401(k) ETHICIST

The Moral Hazard of Paltering & Puffery

*Mark Mensack**

In "The Moral Hazard of Too Big to Jail" last issue, we discussed information asymmetry. It is a situation in which one party, typically the seller, has access to information that another party, typically the buyer, does not. While some might not be familiar with the term, everyone is familiar with the challenge of information asymmetry. One could describe our adversarial legal process as an exercise in information asymmetry.

Consider the oath that every witness takes: Do you swear to tell the truth, the whole truth, and nothing but the truth? Have you ever pondered the necessity of such a repetitious oath? Why isn't it simply, I swear to tell the truth? Or I swear not to lie? An attorney might have a different response, but from an ethical perspective it's because we need all three clauses in this oath in order to address the various types of lies. In other words, we need all three in order to avoid information asymmetry

Everyone knows what a lie is, and the only other type of lie most folks can think of is a white lie; however, consider the following scenario: Your 17-year-old comes home after midnight and you ask, where were you? His response is, I was at my friend John's house. The next day you confirm with John's parents that your son was telling the truth.

What if later you discover your son was at John's house for about an hour but left there to go to a fraternity party? I often use this scenario in my

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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 Some of Mark's articles and presentations regarding the topics mentioned here can be found at www.PrudentChampion.com.

"The Moral Hazard of Paltering & Puffery" is the first installment of a two-part column that will continue to explore the notion of moral hazard in the retirement plan industry, particularly the aspect involving information asymmetry. Part One will address the preponderance of paltering, which amplifies the challenge of information asymmetry. Part Two will explore the effect of puffery on Wall Street. Since Mr. Mensack argued in an earlier column that a strong code of ethics is a way to overcome the challenges of moral hazard, he has learned that a major Wall Street firm has described its own code of ethics as "puffery," with the result that his column takes another necessary look behind the choices that must be made by fiduciaries.

presentations and will ask the parents; did your son lie to you? It's amazing the number of parents who squirm a bit, but reply, I guess not. Their reasoning is that he didn't actually make a false statement or an "untruth."

This scenario is an example of information asymmetry with the son acting as the seller, and the parent the buyer. So let's assume that before answering the parents' question, he was required to swear to tell the truth, the whole truth, and nothing but the truth. Given the "whole truth" clause, there would be no question that the son will violate the oath if his reply is the same as it was before, but did he lie?

PALTERING

Dr. Bennett Blum, in an article addressing elder financial abuse, describes the son's actions in the scenario above as paltering. To palter means to intentionally deceive or mislead without making a false statement in order to advantage one's self and /or disadvantage another. Blum notes that "society often mistakenly considers paltering less harmful than lying."[1]

What is particularly helpful about Blum's paper is that he outlines five types of lies or deceptive behaviors using his CAIN analysis. CAIN stands for Context, Action, and Intention. In the son's case of paltering, we can evaluate the scenario as follows: The context was such that the truth was expected. His intent was to deceive in order to advantage himself (i.e. not be grounded.) His action was to provide partially true information while withholding material information. Blum describes his action here as a "lie of omission."[2]

When comparing paltering to lying, the context and intent are the same. The distinction is in the action where the liar makes a factually false statement. To knowingly make a false statement with the intent to deceive in order to advantage oneself or disadvantage another is sometimes known as a lie of commission.

While most might not be familiar with paltering, at West Point it's known as quibbling. In past columns I've mentioned the West Point Honor Code; A Cadet will not lie, cheat, steal, or tolerate those who do. Given the importance of honor and integrity at West Point, the definition of a lie is quite explicit. A Cadet violates the Honor Code by lying if he or she deliberately deceives another by stating an untruth, or *by any direct form of communication to include the telling of a partial truth and the vague or ambiguous use of information or language with the intent to deceive or mislead.*[3]

Despite the fact that the parents mentioned in the earlier scenario were unsure if their son had actually lied, at West Point, given the italicized clause above, there would be no question. Some believe that to palter is somehow less harmful than a blatant lie; however, what would have been the difference if the son had responded with a blatant lie such as I ran out of gas? The context is the same in both cases. His intent to deceive in order to advantage himself is the same. The only difference is his action, which, ethically speaking, takes a backseat to his intention. Perhaps the difference can be summed-up with this old Yiddish Proverb; a half-truth is a whole lie.

