



FIDUCIARY PLAN GOVERNANCE, LLC

PEBA's 32nd Annual Forum

The Ethics of 401(k) Administration

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AGENDA

- Ethics on Wall Street?
- Ethical Underpinnings of ERISA
- Negative and Affirmative Ethical Obligations
- Moral Hazard
- Criteria for Ethical Decision Making
- Ethical Pitfalls



Ethics on Wall Street

- The Securities Exchange Act of 1934 states that 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 highest ethical standards and integrity* and comply with all laws and rules intended to achieve these goals.
- “The Commission’s mission starts with an uncompromising commitment to *the highest ethical standards...*”

SEC General Counsel David Becker



Ethics on Wall Street

The *foundational rule in FINRA's rather large rule book is an ethical one*: that brokerage firms must conduct their business in accordance with *“high standards of commercial honor and just and equitable principles of trade.”*

Mary Shapiro, CEO, FINRA 10/14/08

What's most important of all is for market participants—from senior executives to individual investors—to *possess a commitment to ethics, integrity, and professional responsibility.*

Rick Ketchum, CEO, FINRA, 10/2/09



Ethics on Wall Street?

- The financial services industry is at a crossroads - we are faced with a little-before seen crisis in the global economy and several instances of *publicized lapses in professional ethics.*

“Enhancing Professional Conduct in the Financial Services Industry” FINRA

- “Wall Street’s *moral lapses call into question the moral justification for capitalism.*”

Joseph Grundfest SEC Commissioner, 1987

- “Wall Street needs to *re-establish trust, honesty...*

John Mack, October 13, 2010



Ethics on Wall Street?

In Gallup's 2009 polling just *19% said the honesty and ethical standards of bankers were high*; 12% felt that way about business executives, and *9% about stockbrokers*. Stockbrokers were tied with members of Congress. Both ranked only slightly above HMO managers (8%) and car salesmen (6%), who took last place in the poll.

Forbes 4/5/10 Karlyn Bowman

There are *many professions in which one can find examples of hollow values, but nowhere is it more evident than on Wall Street...*

Jon Huntsman, Winners Never Cheat



Ethics on Wall Street?



"The First Rule for Fiduciaries Is to Put Their Interests Last."

Ethics on Wall Street?

Goldman Sachs Business Principles

"Our clients' interests always come first. Our experience shows that if we serve our clients well, our own success will follow."

"We are dedicated to complying fully with *the letter and spirit of the laws, rules and ethical principles that govern us.* Our continued success depends upon unswerving adherence to this standard."

"Integrity and honesty are at the heart of our business."



Ethics on Wall Street?

“Puffery” has been described by one legal scholar as vague statements of corporate optimism that is often characterized as *“so obviously unimportant to a reasonable investor that reasonable minds could not differ.”*

Dan Solin: “Puffery’ Can Blow Away Your Retirement Goals”

Puffery: *“an exaggerated, blustering, and boasting statement upon which no reasonable buyer would be justified in relying”* or “a general claim of superiority over comparable products that is so vague that it can be understood as nothing more than *a mere expression of opinion.*”

U.S. Court of Appeals for the Fifth Circuit, 1984



Ethics on Wall Street?

Goldman's attorney's argument against an investor class action:

"Further, the vast majority of the supposed "misstatements" alleged in the Complaint -- e.g., regarding the firm's *"integrity"* and *"honesty"* -- *are nothing more than classic "puffery"* or statements of opinion that, under well-settled law, cannot give rise to a securities fraud claim."

*United States District Court for the Southern District of New York
(In re Goldman Sachs Group, Inc. Securities Litigation: Master File No. 1:10-cv-03461)*



Ethics on Wall Street?

"[I]f Goldman's claim of *"honesty"* and *"integrity"* are *simply puffery*, the world of finance may be in more trouble than we recognize."

U.S. District Judge Paul A. Crotty, June 21, 2012



Ethics on Wall Street?

- Charters v John Hancock

John Hancock countersued their client (Charters) for breach of fiduciary duty, monetary contribution and indemnity *for being negligent in hiring John Hancock in the first place.*

- Haddock v Nationwide Life

“If Nationwide Life is found to have violated ERISA by arranging for, receiving, and retaining payments from *funds...then the Trustees are reckless and also at fault* to the extent the Plans suffered harm..., because the Trustees had the ultimate responsibility for managing the Plan, and investing Plan assets.”

“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.”

