Be Careful What You Ask For:

Questions You Should Ask Your Consultant about ***Outsourced Chief Investment Officer Services (OCIO)***

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“Implemented Consulting”

“Outsources CIO (OCIO)”

“CIO in a Box”

“Trusted Co-fiduciary”

“Delegated Implementation”

As a committee member, staff member or investor of a pool of assets, you have most likely heard these terms a number of times. In this world of increased investment complexity, increased litigation, and limited amount of time to spend on investment issues, it’s no surprise that consulting firms are looking for ways to differentiate themselves. But what do these terms really mean? Why should you, as a fiduciary or key responsible member of an investment decision-making team, care? And should you consider engaging this type of consulting firm arrangement?

Back in 2005, the SEC and Department of Labor (DOL) conducted a study of consultant conflicts of interest which raised real concern among fiduciaries regarding incompatibilities between fiduciary duty and private gain of consulting firms. A list of ten suggested questions investors should ask their consultants was published and was seen as astute and illuminating. But much has changed since 2005, and these questions are becoming increasingly irrelevant – or at least inadequate, today.

The investment world has changed markedly since 2005. Consider these continuing trends: First, market trading structures have become more complex and fragmented. Second, the investment consulting industry has consolidated over the past 10 years. Third, growing numbers of investors are delegating more responsibility to outsourced providers. These outsourced services go by many names such as “Outsourced Chief Investment Officer (or OCIO),” “Delegated Implementation,” or “Fiduciary Management.” Whatever the name, the evolution to outsourced service in its many forms means old questions will prompt insufficient and possibly misleading answers. This white paper considers these changes in markets over the past 10 years and highlights new issues and related, new questions investors should ask of their investment consultants. We also provide context for these issues so that investors can better evaluate responses. Finally, this paper will provide a consolidated list of questions investors should ask of any OCIO provider to determine whether the advice and service you, as an investor, seek will serve your interest first and foremost.

That Was Then: The original 2005 SEC and DOL questions and the evolution of markets

In 2005, the SEC and DOL suggested these questions regarding revenue from brokerage or trading operations:

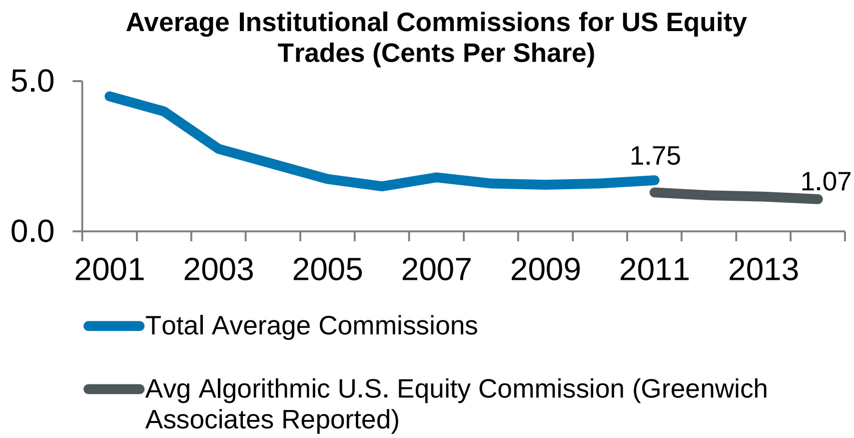
- *If you allow plans to pay your consulting fees using the plan's brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not over-pay its consulting fees?*

- *If you allow plans to pay your consulting fees using the plan's brokerage commissions, what steps do you take to ensure that the plan receives the best execution for its securities trades?*

The evolution of markets over the past ten years has made these questions more challenging to answer. Broker-dealer revenues from commissions are generally lower, but less visible sources of revenue have become more meaningful. Figure 1 on the following page illustrates the decline in brokerage commissions.

"As commissions decline, less transparent sources of revenue increase in importance. Even "commission free" transactions can be profitable for a broker-dealer.

