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New State Law Takes Aim at Consultant Conflicts, Diversity

By Alyson Velati

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Illinois recently rolled out new laws that are trying to snuff out conflicts of interest among investment consultants and asset managers. The wide-ranging regulatory changes also require consultants to annually reveal their efforts to engage with emerging managers.

Under the new regulations, consultants will be required to unveil any compensation or “economic opportunity” received in the last two years from managers that are recommended to and retained by an investment, pension or retirement board, beginning on January 1, 2018.

The rule will seek to essentially alleviate conflicts like pay-to-play scandals, says **Anna Dunn Tabke**, director of research at Alpha Capital Management, who previously worked as an associate at Mercer and as a consultant at **Rogerscasey**.“The best antidote for removing conflicts is disclosure,” she says.

As of January 1, 2018, pensions and retirement funds in Illinois will not be able to engage with a new consultant unless the consultant has complied with all of the new disclosures.

This includes consultants that invite managers to conferences or consultants that offer evaluation services for managers, says **Gilbert Garcia**, managing partner at **Garcia Hamilton & Associates**.

These sorts of potential conflicts have drawn the ire of regulators in the past, and there are signs that the issue is coming to the fore again.

In February 2017, the **Financial Conduct Authority** (FCA), a U.K. regulator, warned of a host of potential problems in the consulting industry – including conflicts of interest and lack of transparency, as reported by the *Financial Times*. That was followed up by a full scale antitrust investigation launched in September, as reported by the FT. While U.S. regulators have yet to make similar moves against U.S. consultants, the Securities and Exchange Commission (SEC) named consultant conflicts as a top priority in 2016, promising to "examine advisers to municipalities and other government entities, focusing on pay-to-play and certain other key risk areas related to advisers to public pensions, including identification of undisclosed gifts and entertainment," as reported.

The last time the SEC made such a push was back in 2003, which culminated in a 2005 report finding "widespread" conflicts. At that time, the SEC looked into 24 consultants, and found more than half provided services and products to both pension fund clients and asset managers. However, in the end, few managers publicly faced consequences from the regulators.

Illinois is not just targeting conflicts, though. According to its new regulations, consultants that are retained by a board of a retirement system, pension fund or investment board must also disclose the total amount of investment manager searches conducted in the previous calendar year, beginning on January 1, 2018 and will have to report the information every January 1, as of November 8, 2017. This also includes the total number of searches for minority, women and disabled-owned investment managers. But, the law goes even deeper and requires consultants to reveal minority, women or disabled-owned manager searches that resulted in recommendations, awarded mandates and the amount of money invested with these firms following a search process.

"The goal is to have more transparency regarding the ability for emerging, minority, women and vet-owned firms to have the opportunity to participate in the RFP process," says Senator **James Clayborne Jr.**, who initially proposed the bill to the Senate back in early February. "It's to ensure there are no barriers that are impeding them."
He further says: "The purpose of codifying this is to make sure there is consistency. Board members and executive directors change over time, where some ideals may be more important for some board members over others. Once it's part of the law, then it's

consistent, whether it’s important to a current administration or the next, it doesn’t matter.”

Some Illinois state pensions have previously taken measures to promote diversity and already provide high levels of transparency related to emerging manager issues. This comes 14 years after Illinois started requiring its top 12 state pensions to set minimum goals “Minority, Female, Persons with a Disability Owned Businesses (MFPDOB)," as reported in 2015.

The $18.6 billion State Universities Retirement System of Illinois released a report asking investment managers to divulge affirmative action data, as reported last year. The results revealed that minorities make up 25% or less of senior-level positions, and woman 30% or less. More than 50 asset management firms provided information involving diversity to the retirement system.

And last week, the $37.6 billion Illinois Municipal Retirement Fund (IMRF) approved commitments up to $25 million to **Clearlake Capital Partners** Fund V, L.P. and up to $75 million to **Artemis Real Estate Partners** Fund III, L.P., which are both minority and women-owned business enterprises (MWBE).

“IMRF is committed to building long-term relationships with its investment managers as demonstrated by the additional commitments to Clearlake and Artemis,” according to a statement from the pension. “IMRF’s goals for the utilization of minority-owned firms in the private equity and real estate asset classes are 10% and 4%, respectively.” Minority- owned firms currently oversee more than 28% of the fund’s private equity assets and more than 11% of real estate assets as of September 30, 2017.

“Diversity is important to IMRF, and our team is committed to hiring minority-owned investment managers,” according to the statement. “We aspire to have 20% of the total fund’s assets managed by minority- and women-owned firms. IMRF’s Emerging Manager Program includes 48 minority-owned firms and is valued at $7.3 billion or 18.3% of the IMRF portfolio, as of September 30, 2017.”

And some managers have had successful relationships with Illinois pensions, including the $10 billion Latino-owned bond manager, Garcia Hamilton & Associates, who is currently on IMRF’s manager roster.

“In this day in age of low returns, consultants have to go the extra mile to get good alpha and find performance wherever you can,” says Gilbert Garcia. “And some of that is with [minority, women, disabled and veteran-owned firms].” Garcia hopes that pension and retirement system trustees will begin to spread the message to other trustees across the country. “Because no one should be afraid of transparency,” he says. “I think the final result will be to equalize the playing field which will be good for minority, women, disabled and veteran-owned firms. This will allow these funds to discover golden gems that may have been overlooked before.”