How is being a CPA similar to being a West Point Cadet?

Mark D. Mensack, AIFA®, GFS®
Senior Consultant
Fiduciary Expenses
This week’s guest cartoonist: Wayno

Okay, people, let’s get started on our orientation. I have 666 PowerPoint slides to cover.

Welcome to Hell

presented by Satan
Objective

Explore the AICPA Code of Professional Conduct from the perspective of:

A former instructor of philosophy & ethics at West Point;

A financial services professional with 22 years of experience;

An independent fiduciary;

A Wall Street Whistleblower.
Agenda

• AICPA Code of Professional Conduct
• Ethical Challenges for Fiduciaries
• Wall Street Ethics?
• Moral Hazard
• Principal of Due Care
• Suggestions
AICPA Code of Professional Conduct

The driving force of any profession includes not only the special knowledge, skills and standards that it demands, but *the duty to serve responsibly, selflessly and wisely, and to establish an inherently ethical relationship* between professionals and society.

*JOHN C. BOGLE  4/21/09*
AICPA Code of Professional Conduct

Membership in the AICPA is voluntary.

By accepting membership, a member assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

The Principles of the Code express the profession’s recognition of its responsibilities to the public, to clients, and to colleagues.

They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct.

The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.
Structure of the AICPA Code of Professional Conduct

**Principles**

Ideal standards of ethical conduct stated in philosophical terms.

**Rules of conduct**

Minimum standards of ethical conduct stated as specific rules.

**Interpretations of the rules of conduct**

Interpretation of the rules of conduct by the AICPA Division of Professional Ethics.

**Ethical rulings**

Published explanations and answers to questions about the rules of conduct submitted to the AICPA.
Quiz

Which of the following ethical principles mandated in the AICPA Code of Professional Conduct is the most onerous?

a) Integrity  
b) Independence  
c) Objectivity  
d) Due Care  
e) Avoiding Conflicts of Interest  
f) Honorable Behavior  
g) Sacrifice of Personal Advantage  
h) Serving the Public Interest  
i) Honoring the Public Trust  
j) Intellectual Honesty
Principle of Integrity

*Integrity is an element of character* fundamental to professional recognition. It is *the quality from which the public trust derives*...

Integrity requires a member to be, among other things, *honest and candid* within the constraints of client confidentiality.

*Service and the public trust should not be subordinated to personal gain and advantage.*

Integrity can accommodate the inadvertent error and honest difference of opinion; *it cannot accommodate deceit or subordination of principle.*
Principle of Integrity

Integrity requires a member to observe both the form and the spirit of technical and ethical standards...

A member shall not knowingly misrepresent facts or subordinate his or her judgment to others.

Integrity also requires a member to observe the principles of objectivity and independence and of due care.
Principles of Objectivity & Independence

The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.

Autonomy - to be autonomous means to have free will and to be self-determining. Autonomy underlies the notion of “fairness.” Something can be unfair when there is an imbalance of power, knowledge or potential between two parties.
Conflict of Interest?
Principle of Due Care

The *quest for excellence* is the essence of due care.

Due care requires a *member* to discharge professional responsibilities with *competence and diligence*.

A *member* should observe the profession’s technical and ethical standards, *strive continually to improve competence* and the quality of services, and discharge professional responsibility to the best of the *member’s* ability.

Competence is derived from *a synthesis of education and experience*.

“Diligence is the mother of good fortune, and idleness — its opposite...”

Don Quixote de la Mancha
Principle of Due Care

The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a member’s professional life.

Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a member to render services with facility and acumen.

It also establishes the limitations of a member’s capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member’s firm.

Facility - readiness or ease due to skill, aptitude, or practice.

Acumen - keen insight; shrewdness
Principle of Due Care

Due care is the most onerous of these principles and is defined as an act or a course of action that is required of one by position, social custom, law, or religion, and *often as an affirmative ethical obligation.*

While the notion of care is straightforward, the concept of “due” often is not. *The word “due” is the root of the word “duty” which implies an obligation to act.*

Due care has greater ramifications for professionals who have specific responsibility and/or specialized *expertise* or *skill.* E.G. The physician – patient relationship is one of trust and vulnerability where the patient relies on the expertise and skill of the physician.
Wall Street Ethics

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*
Wall Street Ethics

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*
Wall Street Integrity?