1: Declining Explicit Brokerage Commissions



Commission rates have generally fallen and most investors now pay less in commissions. However, markets have become increasingly fragmented and complex, and broker-dealers are profiting from client trades in new ways. Much of today's equity trading occurs in "dark pools" away from traditional exchanges. Some trades are internalized entirely inside a broker-dealer. As commissions decline, less transparent sources of revenue increase in importance. Even "commission free" transactions can be profitable for a broker-dealer.

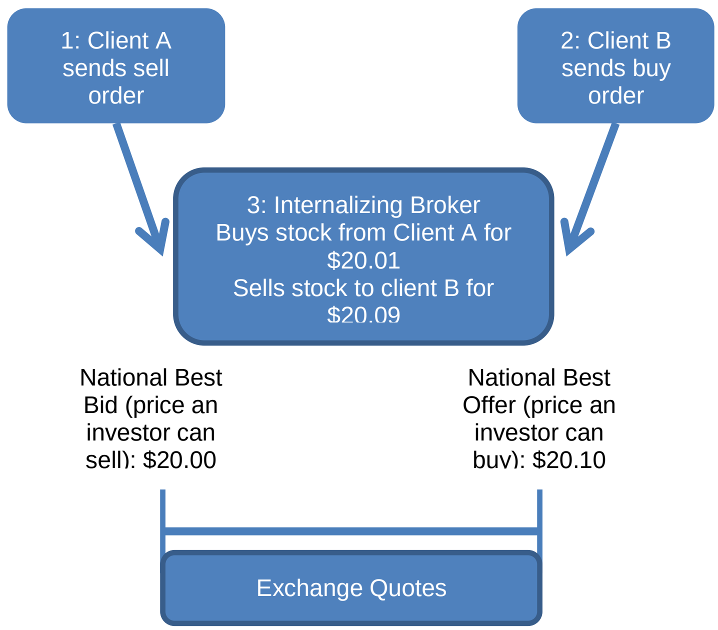
This is Now: *smart questions for today's investor*

In addition to asking the SEC/DOL questions offered in 2005, we suggest a set of additional questions investors should ask.

- **Highland Suggested Question**: *Do you internalize order flow from clients? Would you internalize our order flow?*

Let's consider internalization and how broker-dealers profit from it. Internalization is the execution of buy or sell orders against a broker's inventory without the broker entering an external venue, or open market, like an exchange. In the U.S., brokers are allowed to do this if they offer "price improvement" relative to the best prices available in a market. In the example below, Client A wishes to sell. The best price in the market is $20.00. Instead of sending that order to a stock exchange, the broker can take that order and buy from the client at $20.01. Client A has been given a slightly better price in the process. Client B wishes to buy and the best price on the open market is $20.10. The broker can similarly give Client B a slightly better purchase price by selling at $20.09. By doing so, the broker executes the trade internally. Client orders that are internally executed do not have to be displayed publicly.

2: Example of Internalization



Concerns about internalization are related to the prices at which trades execute, and the ability of brokers to selectively trade for their own accounts in the process. Several studies suggest that the widespread practice of internalization limits the quotes that are publicly disseminated to exchanges, which leads to inferior prices for all investors.[1] In addition to executing orders internally, many

[1] For example, CFA Institute's November 2012 Issue Brief https://www.cfainstitute.org/ethics/Documents/dark_pools_internalization_and_equity_market_quality_final_issue_brief.pdf

brokers will sell client orders to groups that are willing to pay brokers to receive valuable trade flow. Given this, we think there is another useful question to ask:

- **Highland Suggested Question**: *Do you sell client order flow to internalizers or other entities? Please provide a copy of your SEC Rule 606 disclosure and details of your order flow arrangements.*

