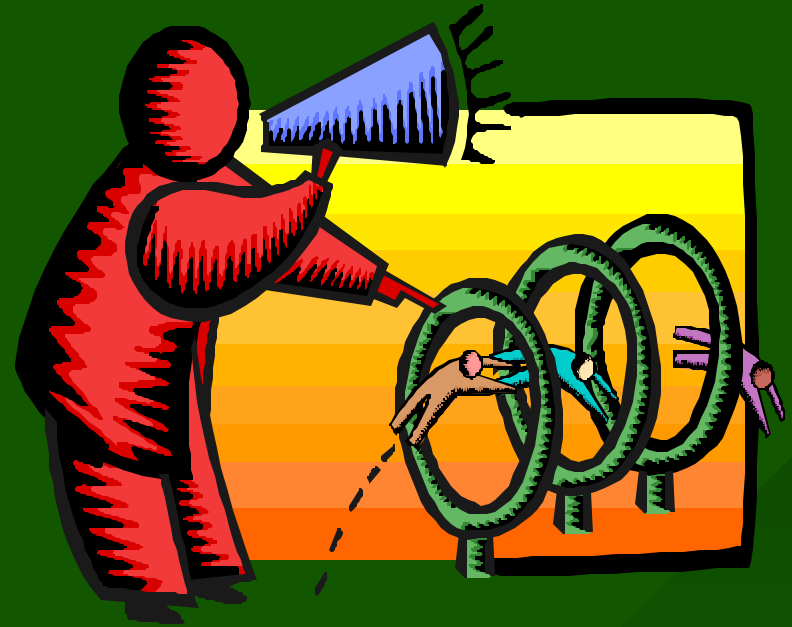


# Persons of Influence

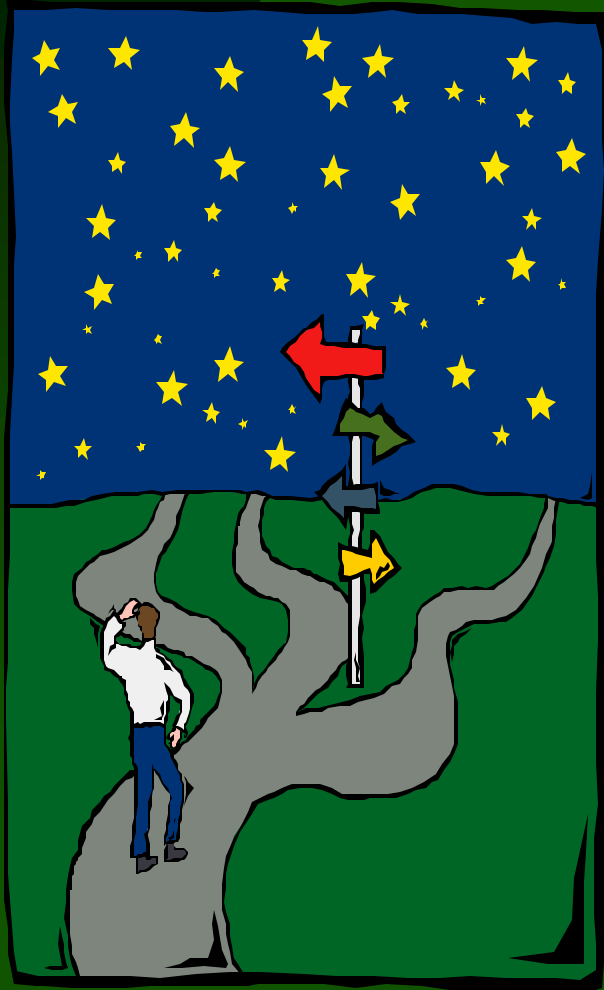
- Investment advisors
- Accountants
- Actuaries
- Attorneys
- Insurance companies
- Banks
- Custodians
- Founders

# Transactions

- Paying fees
- Purchasing assets
- Selling assets
- Making loans
- Paying benefits

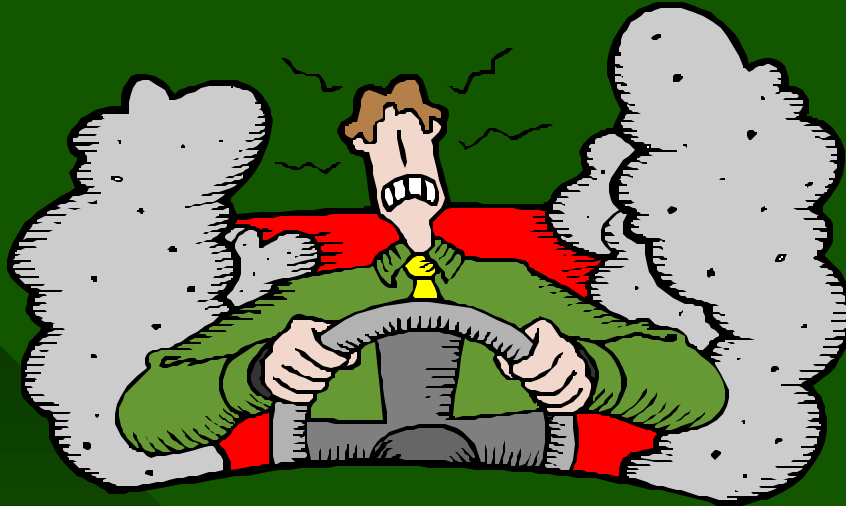


# Decisions



- Investment choices
- Auditing standards
- Benefit calculations
- Plan interpretation
- Hire and monitor service providers
- Plan design