“I do have strong moral values, but I don’t let them rule my life.”
**Ethical Challenge of Fiduciary Expenses**

**Duty of Exclusive Purpose** - “A fiduciary shall discharge his duties . . . For the exclusive purpose of:

(i) providing benefits to participants and their beneficiaries; and

(ii) defraying reasonable expenses of administering the plan. . . .”

*ERISA §404(a)(1)(A)*

1% in excess fees over the average American’s working lifetime, reduces their nest egg at retirement by 28%.

*DOL, EBSA Website*

A penny saved is a penny earned.

*Ben Franklin*
Ethical Challenge of Fiduciary Expenses

A fiduciary is legally obligated to:

1) Understand all fees being charged to the plan/trust;
2) Understand all compensation being paid to any service provider;
3) Ensure the fees and compensation are reasonable relative to the services provided.

The challenge is that plan sponsors often are not aware of all of the fees & compensation, thus making #3 impossible.
Ethical Challenge of Fiduciary Expenses

Direct Expenses – Expenses that are invoiced and/or clearly stated, but plan sponsors don’t benchmark these expenses.
E.G. Actuary, Consultant, Legal, Valuation, etc.

Indirect Expenses – Expenses that are usually taken from within the portfolio of which plan sponsors are often unaware.
E.G. Revenue Sharing (12b-1 fees & Sub-transfer agency fees*) Inappropriate Share Class (Wholesale v. Retail), Soft dollars, National Best Bid & Offer Violations, Insurance-based investments.

*Sub-transfer Agency fees are the cause of most fiduciary breach lawsuits
Ethical Challenge of Fiduciary Expenses

There is no corporate veil for fiduciaries!

A fiduciary who fails to understand and evaluate fiduciary expenses can be held personally liable for any excess expenses.

Tussey v. ABB, Inc. & Fidelity Management

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 for violations of their fiduciary duty under ERISA.
Ethical Challenge of Fiduciary Expenses

Excessive Fee Class Action Lawsuits

Ameriprise Financial - $27.5 million
Lockheed Martin - $62 million
Fidelity Investments - $12 million
International Paper - $30 million
Boeing - $57 million
ABB, Inc. - $35.2 million
Caterpillar – $16.5 million

Fines exclude legal fees spent defending these lawsuits!
Wall Street Ethics?
Wall Street Ethics?

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."
Wall Street Ethics?

“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*
Wall Street Ethics?

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 NY

"[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
Wall Street Ethics?

**Paltering:**
To intentionally deceive or mislead without making a false statement in order to advantage one’s self and /or disadvantage another
Wall Street Ethics?

**Paltering = Equivocation:** making an indirect, ambiguous, or contradictory statement. AKA *Fiduciary Weasel Words*

*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 it’s general revenues.
Wall Street Ethics?

**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.

*See Skin Pathology v. Morgan Stanley*
Wall Street Ethics?

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

“In 2011, when viewed in relation to total XYZ client assets of in excess of $1.6 trillion, the payment made *by each* 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*

*See Skin Pathology v. Morgan Stanley*
Wall Street Ethics?

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

“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).”

\[
\frac{31}{10,000} = 0.0031\% \text{ or } 0.00000031
\]

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

$496,000 from EACH

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

\[
28 \times $496,000 = $13,888,000?
\]
Wall Street Ethics?

Paltering & Puffery Combined

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.”
Wall Street Ethics?

Paltering & Puffery Combined

Excerpt from a “Fiduciary Warranty Disclosure” in a separate document:

“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.**”
Wall Street Ethics?

Paltering & Puffery

XYZ Financial Advisors are not allowed to recommend investments to the plan sponsor or to plan participants what funds.

No XYZ advisor is allowed to recommend funds to a plan sponsor (to include in the 401k menu.)

