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Madoff Scandal Casts Light on Investment Advisers

By LESLIE WAYNE

Kenneth A. Flatto paid a lot of money for expert advice about investing the pensions of municipal workers in Fairfield, Conn. Unfortunately, he says, the experts never warned him about Bernard L. Madoff.

Fairfield was not snookered by some sharper peddling that old Madoff magic. Instead, Mr. Flatto says, the town was relying on the skill of one of the nation's largest investment consultants, NEPC.

The name NEPC probably does not ring many bells. But NEPC and businesses like it play a pivotal — and at times controversial — role as the gatekeepers of the investing world. They stand between trillions of dollars of public and corporate pension money and investment professionals who want a piece of it. And those professionals, it turns out, include the likes of Mr. Madoff, who masterminded a global Ponzi scheme.

NEPC says it urged Fairfield to reduce its investments in a Madoff-linked fund before the scheme came to light. But Mr. Flatto, Fairfield's first selectman and the trustee of its $300 million investment portfolio, contends that NEPC did not do enough. Fairfield paid NEPC $100,000 a year to help it pick investments. The two sides are arguing in court over who will bear the blame for $19 million in losses.

The Madoff affair is rife with finger-pointing. Federal regulators, banks that did business with Mr. Madoff and even his investors have faced criticism.

But the giant Ponzi scheme and similar investment frauds coming to light in recent months have also trained a spotlight on pension and investment consultants like NEPC. For years, troubling questions about these businesses have percolated through the financial industry and the courts. Now, calls for change are growing.

Some consultants, their critics maintain, have conflicts in cases where they collect money as consultants and from the funds they recommend. While others, particularly those specializing in vetting secretive hedge funds, are paid a bounty by the hedge funds for steering investors' money to the funds. And then there are those, their detractors say, who simply fall down on the job. These consultants are hired to keep pension funds out of trouble. But many blessed investments that turned out to be losers — or worse, outright frauds.

Long a backwater, investment consulting took off during the mid-1990s as hedge funds, private equity funds and other so-called alternative investments exploded onto the financial scene. Big investors like pension funds and endowments wanted a piece of the action, but many lacked the time, staff and expertise required to sift through the growing list of investment options.

Enter the consultants. On their advice, big investors shifted hundreds of billions of dollars into investments like hedge funds, the loosely regulated pools of private capital. The idea was that hedge funds would provide the outsize returns that pension funds needed to cover their obligations to retirees.

Now the hedge fund industry is going through an unprecedented shakeout. Investors have lost many billions, and hundreds of these funds have closed. Some public pension funds are considering reducing their hedge fund exposure and have cut ties with those advisers who, they say, gave them bad advice that led to losses. Some federal officials and regulators have warned for years about potential problems in the consulting business.

The Labor Department, for instance, started examining the industry in 2007, and its inquiry is starting to bear fruit. This month, the department settled with Consulting Services Group, based in Memphis, over conflicts of interest. Last December, it sued Zenith Capital Partners, a Santa Rosa, Calif., pension consultant, claiming that Zenith had accepted payments from a hedge fund for steering pension clients to it.

“What we are looking at are pension fund consultants who are fiduciaries, but who use their fiduciary position for their own benefit,” said Virginia C. Smith, director of enforcement at the Labor Department. “We were a step ahead in looking at these issues before Madoff.”

A common complaint is that consultants shirked their responsibility to protect their clients and pushed public pension boards into hedge funds to collect large fees.

“Yes, pension consultants pushed hedge funds onto pension funds,” said Edward A. H. Siedle, president of Benchmark Financial Services in Ocean Ridge, Fla., a company that investigates money managers on behalf of pension funds. “They did this because the fees they could garner are exponentially greater than from a regular advisory retainer.”

Investors are discovering that some hedge funds, and perhaps the consultants who vetted them, are not all they were cracked up to be.

For instance, on the advice of Wilshire Associates, another leading pension advisory firm, the Iowa state pension fund, as well as the University of Pittsburgh and Carnegie Mellon University, poured millions into a hedge fund called Westridge Capital.

Westridge, the authorities now contend, was a fraud. Iowa hired a law firm to try to recover some of the $339 million it lost on Westridge, and has recovered $35 million already.

Julie Economaki, a spokeswoman for the Iowa fund, declined to comment on whether it would file suit against Wilshire, which is based in Santa Monica, Calif. Kim Shepherd, a spokeswoman for Wilshire, declined to comment, saying that the business did not comment on matters involving its clients.

"What you've seen in the last five years is a proliferation of pension fund consultants," said Ross B. Intelisano, a securities lawyer who represents institutional investors. "And, you've seen a failure of consultants to do proper due diligence. The fact that any of these public funds are in a Madoff or a Westridge is amazing to me."

Fairfield conceded that NEPC had told the town that Mr. Madoff advised a fund in its portfolio, the Maxam Absolute Return Fund. But the town contended that NEPC had not mentioned that Maxam was a Madoff feeder fund, taking Fairfield's money and investing it with Mr. Madoff.

The town says that NEPC should have seen obvious red flags over Mr. Madoff's securities business, such as his use of an obscure auditing firm.

"We were in the dark as to what was happening," Mr. Flatto, the selectman, said.

Sean Findlen, a spokesman for NEPC, said that Fairfield's investment in the Madoff feeder fund predated the hiring of NEPC and that the firm had not recommended Mr. Madoff or any of his feeder funds. In fact, Mr. Findlen said, NEPC recommended that Fairfield reduce its exposure to Maxam, but the town did not heed its advice.