401K ETHICIST

The Moral Hazard of Uninformed Consent

*Mark Mensack**

While the notion of voluntary informed consent is a familiar concept in bio-medical ethics, this column applies this patient-physician issue to the 401k advisor-plan sponsor relationship. This article explores the conditions necessary for ethical decision making, particularly the distinction between information and knowledge, and argues that a moral hazard often exists in both relationships. The medical community addresses this moral hazard by mandating that a physician has a fiduciary obligation to put the patient's best interests first. The author argues that Wall Street not only fights against a fiduciary standard to address this moral hazard, but the amended Rule 408(b)(2), the SEC and FINRA exacerbate the hazard.

The inaugural 401k Ethicist column published in November generated a number of comments, but the most disturbing were quips that writing about ethics involving Wall Street was a comical contradiction. Some pointed to the dearth of Wall Street ethical behavior leading up to the 2008 market collapse, others pointed to the current number of fraudulent mortgage foreclosures, and a few mentioned the Muppets at Goldman Sachs.

While many might sneer at the notion of ethics on Wall Street, Mary Ann Gadziala, of the SEC, Office of Compliance Inspections and Examinations, explains that according to the Securities Exchange Act of 1934, "securities in transactions are affected with the national interest, and must be conducted so as to protect interstate commerce and to insure the maintenance of fair and honest markets in such transactions. These general mandates require that market participants operate with the

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Mark has presented to national and state organizations on fiduciary and professional ethics issues, including the American Institute of CPAs, the Center for Fiduciary Studies, the Pennsylvania Institute of CPAs, the New Jersey Society of CPAs, and the Pennsylvania State Society of HR Management (SHRM). Some of Mark's articles and presentations regarding the topics mentioned here can be found at www.PrudentChampion.com.

Mark welcomes comments and criticisms, and suggestions for future topics. He also welcomes examples of ethical issues in the retirement plan space, and especially misleading 401k marketing materials at 401kEthicist@PrudentChampion.com.

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highest ethical standards and integrity and comply with all laws and rules intended to achieve these goals."[1]

More recently SEC Commissioner Luis Aguilar spoke about trust being "the foundation of the capital markets, and some of the ways in which the financial crisis may have damaged that trust." He also echoed the words of FBI Director Robert Mueller, who stated that securities fraud "poses a great challenge, because our free market economy and, indeed, our whole way of life, are built on trust—trust in the markets, and trust in our fellow citizens."[2]

The focus of this column will be to discuss the notions of voluntary informed consent and moral hazard within the retirement plan industry in order to identify a factor for why America has so little confidence in the ideals of trust and high ethical standards on Wall Street.

VOLUNTARY INFORMED CONSENT

Let's begin with an ethical issue with which most of us are familiar, the notion of voluntary informed consent in making medical decisions. For multiple reasons, medical decisions regarding ourselves or our loved ones are some of the most difficult any of us will ever make. Like any significant decision, one must be well informed, but taken as a concept the words *voluntary, informed* and *consent* are a three-prong requirement fraught with ethical pitfalls.

At its most basic definition, to consent means to agree or say yes. But at the more complex ethical level consent must include capacity, or the ability to make a rational decision. Consider the standard phrase found in one's will: "I Mark Mensack, being of sound mind . . ." In both legal and ethical situations we attribute less responsibility to the words or actions of someone who is not of sound mind. For example, capacity in the case of an advanced stage Alzheimer's patient, or an accident victim writhing in pain, is doubtful. One might also question the capacity of someone in a highly emotional state of grief or even someone who took sleeping pills the night before making an important decision.

The notion of "voluntary" is also standard language in a will, such as, "I am not acting under duress or undue influence of any person." If I consent to a course of action because of coercion or a threat, it is not voluntary consent. Nor is it voluntary consent if I am only presented with unacceptable options. For example, imagine a stage four cancer patient given a choice between an experimental treatment fraught with painful side-effects or death. One typically isn't making a voluntary decision when choosing between a rock and a hard place.