Dan Solin, Nationwide Tosses Its 401(k) Clients Under the Bus



Ethical Underpinnings of ERISA

- ERISA §404(a)(1)(a) = Exclusive Benefit (Loyalty)
 - Act “*solely in the interest* of the participants...and for the *exclusive purpose* of providing benefits to participants”
- ERISA § 404(a)(1)(b) = Prudent Expert (Due Care)
 - “with the *care*, skill, *prudence* and diligence”
- ERISA § 406(a)(1)(c) = Prohibited Transactions



Ethical Underpinnings of ERISA

ERISA § 406(a)(1)(c) prohibits plan assets to be used to pay **ANY** party in interest for **ANYTHING!** Violation of this statute is a prohibited transaction!

ERISA §408(b)(1) provides a prohibited transaction exemption only if three criteria are met:

1. The services must be ***necessary*** for the operation of the plan;
2. The services must be furnished under a ***contract or arrangement which is reasonable*** and;
3. No more than ***reasonable compensation*** is paid for the service.



Ethical Underpinnings of ERISA

Reasonable Compensation

Principle of Utility - Requires an empirical evaluation to provide the greatest good for the greatest number of people involved, or alternatively, the least harm to the least number of people involved.

Reasonable Contract or Arrangement

Principle of Justice – Requires a theoretical evaluation based on fairness and reasonableness.



Ethical Underpinnings of ERISA

Loyalty & Due Care

“Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. *A trustee is held to something stricter than the morals of the market place.* Not honesty alone, but the *punctilio of an honor the most sensitive, is then the standard of behavior...* the level of *conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd.*”

Chief Judge Benjamin Cardozo



Negative & Affirmative Obligations

A Cadet will not lie, cheat, steal,
or tolerate those that do.

West Point Honor Code

“Fiduciaries are not sued for what they do,
instead they are sued for what they do not do.”

Fred Reish



Negative Ethical Obligation

A Cadet will not lie, cheat, steal,

- A negative ethical obligation refers to an act that we ***should not perform.***
- One has self-control regarding these acts
- AKA: A Sin of Commission



Affirmative Ethical Obligations

or tolerate those that do.

- An affirmative ethical obligation *requires one to act* relative to the actions of another
- One cannot control the actions of another
- AKA: A Sin of Omission
- Potential for personal repercussions for fulfilling an affirmative ethical obligation



Moral Hazard

- **Information Asymmetry** occurs when one party to a transaction has much more information about the transaction than the other party.
 - Sometimes described as the principal-agent problem.
- **Risk Asymmetry** is where one is likely to take greater risk in a transaction, if one is unlikely to face any potential negative repercussions.
 - Greater risk usually tempers one's desire for greater return; however, if one could obtain greater return at no personal risk, how much would one wager?



Moral Hazard

Information Asymmetry

Service providers typically have greater knowledge regarding the investment vehicle and a plan sponsor's fiduciary duties than the plan sponsor.

“Unless they possess the necessary expertise to evaluate such factors, fiduciaries would need to obtain the advice of a *qualified, independent expert.*”
DOL Reg. § 2509.95-1(c)(6)

“Plan sponsors were *challenged by complex fee arrangements and likely paid more than they realized*”
GAO-12-325 Survey

“Insurance product fees can be *difficult for plan sponsors to identify and evaluate*”
GAO-12-325 Survey



Moral Hazard

Risk Asymmetry

A service provider faces minimal, if any, risk in selling an imprudent product, while a plan sponsor faces great risk for choosing an imprudent product.

A fiduciary is *personally liable for any losses* the plan incurs by reason of its breach. *ERISA § 409*

ABB, Inc., the ABB pension and *benefits committees, and the individuals serving on these committees* (collectively “Plan Fiduciaries”) were found *jointly and severally liable for \$35.2 million* in damages.



Moral Hazard

Is Your Company's 401(k) Plan Operated by any of these Insurance Companies?

**TRANSAMERICA
LINCOLN FINANCIAL GROUP
HARTFORD FINANCIAL GROUP
NATIONWIDE
AXA, OR
JOHN HANCOCK**

If So, You May Have Legal Claims Against, Transamerica, Lincoln Financial Group, hartford financial Group, Nationwide, AXA or JohnHancock.

These potential claims are related to fees and charges taken from retirement assets by Transamerica, Lincoln Financial Group, Hartford Financial Group, Nationwide AXA, or John Hancock.

For a free consultation to learn more about your potential claims contact Robert L. Lakind, Esq. at (609)276-0400 or rlakind@szaferman.com

KNOW YOUR RIGHTS! WE CAN HELP!