Many brokers now sell orders to organized venues outside of exchanges. Rather than internalize an order itself, a broker sends its order to an "internalization pool" where multiple brokers send orders for fulfillment. Many of these pools will pay brokers a fee to send their orders to these internalization pools. A comprehensive discussion of the underlying market structure issues of these arrangements is beyond the scope of this white paper. However, the issue at hand can be simply framed. Under the existing market structure, client trade orders -- by virtue of their existence alone, have inherent economic value. Those trades in external pools have sufficient economic value that firms will pay fees to have brokers route trade orders to them. Someone would be willing to pay a fee on an ongoing basis to receive orders only if they had an expectation of recouping that fee plus some profit based on activities related to that order. In today's market it's widely believed that most brokers route meaningful amounts of order flow to internalizers rather than exchanges. Internalization pools and similar entities typically pay brokers a fee for these orders.[2] Under rule 606, brokers must disclose the venues to which they route orders and also disclose material issues such as payment for routing order flow. Figure 3 on the following page shows a sample rule 606 disclosure.

[2] Example: Thomas Peterffy's 2010 speech to the World Federation of Exchanges available at https://www.interactivebrokers.com/download/worldFederationOfExchanges.pdf

3: Sample Rule 606 Disclosure Report

Report for
SEC Rule 606 Report Disclosure
4th Quarter, 2015

"Although measuring the impact of broker-dealer conflicts grows more complex and imprecise in a murky marketplace, investors have the right to ask for disclosure to make informed choices."

NYSE Listed Securities				
Orders routed to:	**Non-Directed Orders**	**Market Orders**	**Limit Orders**	**Other Orders***
A Securities, LLC	40.48%	52.17%	40.54%	0.03%
B Securities, LLC	29.34%	38.48%	26.00%	99.86%
C Securities, LLC	23.98%	0.24%	27.38%	0.04%
D Securities, LLC	5.93%	8.81%	5.82%	0.00%
Total Orders	97.76%	9.61%	87.50%	2.89%

Broker receives payment from "A Securities, LLC." ("A") for directing order flow. Payment varies based upon a number of factors including but not limited to: Size of the order, time of the order placement, whether an order is marketable at the time of order entry, the underlying price of the security and any special handling instructions. Payment received from "A" averaged less than $0.0020 per share for the period 4Q2015.

Today, even "commission-free" structures can be an important source of less transparent revenue for a broker-dealer. Investors have reason to be wary of advice from institutions affiliated with a broker-dealer given the opportunity for multiple conflicts of interest. Although measuring the impact of broker-dealer conflicts grows more complex and imprecise in a murky marketplace, investors have the right to ask for disclosure to make informed choices.

That Was Then: The original 2005 SEC and DOL questions and the evolution of consultant consolidation and investor governance

In 2005, the SEC / DOL suggested these questions of consultants regarding relationships with affiliates they may recommend:

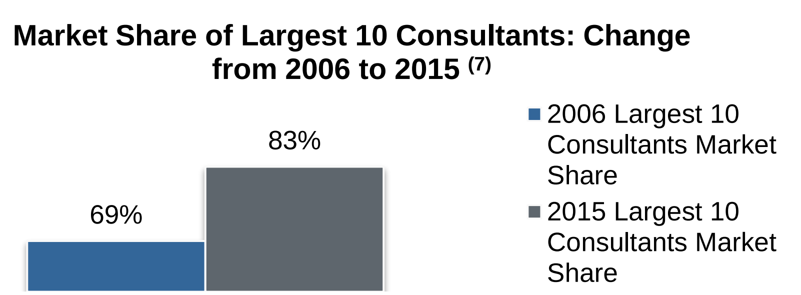
- *Do you or a related company have relationships with money managers that you recommend?*
- *Do you or a related company receive any payments from money managers you recommend?*

- *Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being a factor when you provide advice?*

- *What percentage of your plan clients utilize money managers, investment funds, brokerage services or other service providers from whom you receive fees?*

The importance of independent and conflict-free advice cannot be understated. Despite this, independent advisers are a minority in the financial services marketplace. Many firms have affiliated divisions as part of broader financial services complexes. A consultant may have affiliates that are insurance providers, asset managers, broker / dealers or all of the above. Over the past 10 years, the number of truly independent firms has shrunk. Many consulting firms have been acquired or merged. Figure 4 shows the industry shift over the past 10 years. A decade ago, the largest 10 consulting firms had 69% of market share. Today they control closer to 83%.

