WHAT'S OLD IS NEW AGAIN - A PLAN SPONSOR'S PRUDENT RESPONSE TO THE DEPARTMENT OF LABOR CONFLICT OF INTEREST RULE

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As a professional Employee Retirement Income Security Act (ERISA) fiduciary, I have read the recent opinions from multiple stakeholders about the Department of Labor's Conflict of Interest Rule. The Rule confers fiduciary status on individuals and the organizations they represent when they provide advice to retirement plans and IRAs.

It is called the Conflict of Interest Rule for a good reason – conflicts of interest exist in the financial services industry, and they can have extremely negative impacts on plan participants and IRA holders, and on society in general.

Not much has changed for plan sponsors. They have and will continue to have a fiduciary duty to act prudently, with due care. As an ERISA expert, the plan sponsor must continue to act in participants' exclusive best interest, avoid conflicts of interest, follow the plan document, hire objective experts when prudent to do so, diversify plan assets, and pay no more than reasonable fees for necessary services. Plan sponsors will continue to be judged as prudent experts when performing these duties.

WHAT'S OLD IS NEW AGAIN

Perception

I like the quote in C.S. Lewis's book *The Magician's Nephew*,

"What you see and what you hear depends a great deal on where you are standing. It also depends on what sort of person you are."

As humans, we tend to see and hear what we want to see and hear – or what we have been taught or influenced, over time, to see and hear. Stakeholders in retirement plans – plan sponsors, plan participants and regulators – all have different perspectives, and they tend to view and hear things differently.

As a plan sponsor, you likely know that conflicts of interest can be hard to perceive. Depending on which type of plan service provider you are, fiduciary or non-fiduciary, acceptable actions can vary widely. If a service provider is operating under a suitability (fair dealing/marketplace) standard for a broker-dealer versus a fiduciary standard (legal/client loyalty) as an investment adviser – the recommendations made, if implemented, can make a significant difference financially for participants and the communities in which they live. This difference in standards of care has a major impact on retirement income security success or failure.

One of the much-discussed problems is how difficult it is for the average person to tell which service providers are operating under a suitability standard and which are operating under a fiduciary standard. Much of the look and talk seems the same. The difference lies in loyalty – who is loyal to whom and will they commit to the ERISA fiduciary standard in writing? The salespersons/registered representatives have, and rightly so, a duty of loyalty to their company; advisers have a legal duty of loyalty to their clients or plan participants that supersedes their loyalty to their firm.

Of course,

economic influences can create conflicts of interest and can have a major impact on a person's point of view because they establish – consciously or unconsciously – a bond of loyalty.

In a principal/agency relationship, the tension between an agent and economic influencers can cause an agent to highlight certain aspects of a transaction while downplaying other critical aspects. Too often, the easier road to economic success comes with not identifying or seeking additional insight into a transaction, even though that may be better for the beneficiary, because it is less economically beneficial for the agent.

Conflicts of interest is not a new topic,

it has been going on for thousands of years, across multiple societies and cultures. Where there are people and relationships, there will be conflicts of interest. Discussions of these concerns have been documented throughout history, providing precedents for core fiduciary duties. Historical fiduciary commentary includes:

Code of Hammurabi

(approximately 1790 BC) Ex. Law #265: "If a herdsman, to whose care cattle or sheep have been entrusted, be guilty of fraud and make false returns of the natural increase, or sell them for money, then shall he be convicted and pay the owner ten times the loss." Ex. Law #104: "If a merchant give an agent corn, wool, oil, or any other goods to transport, the agent shall give a receipt for the amount, and compensate the merchant therefor. Then he shall obtain a receipt from the merchant for the money that he gives the merchant."

Aristotle

(approximately 350 BC) – In economics and business, people must be bound by high obligations of loyalty, honesty and fairness, and society suffers when such obligations are not required.

Confucius

(approx. 500 BC) – Three basic questions of self-examination includes the question "In acting on behalf of others, have I always been loyal to their interests?"

Cicero

(80 BC) (agent and principal relationship) – An agent that shows carelessness in his execution of trust behaves very dishonorably and is essentially undermining the basis of the socioeconomic system. Cicero believed that carelessness or insincerity is analogous to theft – and an offender should be tried as a thief.

Biblical: Matthew 6:24 NIV

(where interests are directly contrary to each other) - "No one can serve two masters. For a slave will either hate the one and love the other, or be devoted to the one and despise the other. You cannot serve both God and money."