Finally, the concept of being informed is perhaps the most problematic of the three. To be informed is not merely a matter of disclosure. One must not only have all of the material facts bearing upon the decision, one must be able to comprehend these facts. The act of becoming informed has two parts; one must obtain information from a source, and then one must comprehend this information relative to the decision one is making.

Many challenges can arise in obtaining the relevant information. A physician might not provide all of the relevant information or provide it in a comprehensible manner, or perhaps provide false information, or provide the information in such a way as to deceive or mislead. On the receiving end, the patient might lack the intellectual ability to comprehend a significant amount of information or information that is perhaps too complex. It could also be the case that the patient has the ability, but not enough time to comprehend.

VOLUNTARY INFORMED CONSENT ON WALL STREET

The ethical necessity of voluntary informed consent can be

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found in many situations outside of the medical arena, especially those where significant risk or responsibility are a consideration. Just as a patient relies on a physician to provide medical information in order to make medical decisions, most Americans depend upon Wall Street to provide information in order to make investment decisions. In *A Modal Evaluation of Sales Practices*, David M. Holley explores the ethics of sales practices and his work can serve as a model for how voluntary informed consent applies to Wall Street and the investing public.

Holley focuses on the conditions of an ideal exchange that correspond to the three prongs of voluntary informed consent. His first condition states that both the buyer and the seller must "understand what they are giving up and what they are receiving in return."[3] Implicit in this condition are the concepts of being informed of, and comprehending, the material information of a transaction. Holley does not qualify the necessity of comprehending all of the material information. He argues that if "the prospective buyer lacks some piece of knowledge that might be relevant to the decision to buy. The conditions for ideal exchange are not met."[4]

His second condition requires that "nether buyer nor seller is compelled to enter into the exchange as a result of coercion, severely restricted alternatives, or other constraints on their ability to choose," which is synonymous with the explanation of the word *voluntary* in the medical ethics arena.[5] Holley makes a valuable qualification on this condition when he notes that "another way the condition of uncompelled choice might be subverted is by involving a customer in a purchase without allowing her to notice what is happening."[6] The significance of this qualification will become apparent shortly.

His third condition requires that "both buyer and seller are able at the time of the exchange to make rational judgments about its costs & benefits."[7] This condition relates directly to the notions of capacity and consent in the making medical decisions.

IT'S ALL ABOUT KNOWLEDGE

While television, newspapers and the internet inundate all of us with information, information only becomes valuable knowledge once we comprehend it. Knowledge has been critical to ethical decision making for centuries, and a good example of this can be found in the ethical theory of Immanuel Kant. The key concept to Kantian ethics is the Categorical Imperative, which states, in part, "Act only according to that maxim whereby you can at the same time will that it should become a universal law without contradiction." Kant's writing is pretty dense so here is a more accessible version: *If everyone knew what you were doing, would you still be able to do it?*

Kant uses the example of a person wishing to borrow money with no intention of paying the money back. He poses the question, what if it was universally known that people who borrow money don't pay it back? Kant argues that if this was the case, a contradiction is created. In other words, if everyone knew that you had no intention of paying back a loan, no one would lend you money in the first place.

Unfortunately, on Wall Street, specifically in the retirement plan market, there is rarely universal knowledge that causes a contradiction such that Wall Street wrongdoing can be prevented.

THE MORAL HAZARD

All the information retirement plan sponsors need to comprehend in order to attain voluntary informed consent, and fulfill their fiduciary duties, is available on the Internet. However, while brokerage firms train their 401k salespeople with enough knowledge to sell 401k plans, few plan sponsors have the

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time to comprehend enough of the necessary information in order to attain Holley's conditions for an ideal transaction.

This imbalance of knowledge that prevents the ideal transaction is sometimes described as the principal-agent problem. Referring back to our physician-patient examples, the physician is an agent with a significant knowledge advantage over the patient or principal. Most patients will not fully comprehend all of the information their physician provides, and therefore the patient must trust that the physician is acting in the patient's best interest. The Hippocratic Oath and the medical profession set a fiduciary standard whereby it is typically the case that physicians do indeed act in the best interest of their patients.