In reality, you know full well that advisors recommends investments: “No, I would hope not. We have very distinct policies in place that they don’t.”

“No recommendations, only information. Plan sponsor makes the determination.”

_Sworn testimony of the Chief ERISA Attorney of a major broker-dealer_
Wall Street Ethics?

Paltering & Puffery

“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
Wall Street Ethics?

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
## Wall Street Ethics?

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>1 mo.</th>
<th>3 mos.</th>
<th>YTD</th>
<th>1 yr.</th>
<th>3 yrs.</th>
<th>5 yrs.</th>
<th>10 yrs.</th>
<th>Since* Inception</th>
<th>Expense Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Vanguard Target Retirement 2030 Ret Opt</td>
<td>-0.54</td>
<td>10.59</td>
<td>7.58</td>
<td>9.53</td>
<td>-3.67</td>
<td>N/A</td>
<td>N/A</td>
<td>1.90</td>
<td>0.94</td>
</tr>
</tbody>
</table>

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.*
Wall Street Ethics?

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
Wall Street Ethics?

Needle in a Haystack Quiz

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

539 pages!
Moral Hazard

Gyges was a shepherd for the King. 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. *Plato, The Republic*

*What would you do today with the ring, that you would not have done yesterday without it?*
Moral Hazard

Moral hazard is "any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly."

_Economist Paul Krugman_

_Regarding the Sub-prime mortgages that led to the 2008 financial crisis:_

“Much of the conduct that led to the crisis was unethical and irresponsible, but some of this behavior—while morally reprehensible—may not necessarily have been criminal”

_Attorney General Eric Holder_
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 in the Fiduciary Marketplace

“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
Moral Hazard in the Fiduciary Marketplace

Information Asymmetry

Service providers typically have greater knowledge regarding the investment vehicle, fees and the client’s fiduciary duties than the trustee or plan sponsor.

Risk Asymmetry

A service provider faces minimal, if any, risk in selling an imprudent product, while the fiduciary faces great risk for choosing an imprudent product.
Moral Hazard in the Fiduciary Marketplace

“...several billion dollars of revenue-sharing fees are being hidden annually from plan sponsors and plan participants...”

Jay Sanders, The CPA Journal

48% of plan sponsors did not know if their service providers had revenue sharing arrangements with other providers.

GAO-12-325 Survey

“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
Pilfering?

Our shareholders are suing us for misleading them about our financial problems.

Since when is it illegal to shaft innocent people for personal gain?

Don’t put that in the minutes.

I’ll see what I can do.
Moral Hazard in the Fiduciary Marketplace

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 John Hancock.

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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1-609-275-0400
1-888-534-2571
Moral Hazard in the Fiduciary Marketplace

• Separate Account Investment Management Fee
  
o 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
  
o 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.
Moral Hazard in the Fiduciary Marketplace

“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)*

Service Provider Puffery → Information Asymmetry

“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 can help you make sense of it all.”

See “Wizard of Oz, Retirement Plans & You” for details.
Moral Hazard
Facing your Clients

Because the Principal must depend on the expertise of the AICPA Member, the Principal is vulnerable to Information Asymmetry

When the IRS, Department of Labor, Plaintiff’s Bar or State Attorneys General come knocking, who bears the risk?

The Principle of Due Care requires one to have keen insight regarding potential issues which helps alleviate this vulnerability
Principle of Due Care
Fiduciary Expectation

**Auditor:** There were no noteworthy issues found during our audit.

**TPA:** You’ve passed your ADP & ACP testing this year.

**Advisor:** The funds offered in the plan all have a four or five star Morningstar rating.

**Principal hears:** I’m all squared away!
Principle of Due Care
Fiduciary Expectation

• Principals often lack the knowledge to distinguish the areas of expertise of each Professional

• Principals often assume that:

  a) All of the “experts” they hire are either fiduciaries and/or looking out for their best interest;

  b) If an expert makes a positive statement about the plan, the statement applies to the entire plan;

  c) If there were any issues with their plan, their experts would tell them.
Principle of Due Care
Fiduciary Expectation

FINRA Rule 2210 - Communications with the Public

Govern fiduciary marketing materials

Classifies plan sponsors/trustees as institutional investors.