THE MORAL HAZARD OF PALTERING

Having outlined the notion of moral hazard in previous 401k Ethicist columns, there's no need to do so again here, but I'd like to remind you of a component of moral hazard: information asymmetry. Information asymmetry occurs when one party to a transaction, typically the buyer, has less information upon which to base a decision than the other party, typically the seller.

The focus of this column is not on the false statements that we typically categorize as a lie, but rather the half-truths and the vague or ambiguous statements that some think fall into a grey area short of a lie. On Wall Street, and specifically the retirement plan industry, where lying ought to be grounds for reprimand, termination or losing one's securities license, paltering is rampant. Frederick Schauer and Richard Zeckhauser of the John F. Kennedy School of Government at Harvard University note that "paltering is not only often more harmful than lying, but is also almost certainly much more common than lying."[4]

Schauer and Zeckhauser argue that "palters are likely to be common because though there may be only one way (or just a few ways) to lie about a proposition, there may be many ways to palter. Palters can abound therefore, even when effective lies are likely to be much more limited."[5]

They also argue that paltering is often worse than lying "because lies are easier to identify with some certainty." And "because palters are harder to identify, there is a considerable incentive for those who wish to deceive others to turn to paltering rather than to lying."[6]

At this point you might be wondering where I'm going with this column so let me make a bold statement: The 401k industry is fraught with paltering which often prevents fiduciaries from fulfilling their ethical and fiduciary responsibilities. Worse yet, paltering is often a means to pilfering the assets of retirement plan participants.

Pilfering isn't a word we see all that often but it's defined as: to steal stealthily in small amounts and often again and again. It's worth noting that Merriam-Webster defines stealthily as: intended to escape observation.[7] If you were to review past columns you'll discover that many of the issues I've raised are examples of paltering such as fiduciary warranties, phantom fiduciaries and some Rule 408(b)(2) disclosures. You'll also read many examples of how these examples of paltering have resulted in pilfering. Unfortunately, given the more than $3 trillion in American 401k assets, result of this pilfering is significant.

Industry critic Dan Solin observes that "The existing 401(k) system is a scam far greater than anything Bernie Madoff could have conceived. His $50 billion Ponzi scheme is dwarfed by the $12 trillion 401(k) rip-off imposed on plan participants by their employers, and the mutual fund and insurance industries."[8] And former SEC attorney and 401k Advocate Ted Siedle echoes Solin with, "Fraud of this magnitude, involving trillions, makes Madoff look like chicken feed."[9]

Referring to mutual funds generally along with those in retirement plans, former US Senator from Illinois Peter Fitzgerald, used the synonym for pilfering when he argued "The mutual fund industry is now the world's largest skimming operation, a $7 trillion trough from which fund managers, brokers and other insiders are steadily siphoning off an excessive slice of the nation's household, college and retirement savings."[10]

TYPES OF PALTERING

Equivocation is a type of palter where one uses a single word for multiple meanings, or two apparently different words for the same meaning. Perhaps the most infamous equivocator is President Clinton when he uttered, "I did not have sexual relations with that woman." While most Americans aren't sure what it means to equivocate, this reference ought to make it pretty clear.

In the retirement plan industry, a problematic example of equivocation is the word "Advisor" as found in Financial Advisor or Registered Investment Advisor. A reasonable person would assume that someone with either of these titles gives advice, just as they would assume a Financial Consultant consults.

A Registered Investment Adviser (RIA), also known as an Investment Adviser (IA), is defined by the Investment Advisors Act of 1940 as an individual or a firm that is in the business of giving advice about securities. These advisors can only be compensated with fees, as opposed to commissions, by virtue of having either a Series 65 or Series 66 license. Most importantly they necessarily required by law to adhere to a fiduciary standard whereby they must put the interest of their clients ahead of their own.