4: Investment Consulting Industry Consolidation



Evolution of the Governance: More than ever, investors are scrutinizing their own governance structures. At the same time, groups like the Greenwich Roundtable have published detailed guides and suggestions on how to improve governance.[3] Other authors have examined governance shortcomings and have attributed part of the problem to investment consulting and insufficient accountability for recommendations. In 2012, Charles Ellis the founder of Greenwich Associates, identified a number of criticisms of many consultants' incentives, including pressures to build over-diversified portfolios at the expense of value-added recommendations.[4] Many investors have taken a critical eye to the contributions of their consultants, while others have expanded consultant responsibilities and duties as part of restructured governance procedures.

Revenue Pressures on Consultants and Industry Consolidation: Due in part to these types of institutional pressures, many consultants have faced revenue and profitability challenges. Traditional fee-only consulting can be a difficult business model. Or more precisely, consultants may find it more profitable to enter other lines of business or develop additional sources of revenue. Whether through expansion of business lines, or acquisition of a competitor with broader revenue sources, a significant number of consultants have expanded into other businesses. Investors should ask their consultants about their business. Has the consultant expanded into other types of businesses and why? Has the consultant been an acquirer and under what circumstances?

The Move Toward Investment Outsourcing

Over the past 10 years, more investors have outsourced the management of all or a portion of their investment programs to various OCIO providers. An outsourced provider may perform roles traditionally served by investment committees. Examples of this include the selection and funding of managers, or tactical asset allocation changes. The definition of outsourcing can vary and a comprehensive industry tally of outsourcing does not yet exist. Data provided by some survey providers suggests that outsourcing has grown but still constitutes a minority of institutional investor assets.[5]

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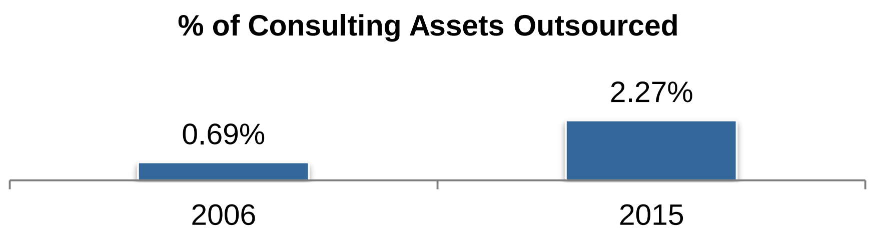
[3] Greenwich Roundtable Best Practices for Investment Committees available at http://www.greenwichroundtable.org/system/files/GR-BP-Governance.pdf
[4] "Murder on the Orient Express" available at http://www.cfapubs.org/doi/pdf/10.2469/faj.v68.n4.2
[5] Source: AICIO OCIO survey data and Pensions and Investments Consultant Surveys

5: Estimated Outsourcing Market Share



Investors commonly cite several reasons to outsource some or all of their decision making for portfolios.

- **Expertise and Speed of Implementation:** Some investors have limited resources, both in staff and budget. Feeling ill-equipped to deal with the wide array of investment strategies and funds, these investors believe an external partner may have the expertise they lack. In addition, an outsourced provider may be able to act more quickly than an internal group that must obtain committee or board approval.

- **Governance:** Some institutions use outsourcing to improve general governance, recognizing that board or a volunteer committee has limited availability. Hiring an external provider to manage certain day-to-day responsibilities may free a board or committee to focus on strategic oversight.

- **Access and Cost:** Some investors perceive their own clout with managers as inadequate. Investing in a pooled fund through an OCIO provider may allow access to a wider array of managers at potentially lower cost.

This is Now: *smart questions for today's investor on outsourcing and conflicts of interest*

The OCIO market has grown over time and today many providers offer OCIO services. But these OCIO services are not without potential pitfalls. To surface these, investors should probe for additional disclosure.