Institutional investors under Rule 4512: Banks, insurance companies, registered investment companies, registered investment advisors; and also “any other person (whether a natural person, corporation, partnership, trust or otherwise) with total assets of at least $50 million.”

Institutional investors have the knowledge and sophistication of a professional investor.

*The large majority of American Fiduciaries are not experts!*
Principle of Due Care

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

*Hippocrates 400 BC*

**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.*
**Principle of Due Care**

**Negative & Affirmative Obligations**

* A Cadet will not lie, cheat, steal, or tolerate those that do.  
  *West Point Honor Code*

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
Principle of Due Care

Negative & Affirmative Obligations

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

West Point Honor Code

An affirmative ethical obligation requires one to act relative to the actions of another.

AKA: A Sin of Omission

Potential for personal repercussions for not fulfilling an affirmative ethical obligation.
Principle of Due Care

Negative & Affirmative Obligations

A member *shall not knowingly permit* a person whom the member has the authority or capacity to control to carry out on his or her behalf, either with or without compensation, acts that, if carried out by the member, would place the member in violation of the rules.

When a conflict of interest exists, *the member should disclose the nature of the conflict of interest to clients and other appropriate parties* affected by the conflict and obtain their consent to perform the professional services.
Principle of Due Care

Conflicts of Interest

• **Plan Sponsor** – “We aren’t changing our service provider; we’re with ABC Bank and we have our lending relationship there.”

• **Firm selling 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.
Principle of Due Care

The Suitability Standard: a *broker* must have a reasonable basis to believe that a *recommended* investment is suitable given the client’s objectives.

Or

Non-Maleficence / Negative obligation to do no harm

The Fiduciary Standard: an *advisor* must put the client’s interests above their own, and act in the client’s best interest.

Or

Beneficence / Affirmative obligation to do good
Criteria for Evaluating Conflicts of Interest*

**Part I:** If our action was outlined on the front page of the Wall Street Journal, how would a Devil’s Advocate criticize us?

**Part II:** If the actions of another (of which you were aware) in a given situation were outlined on the front page of the Wall Street Journal, could a Devil’s Advocate criticize the other’s actions?

*Not part of the AICPA Code of Professional Conduct*
Criteria for Evaluating Conflicts of Interest*

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

*Not part of the AICPA Code of Professional Conduct
Criteria for Ethical Decision Making

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
Criteria for Ethical Decision Making

Voluntary?

$2.7 billion pension in Pennsylvania has $195 million in GMO Int’l Equity V

0.59% - GMO International Equity IV expense ratio
0.09% - Vanguard Developed Markets Index Fund Admiral Share expense ratio

0.50% difference in expense multiplied by $195 million = $975,000!

A cheaper fund doesn’t necessarily equate to better performance. A key question is, how did a fund do net of expenses?

The Vanguard fund outperformed the GMO fund by:

- 5% last year
- 9% over the past 5 years
- 33% over the past 10 years
Criteria for Ethical Decision Making

Informed?

The IM and Admin Charges are 0.93%

The IM and Admin Charges are 0.94%

The IM and Admin Charges are 1.11%

The IM and Admin Charges are 0.97%

The IM and Admin Charges are 1.21%

Found in the footnotes of a 68 page document.
### Criteria for Ethical Decision Making