The titles Financial Advisor and Financial Consultant are used by individuals employed by brokerage firms which are governed by the Securities Exchange Act of 1934. Nowhere in the law will you find these titles, rather the Securities Exchange Act uses the titles of stockbroker and registered representative for these employees. "Brokers" and registered representatives are compensated by commissions by virtue of having either a Series 6 or Series 7 license. Brokers are subject to the suitability standard which means, by law, they can put their own interests ahead of their clients'.

Best-selling Author and host of The Truth about Money, Ric Edelman writes "The industry has conjured up a variety of titles. All are designed to impress, some to obfuscate." Edelman notes:

> Brokers are considered by FINRA and the SEC to be product salespeople whose job is to represent the best interests of their firms. According to the regulators, brokers sell investment products in order to earn commissions; they are not paid to give advice, and any advice they do give is considered "incidental" to the sale of their products.[11]

Equivocation is intended to confuse and obfuscate. Michael Chamberlain, principal of Chamberlain Financial Planning, LLC. sums-up the ethical issue of this type of palter: in an article titled, *Let's Call a Spade a Spade and a Salesperson a Salesperson*:

> It seems clear that when broker-dealers refer to their salespeople as "financial advisers" or "financial counselors" or "financial consultants," their intent is to mislead the public as to the true purpose of their reps . . . when salespeople are called—and viewed as—"advisers," the public can be led into thinking they are being told what is best for them.[12]

Surveys indicate that this palter is working very well and that the large majority of investors, 76% in one survey, wrongly believed that financial advisors working for brokerage firms had a fiduciary duty to their clients. Equivocation is another type of paltering where the plan sponsor must ask; are you telling me the truth, the whole truth, and nothing but the truth?[13]

In the interest of full disclosure, I was a financial consultant/advisor for fourteen years and the objective of the training I received was not merely to be an advisor, but a trusted advisor! In fact, every time the President of my firm spoke to a group of us he would say, "Our only product is advice!" Do you remember the commercial years ago where it appears that a wife is talking to her husband about their financial goals, and we see it's actually their financial advisor? That was the objective of our training. I'd also like to note that the large majority of people with whom I worked were honest and acted in their client's best interests. Some of the firms I worked for? Well, not so much.

Concealment is to deliberately omit information that is material to the context, or to hide material information. Despite the amended Rule 408(b)(2) that was intended to provide transparency to the retirement plan industry concealment has been, and still is, a significant problem for 401k plan sponsors. The Department of Labor mandates that a plan sponsor obtain the answers to both of these questions in DOL Advisory Opinion 97-16A which states: "The responsible Plan fiduciaries must assure that the compensation paid directly or indirectly by the Plan to [a service provider] is reasonable, taking into account the services provided to the Plan as well as any other fees or compensation received by [the service provider] in connection with the investment of Plan assets. The responsible Plan fiduciaries therefore must obtain sufficient information regarding any fees or other compensation that [the service provider] receives with respect to the Plan's investments . . . to make an informed decision whether [the service provider's] compensation for services is no more than reasonable."[14]

The following excerpt is from a brokerage firm's 401k marketing piece that outlines the fiduciary responsibilities of a 401k plan sponsor.

> 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.

Notice 97-16As states "fees or compensation received by [the service provider]" but this piece limits the compensation question to just the individual advisor, thus concealing the requirement to determine the brokerage firm's compensation. In reality, the brokerage firm is the service provider and the advisor is merely one of its employees. Typically the advisor receives between 30% and 45% of the compensation generated by a 401k, plus the brokerage firm often receives additional compensation from the 401k product provider such as a mutual fund company or an insurance company in the case of a group annuity type 401k product. If a plan sponsor is aware only of the compensation received by an individual advisor, as opposed to the advisor's brokerage firm, then a plan sponsor would not be in compliance with DOL Advisory 97-16A.