On Wall Street, where brokerage firms have fought against being subject to the fiduciary standard to act in their client's best interests, this imbalance of knowledge can result in moral hazard. An example of moral hazard is where the brokerage firm has more knowledge regarding the plan sponsor's fiduciary duties than the plan sponsor.

Another aspect of moral hazard is that the more knowledgeable agent may take greater risk than the less knowledgeable principal, because the agent has incentive to do so, or faces minimal downside risk, or is insulated from the ramifications of that risk. The prime example of this aspect are the mortgage companies that foisted subprime mortgages on to borrowers who had little if any knowledge of the downside risk of these sorts of mortgages. Additionally, shortly after originating a risky mortgage, these companies could transfer their risk to eager investors. These eager investors believing they were investing in AAA rated securities had no knowledge of the risk they were assuming.

INSULATION FROM RISK AND PLATO'S RING OF GYGES

While these mortgage companies were able to transfer the risk off their books shortly after a mortgage was sold, there is a second, more disturbing aspect to this moral hazard that Plato described in the Republic.

Gyges was a shepherd for the king of the land. One day, there was an earthquake while Gyges was out in the fields, and he noticed that a cave had opened up on the side of a mountain. When he went to investigate, he discovered the tomb of an ancient King, and on the finger of the corpse was a gold ring. He took the ring and soon discovered that it allowed the wearer to become invisible. Gyges realized that if he was invisible, he could do whatever he desired with no fear of punishment. The next time he went to the palace to give the king a report about his sheep, he put the ring on, killed the king, seduced the queen, and ruled the land.

In every philosophy course I teach, I survey my students on the following question, if you actually received that ring today and knew you were insulated from the risk of punishment for your actions, what would you do today that you would not have done yesterday when there was risk of punishment? An honorable person would probably think to themselves that they would do nothing different because they do the right thing, because it is the right thing to do. Unfortunately, Plato feared that most people would only do the right thing because they feared punishment.

Given the absence of criminal prosecution of Wall Street executives, it's not a stretch to realize that the SEC and FINRA have given Wall Street, or at least the big players on Wall Street the Ring of Gyges. SEC and FINRA critic Larry Doyle makes this argument often, albeit without mentioning the Ring of Gyges, in his Sense on Cents blog. He notes that prosecutions of financial frauds are at a 20 year low and also argues

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that this free pass is "the cause of so much underlying rage and anxiety in our country."[8]

In a blog entitled "Preet Bharara On Too Big to Prosecute" I think Doyle captures how this moral hazard has damaged America's trust when he writes, "I firmly believe that the overwhelming majority of people in our nation embrace the principle of fair play and understand when that principle has been violated. In the process of that violation, people want justice to be served."[9]

THE RING OF GYGES IS REAL

My argument that the SEC and FINRA have given Wall Street the Ring of Gyges might merely be an analogy; however, the Supreme Court of the United States giving FINRA the Ring is fact. Most Americans don't realize that FINRA is a private corporation, not a government agency. FINRA has governmental powers, but it is not subject to the Administrative Procedures Act and can deny American citizens their constitutional right to due process. In Standard Investment Chartered, Inc. v. FINRA the Supreme Court ruled that FINRA is immune from prosecution![10]

So long as any organization in America stands above the Constitution, particularly one who's "chief role is to protect investors by maintaining the fairness of the US capital markets is supposed to the foundation of the capital markets" the Ring of Gyges will exist in America.[11]

THE MORAL HAZARD OF RETIREMENT PLAN FEE DISCLOSURE

Under Rule 408(b)(2) plan sponsors have always had the fiduciary duty to, understand all fees being paid by their plan; identify all compensation received by their service providers; and to ensure that those fees and compensation were reasonable relative to the services being provided. However, what Rule 408(b)(2) did not require was for service providers to disclose all of their fees and compensation the plan sponsor required in order to comply with Rule 408(b)(2). The recently amended Rule 408(b)(2) was intended to fix this obvious imbalance of information, but it has actually made it worse. Although common sense dictates that the DOL, or some state or federal agency, would be responsible to ensure that service providers comply with 408(b)(2), this is not the case. Under the amended rule, it's the plan sponsor's responsibility to ensure that its service provider complies with 408(b)(2)! If the plan sponsor fails to identify excessive fees or compensation, then both the plan sponsor and the service provider are liable for having been engaged in a prohibited transaction.