CONTACT THE FIRM OF
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Attn: Robert Lakind, Esq.

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1-609-275-0400

1-888-534-2571

*Newark Star-Ledger
August 28th, 2010*



Criteria for an Ethical Transaction

Voluntary:

“Neither 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.”

Informed:

“Both the buyer and the seller must *understand* what they are giving up and what they are receiving in return.”

Consent:

“Both buyer and seller are able at the time of the exchange to make *rational judgments* about its costs & benefits.”

A Modal Evaluation of Sales Practices, David M. Holley



Voluntary?

- **Firm selling 401k products** – We only provide our clients with products that pay us for “shelf space.”
- **Product Provider** – We only include investment options on our platform that pay us for “shelf space.”
- **TPA** – I recommend XYZ products; once we have \$25 million with them they pay us an additional 10 bps override
- **Salesperson** – I recommend investment options that pay me a higher commission.



Informed?

Disclosure \neq Informed

Does the client have the haystack or the needle?

Does the client have information or knowledge?



Informed?

Needle in a Haystack QUIZ

- How many pages of documentation must a plan sponsor review in order to read all of the available information regarding fees, compensation & potential conflicts of interest?

(Lets assume there is just one mutual fund in the plan!)

- a) 127
- b) 539
- c) 827



Informed?

Needle in a Haystack Quiz

1. Prospectus – 72 pages
2. SAI– 285 pages
3. Annual Report – 44 pages
4. Semi-Annual Report – 36 pages
5. Group Annuity Contract – 33 pages
6. Plan Level Documents – 58 pages
7. Adm. Service Agreement – 11 pages

539 pages!



Informed?

FOOTNOTES FOR INVESTMENT FUNDS PERFORMANCE

For Period From July 01, 2010 through September 30, 2010

Contract Number [REDACTED]

⁴¹ Transamerica Aggressive Growth Ret Opt- Effective 01-29-07, the Transamerica Aggressive Growth Fund changed its name to the Transamerica Aggressive Growth Ret Opt.

⁴² Transamerica Balanced Ret Opt- Effective 01-29-07, the Transamerica Balanced Fund changed its name to the Transamerica Balanced Ret Opt.

⁴³ Transamerica Core Equity Ret Opt- Effective 01-29-07, the Transamerica Core Equity Fund changed its name to the Transamerica Core Equity Ret Opt. Effective 02-11-02, the Transamerica Value Fund changed its name to the Transamerica Core Equity Fund to be consistent with its expanded investment criteria.

⁴⁴ Transamerica Partners Core Bond Ret Opt - The Transamerica Partners Core Bond Ret Opt invested in the Investor Class Shares of the underlying mutual fund prior to 05-14-10 but currently invests in the Transamerica Partners Core Bond Ret Opt. Account charges changed. The IM and Admin Charges are 0.93%. No adjustments have been made to reflect the difference between the charges and expenses for the Separate Account invested in the mutual fund in the collective trust fund. This Separate Account was named Diversified Investors Core Bond Ret Opt before 06-30-08.

The IM and Admin Charges are 0.93%

⁴⁵ Transamerica Partners High Quality Bond Ret Opt - The Transamerica Partners High Quality Bond Ret Opt invested in the Investor Class Shares of the underlying mutual fund prior to 05-14-10 but currently invests in the Transamerica Partners High Quality Bond Ret Opt. Account charges changed. The IM and Admin Charges are 0.94%. No adjustments have been made to reflect the difference between the charges and expenses for the Separate Account invested in the mutual fund in the collective trust fund. This Separate Account was named Diversified Investors High Quality Bond Ret Opt before 06-30-08.

The IM and Admin Charges are 0.94%

⁴⁶ Transamerica Partners Large Core Ret Opt - The Transamerica Partners Large Core Ret Opt invested in the Investor Class Shares of the underlying mutual fund prior to 05-14-10 but currently invests in the Transamerica Partners Large Core Ret Opt. Account charges changed. The IM and Admin Charges are 1.11%. No adjustments have been made to reflect the difference between the charges and expenses for the Separate Account invested in the mutual fund in the collective trust fund. This Separate Account was named Diversified Investors Large Core Ret Opt before 06-30-08.