- **Highland Suggested Questions:** *What is the associated fee for outsourced services and how does it compare to a traditional advice fee? Does the consultant have an incentive to sell outsourcing? Does the OCIO business resemble an asset manager or an advisor?*

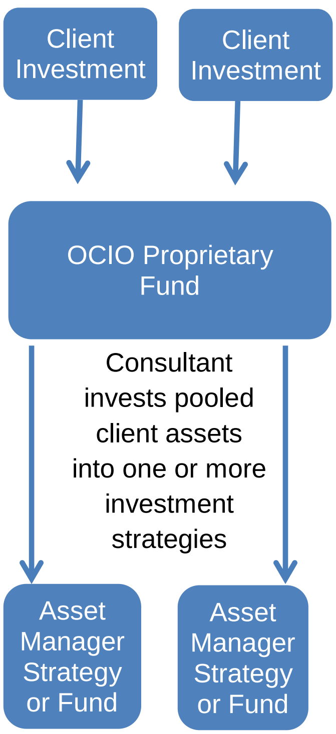
In the following sections we explore several key issues and suggest questions that investors should ask OCIO providers.

Potential Conflicts of Interest?

Revenue Pressures for Consultants: For reasons mentioned earlier, many consultants faced pressure to expand into other business lines. Service offerings with different fee structures can lead to potential conflicts of interest. A consultant may have a strong incentive to upsell a higher fee service even if that service is not best suited to the investor. Fees that some consultants charge for outsourced management can be dramatically higher than fees for traditional advice-only arrangements.

Proprietary Products or Funds: Figure 6 on the following page shows an example proprietary fund model. In most consultant proprietary funds, multiple clients invest in the same consultant fund. That fund then goes on to allocate assets among one or more managers or strategies. Consultants who offer proprietary funds may have conflicts of interest that arise due to multiple issues.

Proprietary fund model 6



- Revenue received from a client may be higher in a proprietary fund as compared to direct client investments with a third party asset manager. Proprietary funds may levy their own layer of additional management fees to offset administrative, legal costs and audit expenses. Clients may have the ability to directly invest funds with managers and avoid these additional layers of fees associated with proprietary fund vehicles.
- A proprietary fund may directly compete with clients for allocations to managers with limited capacity. Investors should ask their consultants detailed questions on how exactly allocations to managers are divided. Do client's individual allocations stand on equal footing with a consultant's proprietary fund?
- A proprietary fund may shift the research agenda of a consultant. To minimize administrative costs and maximize profitability for an OCIO firm, a proprietary fund usually needs to grow large. Often to manage that growth, a fund may need to find large number of managers to accommodate all of its assets. If a fund grows too large, it may need to make compromises in the quality of strategies and managers where it invests. The research agendas of consultants may shift from finding the highest potential investments for its smaller clients to meeting the needs of its large client: its own fund. Another more subtle conflict is any recommendation to invest in the proprietary fund. Because most proprietary funds are cost efficient when they are large, field consultants may have business incentives to recommend the usage of proprietary funds because it may improve the OCIO firm's own economics.

  - **Highland Suggested Questions:** *Do client's individual allocations stand on equal footing with a consultant's proprietary fund? Is a consultant's proprietary fund business so meaningful that it impacts the consultant's general research agenda?*

A Closer Look at Proprietary Funds

Proprietary funds, or "house brands," offered by banks, credit unions, and brokerage firms complement investors' portfolio, but investors should understand some common criticisms of the funds and ask their consultants to provide a counter point-of-view in response. Consider, for example, manager access.

Do Proprietary Funds Improve or Harm Manager Access?
The unfortunate answer to the question is "it depends." Some contend that aggregating client assets into proprietary funds increases access to higher quality managers. Let's take a closer look.

How proprietary funds may increase manager access:

- **Access to managers with high minimums:** Aggregate assets allow for larger investments with single managers. To the extent managers have very high minimum investment sizes, clients can benefit from pooling assets.

- **Negotiation of fees:** Larger asset sizes may allow negotiation of fees and terms.