Jeff Mamorsky, one of the original authors of ERISA, explains that the "burden of having to reasonably believe that service providers disclosed the requisite information is of great concern."[12] This hen must ask the fox if the chicks are safe scenario is fertile ground for moral hazard.

Mamorsky goes on to say that, "in effect, the employer plan sponsor must retain experts to ascertain compliance with the regulations and identify all *hidden* fees."[13] In other words, the hen must hire an independent fox to ensure that initial fox hired is taking care of the chicks! The moral hazard lies in the fact that between the DOL, the service provider and the plan sponsor, the plan sponsor has the least amount of knowledge, but faces the greatest potential risk.

AM I TAKING THIS FOX AND HEN MORAL HAZARD EXAMPLE TOO FAR?

The service provider might be tempted to take advantage of the plan sponsor by acting in a way that benefits the brokerage firm while placing the plan sponsor at greater risk. An example of this moral hazard in the re-

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tirement plan industry is Haddock v. Nationwide. Haddock, representing the trustees of a retirement plan utilizing a Nationwide 401k product, alleged that Nationwide was a fiduciary and its acceptance of revenue sharing compensation from the mutual funds within the Nationwide product was in violation of ERISA's exclusive benefit rule.

Nationwide argued that it was not a fiduciary and that the revenue sharing compensation was legal. The Haddock trustees, and the members of the class action, are indisputably acting as fiduciaries, and therefore face the potential risk of personal liability if they don't attempt to recover the additional compensation paid to Nationwide. Taking an all or nothing risk, Nationwide filed a counter-class action against all of the Haddock trustees. 401k Industry Critic Dan Solin summarizes Nationwide's argument: "It argued that, to the extent the plans were harmed by its revenue sharing arrangement, the trustees (its clients!) were responsible to reimburse them because of their ". . . failure to exercise reasonable prudence and care. "Solin summarizes Nationwide's argument in moral hazard language, "If our conduct caused harm to the plan participants, it was our clients' fault for not being smart enough to put a stop to it."[14]

While Nationwide's countersuit was dismissed, the arrogance necessary to make such an argument is astounding! Moreover, Nationwide's retirement plan business has not noticeably suffered as a result of such chutzpah.

CONCLUSION

The medical community minimizes the danger of moral hazard by enforcing a strong code of ethics and maintaining a fiduciary standard of care for patients that puts the patient's interest first. Until Wall Street is required to act under a fiduciary standard, retirement plan sponsors and all American investors ought to fear this moral hazard.

NOTES:

[1]Rebuilding Ethics and Compliance in the Securities Industry, http://www.sec.gov/news/speech/spch062305mag.htm.

[2]SEC Commissioner Luis Aguilar, http://www.sec.gov/news/speech/2012/spch101812laa.htm.

[3]David M. Holley, A Modal Evaluation of Sales Practices https://portfolio.du.edu/portfolio/getportfoliofile?uid=151826.

[4]Ibid.

[5]Ibid.

[6]Ibid.

[7]Ibid.

[8]Doyle, lack of prosecution, http://www.senseoncents.com/?s=lack+of+prosecutions+on+wall+street.

[9]Doyle http://www.senseoncents.com/2012/07/preet-bharara-on-too-big-to-prosecute/.

[10]Haddock: No. 3:01 cv 1552. US District Court for the District of Connecticut.

[11] www.FINRA.org.

[12]Mamorsky: http://www3.cfo.com/article/2012/5/retirement-plans__mamorsky-traurig-401k-fee-disclosure-erisa-dol-dingwell-ebsa?currpage=0.

[13]Mamorsky: http://www3.cfo.com/article/2012/5/retirement-plans__mamorsky-traurig-401k-fee-disclosure-erisa-dol-dingwell-ebsa?currpage=0.

[14]Haddock v. Nationwide http://www.huffingtonpost.com/dan-solin/nationwide-tosses-its-401__b__666934.html.

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