The IM and Admin Charges are 1.11%

⁴⁷ Transamerica Partners Large Value Ret Opt - The Transamerica Partners Large Value Ret Opt invested in the Investor Class Shares of the underlying mutual fund prior to 05-14-10 but currently invests in the Transamerica Partners Large Value Ret Opt. Account charges changed. The IM and Admin Charges are 0.97%. No adjustments have been made to reflect the difference between the charges and expenses for the Separate Account invested in the mutual fund in the collective trust fund. This Separate Account was named Diversified Investors Large Value Ret Opt before 06-30-08.

The IM and Admin Charges are 0.97%

⁴⁸ Transamerica Partners Mid Value Ret Opt - The Transamerica Partners Mid Value Ret Opt invested in the Investor Class Shares of the underlying mutual fund prior to 05-14-10 but currently invests in the Transamerica Partners Mid Value Ret Opt. Account charges changed. The IM and Admin Charges are 1.21%. No adjustments have been made to reflect the difference between the charges and expenses for the Separate Account invested in the mutual fund in the collective trust fund. This Separate Account was named Diversified Investors Mid-Cap Value Ret Opt before 06-30-08. The historical return prior to 09-30-01 is calculated based on the Mid Cap Value Mutual Fund (Institutional Shares) Composite performance of the initial sub-adviser (Cramer, Rosenthal, McGlynn, LLC), but is adjusted to reflect the 1.25% total operating expenses of the underlying mutual fund.

The IM and Admin Charges are 1.21%

Consent?

“For many plan sponsors, investment and other *fiduciary responsibilities can seem overwhelming. That’s where we can help.*”

“We are *dedicated to making your retirement plan a success* and, at the same time, *helping you meet your fiduciary responsibilities.*”

“When it comes to meeting your complete fiduciary responsibilities as a retirement plan sponsor, there are many considerations. *XYZ Firm can help you make sense of it all.*”



Consent?

“If I know *he’s a salesman, I will evaluate his recommendations differently*,...When he is an adviser, I don’t question him, I assume he is a *better expert* than I am.”

Professor Tamar Frankel, Boston University

“The *greatest risk* the average investor runs is the *risk of being misled* into thinking that the broker is acting in the best interest of the client, as opposed to acting in the firm’s interest.”

Professor Arthur Laby, Rutgers School of Law



Criteria for Ethical Decision Making

“Make a habit of two things: to help, or at least, to do no harm.”

Hippocrates 400BC

Beneficence: an affirmative obligation that means “do good.”

- One ought to act in ways that promote the well-being of others.

Non-maleficence: a negative obligation that means “do no harm.”

- One ought to act in ways that do not cause harm to others.*

****Includes the negative obligation not to do harm inadvertently or by carelessness, or malice or negligence.***



Ethical Pitfalls

Paltering:

To intentionally deceive or mislead without making a false statement in order to advantage one's self and /or disadvantage another



Ethical Pitfalls

Paltering = Equivocation: making an indirect, **ambiguous**, or contradictory statement. To use one word but for multiple meaning, or two words with the same meaning.

*XYZ Firm receives payments of **up to** 0.15% on new asset purchases made by the plan. These payments **may be** referred to as “revenue sharing” **under some circumstances**. The payments are made by the ABC Company to XYZ Firm. Your Financial Advisor does not receive any part of these payments. Amounts payable by ABC Company to XYZ Firm do not result in an additional **direct charge** to your Plan or to the products, **except to the extent** ABC Company applies an asset charge or other charge and pays compensation to XYZ Firm from its general revenues.*



Ethical Pitfalls

Paltering = Concealment: omitting information that is material to the context, or hiding material information

Fiduciaries are required to know all expenses that are being paid by the plan, directly or indirectly, and to determine if they are reasonable (that is, whether the expense is competitive in the marketplace and whether the plan and its participants receive value commensurate with the cost). In addition, *the advisor should be able to explain the structure of the compensation he or she individually receives* from each investment. Fiduciaries are not required to choose the least expensive services; rather, they should ensure that they are getting good value for the plan's money.



Ethical Pitfalls

Needle vs. Haystack Quiz #2

Under Rule 408(b)(2), suppose a Service Provider needed to disclose compensation in the amount of \$496,000.

How many words would be reasonably necessary to fill in the blank?

ABC Firm is paid _____.

- a) “\$496,000” is a number; No words are necessary.
- b) It depends on what the meaning of is is.
- c) 93 words



Ethical Pitfalls

“In 2011, when viewed in relation to total XYZ client assets of in excess of \$1.6 trillion, the payment made *by each** such service provider...equaled an amount of not more than 31/10,000 of one basis point (otherwise expressed, 31/1,000,000 of one percent). *We do not believe that such payments were made in connection with retirement plan business specifically, and were certainly not made in connection with any particular retirement plan,* but, for perspective, the amount of retirement plan assets included in the total XYZ client asset number set forth above is approximately \$112 billion.”