# Conflicts Related to Portability



- Delay in transfer of plan assets when a member changes to a new plan
- Also occurs as a delay in paying benefits

# Timeline

Day 1 - Member submits papers to transfer assets to new plan. Member has 100 shares of stock.

Day 3 – Paperwork received and processed. Shares are valued for transfer at \$4/share.

Day 7 – Securities now valued at \$5/share

Day 19 – Securities now valued at \$6/share.

Day 28 – Member's shares are sold and account is liquidated at \$4/share. Shares net \$600.

Day 30 – Member's fund of \$400 is wired to new plan. What happens to the \$200 net?

# Why is this a conflict?

- Without set valuation dates, funds can arbitrarily decide on what day to value transferred assets
  - To maximize float
  - To increase administrators fees
  - To increase potential gains to the pension company
- Unearned gains by plan
  - Remaining members receive benefit if gains are passed on to plan
    - If there is a loss, remaining members absorb it
  - If gain is retained by administrator, may increase fees above regulated amount
- Inaccurate asset accounting
  - Unless disclosed clearly in financial notes of audit
  - Could be used to manipulate amount of reserves required

# How to prevent this conflict?

- Regulation and legislation
  - Set reasonable but strict time limits on transfers of assets and benefit payments
  - Require disclosure in financial notes regarding the plan's practice for timing these valuations and transactions
  - Compel consistency in how these interim gains/losses will be used
- Plan Documents
  - Have plans designate a consistent procedure for setting valuation dates
  - Require plans to identify ahead of time how these gains/losses will be applied

# Which countries set time limits?

- Most countries have not set firm time limits on these processes
  - Some employ a “reasonable amount of time” standard
- Hungary is presently working to add regulations addressing this issue
  - Accounting law requires written accounting policies
- Problematic in Chilean system which not only allows frequent transfers between plans, but pension companies further encourage it
  - Some companies may delay transfers as a competitive strategy, hoping to win back members who are leaving

# Conflicts Related to Relatives

Parties	Relation to Plan	Duties
ABC Pension Plan	Plan	
James	Director	Administration, hires service providers
Mary	Secretary	Calculates benefits
George	Relative	Mary's husband
George	Participant	Contributes to account, receives benefits
Joe's Accounting Serv	Service Provider	Conducts independent audit of Plan
Joe's Accounting Serv	Tenant	Rents office space from Plan
Claire	Service Provider	Actuary, Employee of service provider, Joe's Accounting Se
Helen	Investment Manager	Selects investment products for assets
Helen	Relative	James' husband
Michael	Broker	Carries out investments

- Plan provides retirement benefits to members, so choosing suitable investments is critical to success of the Plan
- Director is responsible for hiring service providers to the Plan, including investment managers
- Investment managers are responsible for prudent investing to ensure good return on investments

# Transaction

Plan



Plan pays investment manager for advice.

Plan pays Director to hire service providers



Director

Relatives



Director hires investment manager



Investment manager

# Why is this a conflict?

- Divided loyalty
  - Plan administrator has duty to monitor service providers
  - Investment manager is incompetent
  - Plan administrator will not terminate investment manager because she is his spouse
- Opportunity for collusion
  - Also occurs when a service provider offers more than one service to the same plan
  - Can occur with non-relatives in small countries, or in countries with highly centralized financial centers

# How to prevent this conflict?

- Regulation and legislation
  - Prohibition against fiduciaries or service providers having any familial relationships with any other entity related to the plan.
  - Prohibit service providers from offering more than one service to a plan
- Plans should change service providers every few years for a “fresh look” and to avoid relationships becoming too close



# How far do the prohibitions reach?

- Chilean Corporate Governance Standards
  - Transactions with related parties must be conducted at “arm’s length”
  - Includes spouses and “close family members”
- Hungary
  - Self dealing transactions are prohibited
  - Persons with apparent conflicts cannot hold certain offices
  - Auditors cannot be a relative of any officers, boards members, or directors

# Detecting conflicts after the fact

- Interview plan officials and service providers.
  - Look for other business interests and professional obligations.
  - Question educational background, club memberships, religious affiliations.
- Prepare a complete list of all entities related to the plan, from administration to investment.
  - Note any family names that are the same.
  - Question these parties as to any family relationship.
- Examine business registers for ownership and officers that may have commonalities with plan officials and service providers

# Conflicts Related to Service Providers

Parties	Relation to Plan	Duties
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- Contracting or making arrangements with a service provider for office space, or legal, accounting, or other services for the establishment or operation of the plan.