**Consent?**

<table>
<thead>
<tr>
<th>Form 5500</th>
<th>Annual Return/Report of Employee Benefit Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>AMERICAN FUNDS</strong></td>
<td><strong>GROWTH FD OF AMERICA R3</strong> R3 <strong>6,480,989</strong></td>
</tr>
<tr>
<td><strong>AMERICAN FUNDS</strong></td>
<td><strong>SMALLCAP WORLD FUND - R3</strong> <strong>1,955,030</strong></td>
</tr>
<tr>
<td><strong>AMERICAN FUNDS</strong></td>
<td><strong>BOND FUND OF AMERICA R3</strong> <strong>1,292,360</strong></td>
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<tr>
<td><strong>AMERICAN FUNDS</strong></td>
<td><strong>NEW ECONOMY FUND R3</strong> <strong>995,142</strong></td>
</tr>
<tr>
<td><strong>DREYFUS</strong></td>
<td><strong>BD MARKET INDEX FD</strong> <strong>2,348,816</strong></td>
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<tr>
<td><strong>DREYFUS</strong></td>
<td><strong>S&amp;P 500 INDEX FD</strong> <strong>6,283,229</strong></td>
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<td><strong>DREYFUS</strong></td>
<td><strong>STRATEGIC VALUE FD CL A</strong> <strong>2,580,231</strong></td>
</tr>
<tr>
<td><strong>FIDELITY</strong></td>
<td><strong>FIDELITY ADVISOR SMALL CAP FD CL A</strong> <strong>1,370,450</strong></td>
</tr>
<tr>
<td><strong>LORD ABBETT</strong></td>
<td><strong>VALUE OPPORTUNITY FUND CLASS A</strong> <strong>392,749</strong></td>
</tr>
<tr>
<td><strong>MFS</strong></td>
<td><strong>MFS TOTAL RETURN FUND CLASS A</strong> <strong>1,511,798</strong></td>
</tr>
<tr>
<td><strong>OPPENHEIMER</strong></td>
<td><strong>OPPENHEIMER SMALL &amp; MID CAP VALUE FD A</strong> <strong>1,766,876</strong></td>
</tr>
</tbody>
</table>
Criteria for Ethical Decision Making

Consent?

<table>
<thead>
<tr>
<th>Annual fund operating expenses</th>
<th>Share classes</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>A</td>
</tr>
<tr>
<td>Management fees</td>
<td>0.27%</td>
</tr>
<tr>
<td>Distribution and/or service (12b-1) fees</td>
<td>0.24</td>
</tr>
<tr>
<td>Other expenses</td>
<td>0.14</td>
</tr>
<tr>
<td>Total annual fund operating expenses</td>
<td>0.65</td>
</tr>
</tbody>
</table>

|                                 | 529-F-1 | R-1 | R-2 | R-2E | R-3 | R-4 | R-5E | R-5 | R-6 |
| Management fees                 | 0.27% | 0.27% | 0.27% | 0.27% | 0.27% | 0.27% | 0.27% | 0.27% | 0.27% |
| Distribution and/or service (12b-1) fees | 0.00 | 1.00 | 0.74 | 0.60² | 0.50 | 0.25 | none | none | none |
| Other expenses                  | 0.24 | 0.15 | 0.41² | 0.20 | 0.21² | 0.15 | 0.22² | 0.11 | 0.06 |
| Total annual fund operating expenses | 0.51 | 1.42 | 1.42 | 1.07 | 0.98 | 0.67 | 0.49 | 0.38 | 0.33 |

R3 = 0.98%
R6 = 0.33%
0.65%
DO YOU EVER FEEL GUILTY FOR SCAMMING INNOCENT PEOPLE OUT OF THEIR MONEY?

I ONLY SCAM THE PEOPLE WHO WOULD DO THE SAME THING TO ME IF THEY WERE SMARTER.

SO YOU USE ARROGANCE TO CANCEL GUILT?

IT'S A GOOD SYSTEM.
Avoid Information Asymmetry
Maximize Keen Insight

Practice 4.4: Periodic reviews are conducted to ensure that investment related fees, and expenses are fair and reasonable for the services provided.

1) Ask their CPA?
2) Do it themselves?
3) Conduct an RFP?
4) Independent Assessment?
Avoid Information Asymmetry
Maximize Keen Insight
Fiduciary Best Practices Criteria Check