These important historical influences played a key role in developing the English common law legal system, which in turn influenced the U.S. legal system, including fiduciary laws.

Sir James Rose Innes was the chief justice of South Africa from 1914 to 1927. In *Robinson v. Randfontein Estates Gold Mining Company*, he said, "Where one man stands to another in a position of confidence involving a duty to protect the interests of that other, he is not allowed to make a secret profit at the other's expense or place himself in a position where his interests conflict with his duty."

Precedence, derived from common law, plays a key role in our legal system. Stare decisis – the legal points in litigation, according to precedent – is a core tenet of our legal system. U.S. Supreme Court Justice Cardozo's statement in *Meinhard v. Salmon* speaks volumes about the importance of fiduciaries maintaining high standards. He wisely said that the

"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 marketplace – an **unbending**, most sensitive standard of honor, undivided loyalty and honesty – the standard should not be eroded by exceptions – as it will be trodden by the crowd."

(emphasis added). The historic examples of trustees treading on the fiduciary duties of those they were charged to protect helped shape ERISA.

Recent major case law on breaches of fiduciary duties in ERISA-covered plans are creating precedents that could very well impact most plans.

Stewardship Ethos Under ERISA

ERISA was enacted in 1974 to address the rightful public concerns about mismanagement of private pension plan funds. This mismanagement was eroding the financial security of millions of preretirees and retirees and was due, in major part, to the erosive power of conflicts of interest. Whether it was accessing funds to support poor fiscal management of organizations or taking excessive fees for plan management, the net effect was the same: Plan participants were being robbed of their future retirement income benefits. ERISA codified the standards of conduct and duties that plan fiduciaries must adhere to when managing plan assets. When managing plan assets, essentially, a fiduciary should focus solely on what is in the best interest of the plan participants. This can be very difficult when you are accustomed to acting as an organization's executive. ERISA added additional incentives to avoid these potential conflicts of interest by establishing appropriate remedies and penalties for violation of fiduciary duties and obligations – including personal liability.

ERISA Section 404(a)(1) describes the basic duty of a fiduciary. The emphasis is on performing duties in the sole interest of the plan's participants and beneficiaries, and ERISA establishes the "prudent expert" standard for plan fiduciaries. Field Assistance Bulletins 2002-3 and 2007-01 provide objective service provider selection standards and implore plan fiduciaries to

"**avoid** self-dealing, conflicts of interest or other improper influence." (emphasis added). **Avoiding risky behavior is one of the most cost-effective ways to mitigate personal and organizational risks, but it does require awareness of the risk.**

The Investment Advisers Act of 1940 (the "AA") resulted from advisers' mistreatment of clients; advisers were tending to favor their own financial interests. It imposed a broad fiduciary duty to act in the best interest of clients and was established to monitor those who, for a fee, advise people, pension funds and organizations on investment related matters. Additionally, the AA requires registration with the Securities and Exchange Commission (SEC) to monitor who is acting in an advisory capacity for a fee and to detail their methods of operation.

Later, the AA was amended to include prohibited transactions and misuse of nonpublic information – among other items. Section 206 of the AA clarifies the fiduciary duty of advisers to their clients. The Supreme Court in SEC v. Capital Gains Research Bureau said that the AA reflects a congressional recognition "of the delicate fiduciary nature of an investment advisory relationship." The Court identified the origins of fiduciary duties from the common law principles of agency, which provide that an agent owes fiduciary duties to its client as principal. Additional duties of advisers evolve from the law of trusts. Capital Gains identified a

"congressional intent to eliminate, or at least expose, all conflicts of interest which might incline an investment advisor – consciously or unconsciously – to render advice which was not disinterested."

Interestingly, the SEC, which has authority over enforcing the AA, uses more of a disclosure remedy for solving conflict of interest issues, rather than the "avoidance" remedy of ERISA. Disclosure is not actually a way to ensure strict fiduciary compliance, but is instead a way to be crafty in avoiding being a fiduciary. This SEC standard isn't what Justice Cardozo was concerned about in his Meinhard opinion. Disclosure as a standard is not in keeping with the duty of loyalty to which plan fiduciaries should aspire.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 recognized this "disclosure failing" and mandated a uniform fiduciary standard that requires acting in the best interest of the client, without regard to the financial interests of the broker or the firm. Unfortunately, the Best Interest Contract Exemption (BICE) in the Department of Labor (DOL) Conflict of Interest Rule seems to apply disclosure treatment to the symptoms of the conflicted interest problem, which appears to be an appeasement of special interests and will not likely lead to more prudent management of retirement plans.