**28 service providers listed below this paragraph*

c) 93 Words!



Ethical Pitfalls

“In 2011, when viewed in relation to total XYZ client assets of in excess of \$1.6 trillion, the payment made by each such service provider... equaled an amount of not more than 31/10,000 of one basis point (otherwise expressed, 31/1,000,000 of one percent).”

$$31/10,000 = 0.0031\% \text{ or } 0.00000031$$

$$\$1,600,000,000,000 \times 0.00000031 = \$496,000$$

\$496,000 from EACH

28 listed (“but other providers may have made similar payments.”)

$$28 \times \$496,000 = \$13,888,000?$$



Ethical Pitfalls

Excerpt from a “Fiduciary Warranty”

“...we are committed to helping you meet the highest fiduciary standards in the investment selection and monitoring process and commit to restore losses and pay litigation costs in the event that legal action is brought against qualifying plans. Now that’s security for your plan!”

“Review the minimum Fund requirements and a copy of the Warranty Certificate to see if your plan qualifies.”



Ethical Pitfalls

“Also, since past performance is not a guarantee of future results, we cannot warrant or guarantee either that any investment option will yield any specific return, or even that it will yield a positive return. *Nor does our Fiduciary Standards Warranty extend to claims that any expenses paid directly or indirectly by the Plan are reasonable.*”



Ethical Pitfalls

Fee /Share Class	A	R-1	R-2	R-3	R-4	R-5	R-6
Management Fee	0.43%	0.43%	0.43%	0.43%	0.43%	0.43%	0.43%
Distribution and/or 12b-1 Fees	0.24%	1.00%	0.75%	0.50%	0.25%	none	none
Sub-TA and Other Fees	0.18%	0.21%	0.48%	0.22%	0.18%	0.13%	0.09%
Total Expense Ratio	0.85%	1.64%	1.66%	1.15%	0.86%	0.56%	0.52%
Annual Cost per \$1MM	\$8,500	\$16,400	\$16,600	\$11,500	\$8,600	\$5,600	\$5,200



"The First Rule for Fiduciaries Is to Put Their Interests Last."

Ethical Pitfalls

- ***Separate Account Investment Management Fee***
 - ABC periodically withdraws a separate account investment management fee from each separate account. ***This fee will be at a daily rate that on an annual basis does not exceed 1.0%*** of the average daily SIA Market Value of the applicable Separate Investment Account.
- ***Separate Account Services Fee***
 - For each asset allocation and alternative equity separate investment account, ABC may periodically withdraw a fee for ancillary separate account services. ***This fee will be at a daily rate that on an annual basis does not exceed 1.0%*** of the average daily SIA Market Value of the applicable Separate Investment Account.



Ethical Pitfalls

	1 mo.	3 mos.	YTD	1 yr.	3 yrs.	5 yrs.	10 yrs.	Since* Inception	Expense Ratio
Vanguard Target Retirement 2030 Ret Opt	-0.54	10.59	7.58	9.53	-3.67	N/A	N/A	1.90	0.94

Performance shown is average annual total separate account investment choice returns (except 1 month, last quarter, and year-to-date) for the period indicated, net of the total operating expenses of the separate account or underlying investment as listed on the individual investment fact sheets. Performance returns reflect reinvestment of dividends and capital gains distributions. *Application of the contract asset charge and any discontinuance charges or service fees deducted from the account would reduce this return.*



Criteria for Ethical Decision Making

Voluntary:

Have all of the reasonable options been presented to the plan sponsor?

Informed:

Does the plan sponsor comprehend the details or limitations?

Consent:

Does the plan sponsor understand that to which he is agreeing?

Beneficence:

Am I acting in a way that promotes the well-being of others?

Non-maleficence:

Am I acting in a way that will cause harm to others?



Parting Thoughts

Strengthen and increase our admiration for honest dealing and clean thinking, and suffer not our hatred of hypocrisy and pretense ever to diminish. *Encourage us in our endeavor to live above the common level of life. Make us to choose the harder right instead of the easier wrong, and never to be content with a half-truth when the whole can be won.*

Endow us with courage that is born of loyalty to all that is noble and worthy, that scorns to compromise with vice and injustice and knows no fear when truth and right are in jeopardy.

West Point Cadet Prayer



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