<table>
<thead>
<tr>
<th></th>
<th>Inception Date: The investment must have at least a 3 year track history.</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>Manager Tenure: The investment manager must have at least a 2 year track history. (Most senior manager’s tenure)</td>
</tr>
<tr>
<td>3</td>
<td>Assets: The investment must have at least 75 million under management. (Total across all share classes for funds/etfs)</td>
</tr>
<tr>
<td>4</td>
<td>Composition: The investment’s allocation to its primary asset class should be greater than or equal to 80%. (Not applied to all peer groups)</td>
</tr>
<tr>
<td>5</td>
<td>Style: The investment’s current style box should match the peer group. (Not applied to all peer groups)</td>
</tr>
<tr>
<td>6</td>
<td>Prospectus Net Exp Ratio: The investment must place in the top 75% of its peer group.</td>
</tr>
<tr>
<td>7</td>
<td>Alpha: The investment must place in the top 50% of its peer group.</td>
</tr>
<tr>
<td>8</td>
<td>Sharpe: The investment must place in the top 50% of its peer group.</td>
</tr>
<tr>
<td>9</td>
<td>1 Year Return: The investment must place in the top 50% of its peer group.</td>
</tr>
<tr>
<td>10</td>
<td>3 Year Return: The investment must place in the top 50% of its peer group.</td>
</tr>
<tr>
<td>11</td>
<td>5 Year Return: The investment must place in the top 50% of its peer group.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investment Name</th>
<th>Peer Group</th>
<th>Score</th>
<th>1 Yr</th>
<th>3 Yr</th>
<th>5 Yr</th>
<th>10 Yr</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
</tr>
</thead>
<tbody>
<tr>
<td>iShares Morningstar Large-Cap (JKD)</td>
<td>Large Blend</td>
<td>0</td>
<td>4</td>
<td>6</td>
<td>9</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>Putnam Equity Income A (PEYAX)</td>
<td>Large Value</td>
<td>0</td>
<td>2</td>
<td>17</td>
<td>15</td>
<td>13</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Jensen Quality Growth J (JENFX)</td>
<td>Large Growth</td>
<td>78</td>
<td>54</td>
<td>42</td>
<td>35</td>
<td>35</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
</tr>
<tr>
<td>American Century Equity Income Inv (TWEIX)</td>
<td>Large Value</td>
<td>80</td>
<td>74</td>
<td>65</td>
<td>54</td>
<td>48</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✗</td>
</tr>
</tbody>
</table>
### Avoid Information Asymmetry
### Maximize Keen Insight
### Investigate Lower Expense Alternatives

<table>
<thead>
<tr>
<th>Current Fund Option</th>
<th>Expense Ratio</th>
<th>Similar Fund With Lower Fee</th>
<th>New Expense Ratio</th>
<th>Similarity</th>
<th>Participant Savings Assumptions</th>
</tr>
</thead>
<tbody>
<tr>
<td>OSTERWEIS $10,078,347 <strong>1.00 %</strong></td>
<td></td>
<td>LCIAX SEI Institutional Investment:LC Index</td>
<td><strong>0.03 %</strong></td>
<td><strong>0.90</strong></td>
<td><strong>$97,760</strong></td>
</tr>
<tr>
<td>BBGNY $11,223,984 <strong>1.25 %</strong></td>
<td></td>
<td>VTWIX Vanguard Total World Stock Index I; Institutional</td>
<td><strong>0.13 %</strong></td>
<td><strong>0.94</strong></td>
<td><strong>$125,709</strong></td>
</tr>
<tr>
<td>DIIIX $2,546,469 <strong>0.60 %</strong></td>
<td></td>
<td>TCIEX TIAA-CREF International Equity Index Institutional</td>
<td><strong>0.06 %</strong></td>
<td><strong>0.95</strong></td>
<td><strong>$13,751</strong></td>
</tr>
<tr>
<td>MPISX $2,033,946 <strong>0.80 %</strong></td>
<td></td>
<td>SCHD Schwab US Dividend Equity ETF</td>
<td><strong>0.07 %</strong></td>
<td><strong>0.93</strong></td>
<td><strong>$14,848</strong></td>
</tr>
<tr>
<td>DPUYX $1,351,413 <strong>0.79 %</strong></td>
<td></td>
<td>SCHG Schwab US Large-Capital Growth ETF</td>
<td><strong>0.06 %</strong></td>
<td><strong>0.93</strong></td>
<td><strong>$9,865</strong></td>
</tr>
</tbody>
</table>
Avoid Information Asymmetry
Maximize Keen Insight