- **Speed of execution for opportunistic investments:** Another argument for enhanced access is that proprietary funds invest assets faster and in unison on an opportunistic basis. This compares to an individual client allocation process where allocations may come at differing times based on committee or board approvals. Managers pursuing opportunistic or fleeting opportunities may prefer the speed and size available from proprietary funds.

Alternatively, there are counter assertions that proprietary funds impair manager access.

How proprietary funds may impair manager access:

- **Reticence of some managers to take "intermediary" assets:** Some managers have articulated desires to only take investments directly from clients rather than intermediary funds such as OCIO funds. In fact, several prominent private equity and venture capital managers have barred intermediary investors from their funds in recent years [6]

- **Managers generally maximize revenue by having multiple smaller clients versus large clients with negotiated fees:** Another argument is that top-tier managers with limited capacity seek to have a diverse client base rather than a small number of very large investors. Some managers with limited capacity may be unwilling to offer fee concessions to large investors, preferring to cultivate direct relationships with smaller investors at higher fees.

Do Proprietary Funds Allow Investors to Achieve Economies of Scale and Lower Costs of Investment?

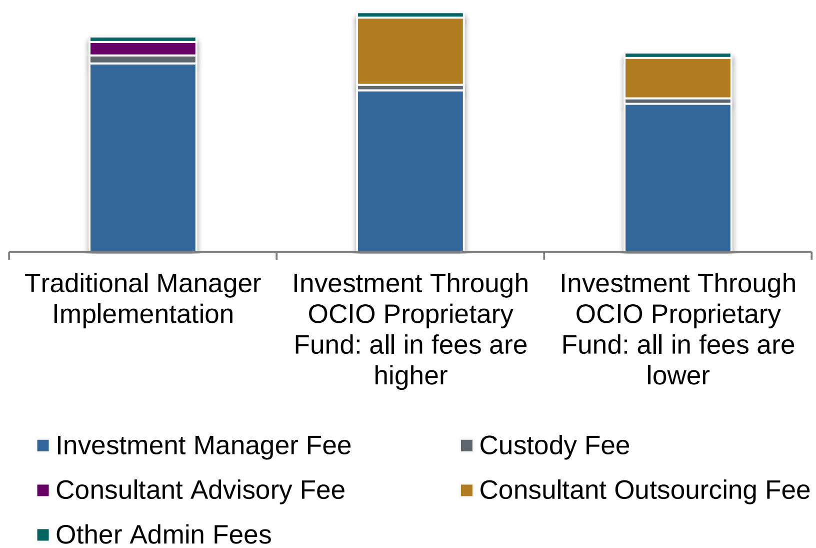
Sometimes all-in costs are higher. Sometimes they are lower: Investors need to evaluate various component costs of an outsourced arrangement. It's usually the case that some manager fee concessions have been obtained. The operative issue is the size of those concessions relative to additional fees such as an OCIO's ongoing management fee or other administrative costs. As mentioned earlier, most proprietary funds entail ongoing administrative and legal expenses. Total cost savings can and sometimes do exist for investors, but sometimes these savings can be negligible. And in other cases, costs can actually be higher than if investors implemented portfolios directly.

[6] http://www.pionline.com/article/20060612/PRINT/606120740/fund-of-funds-investors-get-shut-out-by-sequoia

6: Evaluating "All-In" OCIO Fees

Proprietary funds are one of the potential contributors to higher fees for investors who outsource investment management. Model six illustrates how these fees and fee structures may vary.

Evaluating Fee Savings From Investment Outsourcing: Hypothetical Example



Highland Suggested Questions: Investors should scrutinize proprietary funds to discover their benefits and drawbacks. Here are a few lines of questioning to help in that process:

- *What examples of increased or special access can be provided? Investors should ask about the rationale for either the pooling of client assets into proprietary funds, or an open architecture approach.*
- *Investors need to carefully review all associated fees and expenses in an OCIO arrangement. Investors need to thoughtfully compare total costs to comparable alternative portfolio structures.*

Will Investment Outsourcing Address Your Challenges?