Bill McVay, founder of RDK Strategies in Baltimore observes, "This piece could have been written by any of dozens of financial service firms. You don't have to say something that is correct; just not something that is incorrect. It might be misleading, or maybe walking a thin line between correct and incorrect, but strictly speaking it's not incorrect. The problem with the rules that govern financial services marketing material is that they miss a critical point; the opposite of wrong is not right; the opposite of wrong is not wrong."[15]

Concealment is one more type of paltering where the plan sponsor must ask; are you telling me the truth, the whole truth, and nothing but the truth?

Prevarication is to make deliberately ambiguous or unclear statements in order to mislead or withhold information. We are all familiar with the meaning of "qualifiers" and "quantifiers," but to battle prevarication one must understand "fuzzifiers." This is an actual term I learned in graduate school! A fuzzifier is a word or phrase that changes a fact to an unclear or ambiguous statement. For example, if you were to ask an expert, let's assume a tenured law professor, a basic legal question and his response was, the answer is X. Reasonably, given his expertise, we would accept his answer as a fact. However, if he responded with, under some circumstances the answer is X. Or, the answer may be X, then we do not have a fact.

As an example, the following is the pertinent portion of what one firm stated was sufficient disclosure for a plan sponsor to determine the additional compensation this firm was receiving from a 401k product provider:

> ABC 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 XYZ Company to ABC Firm. Your Financial Advisor does not receive any part of these payments. Amounts payable by XYZ Company to ABC Firm do not result in an **additional direct charge** to your Plan or to the products, **except to the extent** XYZ Company applies an asset charge or other charge and pays compensation to ABC Firm from its general revenues.

The bolded words are all fuzzifiers or prevarications. There is no way a plan sponsor could accurately calculate the compensation using this disclosure. Many have questioned why the word direct is a fuzzifier in this disclosure. It's a fuzzifier because it begs the question of whether there is an additional *indirect* charge to your plan.

It's noteworthy that the firm responsible for this disclosure has the following statement in its marketing material: "We are dedicated to making your retirement plan a success and, at the same time, helping you meet your fiduciary responsibilities." You might be wondering, isn't there a law against paltering?

Part II of this column will begin with the section: Law and Ethics to the Rescue.

NOTES:

[1] *Lying and Paltering*, Bennett Blum, MD — http://www.tlealerts.com/litigation/18.htm.

[2] *Lying and Paltering*, Bennett Blum, MD — http://www.tlealerts.com/litigation/18.htm.

[3] As found in *Stand Your Ground: Building Honorable Leaders the West Point Way*, Evan Offstein.

[4] *Paltering*, Frederick Schauer and Richard Zeckhauser, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=832634.

[5] *Paltering*, Frederick Schauer and Richard Zeckhauser, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=832634.

[6] *Paltering*, Frederick Schauer and Richard Zeckhauser, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=832634.

[7] http://www.merriam-webster.com/dictionary.

[8] *Shining a Bright Light on a Dark 401(k) Secret*, Dan Solin http://www.huffingtonpost.com/dan-solin/shining-a-bright-light-on_b_162767.html.

[9] *401ks: America's Biggest Investment Fraud Was Foreseen and Preventable*, Edward Siedle http://www.forbes.com/sites/edwardsiedle/2010/10/07/401ks-americas-biggest-investment-fraud-was-foreseen-and-preventable/.

[10] *Shining a Bright Light on a Dark 401(k) Secret*, Dan Solin.

[11] *The Truth About Money*, Ric Edelman http://www.ricedelman.com/cs/education/article?articleId=2238.

[12] Let's Call a Spade a Spade and a Salesperson a Salesperson, Michael Chamberlain, http://www.investmentnews.com/article/20091004/REG/310049996#.

[13] The ORC/Infogroup Survey August 19-23, 2010 as quoted at: http://www.sec.gov/comments/4-606/4606-2748.pdf.

[14] http://www.dol.gov/ebsa/programs/ori/advisory97/97-16a.htm.

[15] Bill McVay as quoted in conversation 4/11/2013.