Benchmark Service Provider Expenses

<table>
<thead>
<tr>
<th>Type of Service</th>
<th>Total Fees</th>
<th>Fee Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting</td>
<td>75,156</td>
<td>1st Quartile</td>
</tr>
<tr>
<td>Consultant</td>
<td>3,370,637</td>
<td>4th Quartile</td>
</tr>
<tr>
<td>Custodial</td>
<td>663,180</td>
<td>1st Quartile</td>
</tr>
<tr>
<td>Insurance Agent/Broker</td>
<td>225,519</td>
<td>2nd Quartile</td>
</tr>
<tr>
<td>Investment Management</td>
<td>5,490,294</td>
<td>3rd Quartile</td>
</tr>
<tr>
<td>Legal Services</td>
<td>6,175</td>
<td>1st Quartile</td>
</tr>
<tr>
<td>Participant Communication</td>
<td>259,645</td>
<td>3rd Quartile</td>
</tr>
<tr>
<td>Recordkeeping</td>
<td>17,038,912</td>
<td>4th Quartile</td>
</tr>
<tr>
<td>Securities Brokerage</td>
<td>525,254</td>
<td>3rd Quartile</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Service Group</th>
<th>Plan Total Fees</th>
<th>Peer Group: Average Total Fees</th>
<th>Industry Average Total Fees</th>
<th>Plan: Fees / Total Assets(%)</th>
<th>Peer Group: Fees / Total Assets(%)</th>
<th>Industry: Fees / Total Assets(%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal Services</td>
<td>6,175</td>
<td>70,591</td>
<td>58,784</td>
<td>0.0001</td>
<td>0.0057</td>
<td>0.0034</td>
</tr>
<tr>
<td>Accounting</td>
<td>75,156</td>
<td>45,941</td>
<td>27,286</td>
<td>0.0009</td>
<td>0.0052</td>
<td>0.0031</td>
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<tr>
<td>Insurance Agent/Broker</td>
<td>225,619</td>
<td>57,308</td>
<td>156,889</td>
<td>0.0026</td>
<td>0.0046</td>
<td>0.0103</td>
</tr>
<tr>
<td>Participant Communication</td>
<td>259,645</td>
<td>46,262</td>
<td>69,642</td>
<td>0.0032</td>
<td>0.0017</td>
<td>0.0016</td>
</tr>
<tr>
<td>Securities Brokerage</td>
<td>525,254</td>
<td>100,471</td>
<td>84,414</td>
<td>0.0064</td>
<td>0.0030</td>
<td>0.0109</td>
</tr>
<tr>
<td>Custodial</td>
<td>663,180</td>
<td>169,415</td>
<td>254,430</td>
<td>0.0081</td>
<td>0.0174</td>
<td>0.0169</td>
</tr>
<tr>
<td>Consultant</td>
<td>3,370,637</td>
<td>199,403</td>
<td>531,508</td>
<td>0.0413</td>
<td>0.0113</td>
<td>0.0363</td>
</tr>
<tr>
<td>Investment Management</td>
<td>5,490,294</td>
<td>1,295,386</td>
<td>1,796,012</td>
<td>0.0673</td>
<td>0.0329</td>
<td>0.1850</td>
</tr>
<tr>
<td>Recordkeeping</td>
<td>17,038,912</td>
<td>533,174</td>
<td>326,643</td>
<td>0.2090</td>
<td>0.0464</td>
<td>0.0503</td>
</tr>
<tr>
<td>All Service Groups</td>
<td>27,654,872</td>
<td>994,456</td>
<td>1,452,289</td>
<td>0.3392</td>
<td>0.0892</td>
<td>0.2850</td>
</tr>
</tbody>
</table>
Questions?

“We should hurry up and close this deal, before the ethical side effects kick in.”
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 be content with a half-truth when the whole can be won.

**West Point Cadet Prayer**

Articles can be found at [http://bit.ly/PruChampArticles](http://bit.ly/PruChampArticles)

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