Investment outsourcing is not a panacea for all problems. Investors should take thoughtful review of their own needs and challenges as they consider where and how outsourcing can accomplish their objectives. One of the most common issues institutional investors grapple with is the optimal structure for their investment committee. Investors must thoughtfully consider composition issues like the size of the committee and desired skill set, viewpoints, and areas of expertise needed. Investors must then take the next step of recruiting engaged and capable people to serve on these committees or boards, often on a volunteer basis. In addition, investors also must determine and delineate responsibilities among boards, investment committees and staff. John Mintz of the MacArthur Foundation cited key attributes of investment committees[7]. He said,

- *"The size of the committee should be limited to a number that provides diversity of views without risking paralysis," and that*
- *"An effective chair is important to a well-functioning committee."*

Mintz also identified pitfalls that ensnare committees and referenced these comments by Charlie Ellis:

- *"Long-term policy formation is the role and responsibility of investment committees. What's the right asset mix, what's the spending rule going to be? It's not manager selection. ... It's awfully easy to slip into a short-term focus, while maintaining a long-term focus can be hard."*
- *"Less successful committees involve themselves in more day-to-day management and the selection and termination of managers."*

Institutions can suffer unintended consequences of sub-optimal committee structures or poor relationships among the committee and staff. Some committees or boards are challenged to strike a good balance between

[7] "The Roles and Responsibilities of Investment Committees" available at https://www.macfound.org/media/article_pdfs/ARTICLEONINVESTMENTCOMMITTEESREV4.PDF

"Rather than solving a contentious relationship between committee and staff, an OCIO arrangement may simply substitute one contentious arrangement for another."

empowering staff to act but also challenging and overseeing staff. More complex structure issues like these may not be solved by hiring a new service provider. Rather than solving a contentious relationship between committee and staff, an OCIO arrangement may simply substitute one contentious arrangement for another.

Questions Every Investor Should Ask About OCIO…*and every consultant should answer*. (And Highland's approach and answers to the same)

Highland Consulting Associates equips its clients to assess their unique requirements and evaluate right-fit solutions – whatever form they take, because our allegiance is first and foremost to our clients. We are client-centered, not solution-biased. And so, we suggest investors ask their consultants these important questions. We have provided our responses as a helpful frame of reference.

- *If you allow clients to pay your consulting fees using brokerage commissions, do you monitor the amount of commissions paid and alert plans when consulting fees have been paid in full? If not, how can a plan make sure it does not over-pay its consulting fees?*
- *If you allow clients to pay your consulting fees using brokerage commissions, what steps do you take to ensure that the plan receives best execution for its securities trades?*
- *Do you internalize order flow from clients? Would you internalize our order flow?*
- *Do you sell client order flow to internalizers or other entities? Please provide a copy of your SEC Rule 606 disclosure and details of your order flow arrangements.*

Since its inception over 20 years ago, Highland has never had any affiliation with a broker-dealer, nor have we ever accepted payment through brokerage commissions or any other trading arrangement. Every dollar of revenue we have received has been pursuant to a signed contract with each client and a stated fee schedule. On an ongoing basis an invoice is sent for services and receive a check or electronic payment is approved

by the client in return. Any stakeholder of any client can know with certainty exactly what we have been paid.

- *Do you or a related company have relationships with money managers that you recommend?*
- *Do you or a related company receive any payments from money managers you recommend?*
- *Do you have any policies or procedures to address conflicts of interest or to prevent these payments or relationships from being a factor when you provide advice?*
- *What percentage of your clients utilize money managers, investment funds, brokerage services or other service providers from whom you receive fees?*

Highland has never had a related investment manager or received payments from any manager. All of our revenue comes solely from clients and our only incentive is to serve clients with our best thinking and advice.