The BICE is something akin to a person who sees a zebra and calls it a horse. Neither horses nor zebras are exactly safe, but horses seem to have an enduring sense of loyalty to those who treat them well, while zebras have never been fully domesticated.

This morass of securities laws, multiple standards, multiple enforcement agencies, allowed exemptions, and the confusion between the "disclosure standards" of the SEC and the "avoidance standards" of ERISA has created an environment of confusion among plan fiduciaries, plan participants and individual consumers. It is hard to determine whether someone is providing conflict of interest free "advice" or nicely constructed "education" with a dash of disclosure. The problem is that responsible plan fiduciaries are required to act as experts – and as such are required to identify conflicts of interest, even though most lack enough understanding of our industry to do it well. Plan sponsors should ask why an organization providing investment advice would not want to act as a fiduciary and think hard before actually engaging a service provider that uses a BICE arrangement.

SO WHAT IS A PLAN FIDUCIARY TO DO IN ORDER TO NAVIGATE THESE CHOPPY WATERS OF THE CONFLICT OF INTEREST RULE?

FIRST

I would read the feedback to the DOL on the Conflict of Interest Rule that was given by the organizations you are currently using or considering using. This may provide you some idea of the type of organizational culture you are choosing as you steer through the land mines of the retirement plan world.

SECOND

Review your plan's educational materials to ensure they are in compliance with DOL FAB 96-1 and the new best practices under ERISA for participant education.

THIRD

Know your adviser and other plan fiduciaries. Read your adviser's Form ADV, Part 2, to identify the dual registration status of some organizations. Many are both a Registered Investment Advisor and a broker-dealer. Beware. Would you go to a doctor who was both a physician and a pharmaceutical salesperson?

FOURTH

Ask for an adviser's 408(b)(2) service provider fee disclosure document. Generally the shorter and simpler the disclosure – the better. Beware of the multi-page documents dripping with disclosures and references to multiple web sites. Also, there should be a clearly documented disclosure of fiduciary status to clients for specific services. Remember the queen's line in Shakespeare's "Hamlet" – "The lady doth protest too much, methinks."

FIFTH

Read what the DOL considers to be evidence of prudence in "Meeting your Fiduciary Responsibilities."

SIXTH

Ask plan service providers if they are going to use a BICE for complying with the new ERISA rules. If they are, I would recommend that you solicit a request for information or request for proposal from organizations that are not going to use the BICE. This should be an interesting lesson in how easy it is to simply avoid the aforementioned conflicts of interest.

SEVENTH

Do as the Internal Revenue Service recommends in publication 3066: "Get an independent reviewer to check your plan. An independent reviewer may see something that has been overlooked by others, which could save money for you and your employees and may improve benefits." This also holds true for evaluating the liability you and your organization have taken on in operating a plan using service providers that simply disclose the ways they are not going to act in your best interest.

LAST BUT NOT LEAST

If you don't want to do all this yourself, avoid the confusion over horses and zebras and follow sound advice:

Hire an independent plan consultant to provide your plan with objective fiduciary guidance.

ABOUT THE AUTHOR

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Ken leads Hardy Reed's retirement plan services division as Vice President of Retirement Plan Services where he works with organizations across the country to help govern their retirement plans.

When Ken joined Hardy Reed in 2009, he brought with him 15 years of experience in group plan design, employee education, and holistic financial planning at one of the country's largest retirement planning firms. Ken has served corporations, healthcare, government and university employers.

Ken is a native of Georgia where he graduated from Berry College with a double major in economics and psychology. He now lives in Oxford, Mississippi, with his wife, Laura, and their daughter and son.

Ken has earned the Accredited Investment Fiduciary Analyst™ (AIFA®), Professional Plan Consultant™ (PPC™), and Certified Fund Specialist® (CFS®) designations. Ken is also a CEFEX Analyst, having met the criteria established by the Centre for Fiduciary Excellence (CEFEX). He has received formal training in ERISA fiduciary responsibility.

Ken is a clean-water advocate and trained volunteer for Living Waters for the World, whose Oxford team has installed community water purification systems in the Yucatan region of Mexico.