# Transaction

Plan pays accountant for auditing services

Plan



Pension company administers the plan



Pension Company



Accountant

Accountant rents office space from pension company

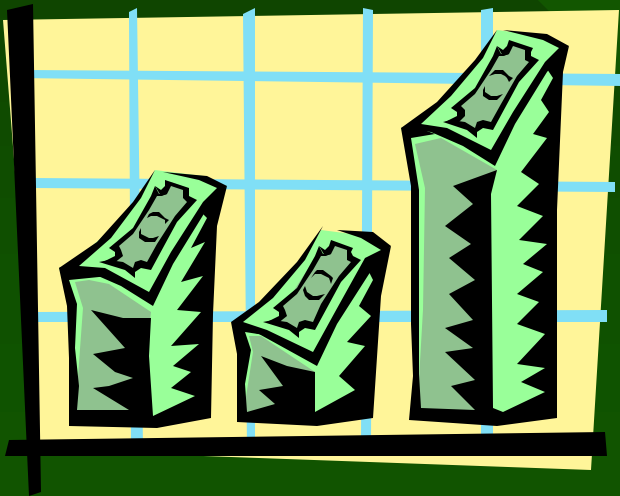
# Why is this a conflict?

- Divided loyalty
  - Accountant finds irregularity in plan
  - Pension company harmed if irregularity is reported
  - Accountant may lose office space if he reports irregularity
  - Accountant must decide whose interest to serve



# How to prevent this conflict?

- Regulation and legislation
  - Prohibition against service providers having self-interested financial relations with any other entity related to the plan that engaged him.



# Which countries have instituted this type of prohibition?

	Yes	No
Chile	XX	
Hungary	XX	
Slovenia		XX

# How far do the prohibitions reach?

- Chilean Corporate Governance Standards
  - Transactions with related entities must be carried out at “arm’s length,” but are still permitted



# How can we detect these conflicts after the fact?

- Review all service provider contracts to determine what duties are included.
- Prepare a complete list of all entities related to the plan, from administration to investment.
- Note any duties that potentially conflict with any of the entities.

# Conflicts Related to Dual Roles

- A trustee negotiating a loan between two separate plans on whose behalf he serves as trustee, where the members of both plans are not identical.
- Similar situation with “insider trading”



# Transaction

Trustee

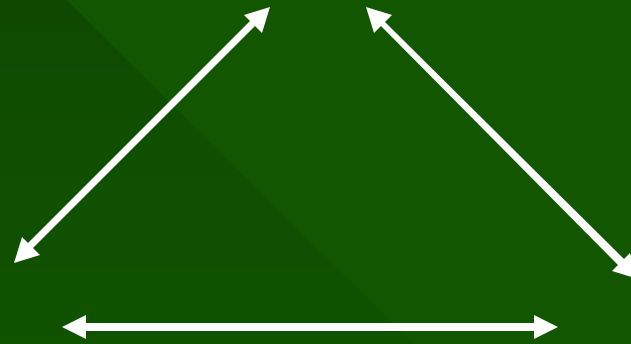
Trustee negotiates terms of a loan between two plans



Plan One



Plan Two



# Why is this a conflict?

- Trustee must get highest interest rate possible for Plan One, which is lending money to Plan Two
- Trustee must get lowest interest rate possible for Plan Two, which is borrowing money from Plan One
- How can he do both?

# How to prevent this conflict?

- Legislation and regulation
  - Stringent regulations regarding who receives loans from pension assets
  - Clear regulations on which duty of loyalty receives highest priority to prevent insider trading under a conflict of laws
  - Strict standards regarding credentials of trustees
- Plans
  - Require proper documentation of all loans, including applications, credit references, independent valuation of collateral

# Which countries have instituted this type of prohibition?

- Several OECD countries do not permit pension plans to make any loans as investments
  - Hungary
  - Poland
- Poland does not permit one pension fund to invest in shares of another fund
- Most pension laws address insider trading as a conflict of interest

# How can we detect these conflicts after the fact?

- Examine all loans from one plan to another
  - Interview trustees of both plans to determine who negotiated the loan
  - If the same trustee worked both sides of the transaction, it is a conflict.
- Determine what insider information is available to a plan official
  - Examine personal holdings and business interests
  - Compare these with the holdings of the pension fund

# Conflicts of Laws

- Two or more laws that create opposing duties
  - Which law will control?
  - Example
    - Securities law v. pension law
    - Insider trading v. fiduciary duty to plan

# Conclusion

- A conflict of interest is a breach of loyalty
  - Detrimental to welfare of pension funds
- Numerous situations in which they can occur
  - Directly or indirectly
- Proper legislation can make conflicts more difficult to achieve, and easier to detect
- Diligent supervision is necessary to find conflicts