- *Have you expanded into other types of businesses and why?*
- *Have you been an acquirer or acquired and under what circumstances?*

We have been 100% employee owned since inception. In 2009, we implemented an employee stock ownership plan to broaden employee ownership and investment in the success of Highland. Acquisition has not been a material part of our growth strategy. Historically, our client retention rate has averaged 97%. Our employee retention rate has averaged 95%.

- *What is the associated fee for outsourced services and how does it compare to a traditional advice fee? Does the consultant have a strong incentive to sell outsourcing? Does the business resemble an asset manager or an advisor?*

Be Careful What You Ask For:

Questions You Should Ask Your Consultant about
Outsourced Chief Investment Officer Services (OCIO)

For over 20 years, we have provided proactive recommendations to clients. We have also acted as an extension of staff. We regularly assist with bank trust accounts, negotiating with managers, rebalancing, and communicating with auditors and other stakeholders. Much of this activity is described in the industry as OCIO. We have traditionally treated this activity as part of the Investor Advocacy that is a core function of an ongoing retainer relationship.

"Our incentive is to help clients implement strategies which best serve them, and our compensation is not impacted by the choices that clients make."

Our approach to additional services is to preserve the same objectivity that exists in our traditional consulting business. We have only one source of revenue and a pre-determined quarterly retainer. Our incentive is to help clients implement strategies which best serve them, and our compensation is not impacted by the choices that clients make.

This principle can be extended to implemented consulting. The documentation, compliance, control environment and audit requirements of OCIO are operational functions at their core. A retainer fee can be structured to include or exclude these services. Clients who want to delegate implementation could do so; an additional fee could be incurred to reflect additional these additional operational costs. Clients who subsequently wish to return to a traditional arrangement could do so by revoking delegated authority. Clients have flexibility to choose the solutions that best meet their needs. A client seeking delegation can be thought of much like a client who seeks more frequent meetings or customized reporting. Fees can adjust based on the type of ongoing services required.

- *Do client's individual allocations stand on equal footing with a consultant's proprietary fund? Is a consultant's proprietary fund business so meaningful that it impacts the consultant's general research agenda?*

We do not have our own proprietary funds. Clients who directly own their own investments retain higher levels of flexibility. Delegation can be granted, revoked or customized based on needs at any point in time.

This allows clients flexibility to delegate as much or as little control as they wish, and to change their approach over time if needed. We believe that having no proprietary funds removes a number of potential conflicts of interest.

- *What examples of increased or special access can be provided? Investors should ask about the rationale for either the pooling of client assets into proprietary funds, or an open architecture approach. Do proprietary funds enhance or limit manager access?*

It is true that by aggregating client assets into one fund, a consultant could present a larger allocation to an investment manager and negotiate fee reductions in some situations. However, in many cases our experience shows that negotiation of fees or other terms does not require a large pooled vehicle or a single bulk allocation. Managers have often negotiated blanket fee terms which apply to any Highland client that invests, even if those allocations come on an individual basis. In our experience, managers are more concerned with the quality of clients; are they stable, knowledgeable, long-term investors? Managers are also concerned about servicing requirements that some investors have. Some investors place large demands on the time of senior portfolio managers at investment funds. They may require portfolio managers to travel to in-person client meetings several times a year. Some investors require managers to fill out lengthy inefficient questionnaires on an ongoing basis. Against this backdrop, investment managers are often willing to discount fees, waive minimums, or adjust terms for who they perceive will be a "good client" -- a client who is a long term and knowledgeable investor, who will also make good use of time by asking thoughtful questions and having well designed information requests.

These factors often trump sheer asset size when trying to gain access to quality investment managers.

For legitimate reasons many investors have considered outsourcing investment or fiduciary management, but in an increasingly complex marketplace, unintended (and often costly) consequences can result from that decision. As our clients' "Investor Advocates®" we encourage investors to ask insightful questions -- many of which are more nuanced than the questions investors might have posed just a few years ago. Likewise, investors should expect full disclosure from their consultants in order to make informed decisions. The best advice an investor can receive is client-centered and solution-neutral. Making sure you receive that begins with "being careful what you ask for."

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