Ethics, Fiduciary Duty, Errors, and Omissions

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Agenda

- Ethics
- Fiduciary Duty
- Impartial Conduct
- Practice Management Avoiding Errors and Omissions (E&O)

"I can't describe it,
but I'll know it when I see it"

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Ethics

- Merriam-Webster Dictionary, “The discipline dealing with what is good and bad and with moral duty and obligation”
- St. Thomas Aquinas considered the notion of what was a just price in his Summa Theologica*
- Aquinas would seem to be the founder of business ethics, at least in terms of a continuous tradition of a considered ethics of fairness in business activity

***The Summa Theologica** (Benziger Bros. edition, 1947) Translated by Fathers of the English Dominican Province

Ethics

- The Enron scandal, October 2001
  - Misled Enron's board of directors and audit committee on high-risk accounting practices
  - Pressured Arthur Andersen to ignore the issues
- Bernie Madoff, December 2008
  - Falsely promising consistent profits
- OneWest Bank, “robosigning,” 2010
  - Employees at mortgage-servicing companies signed dozens -- sometimes hundreds -- of foreclosure documents a day without ensuring that they were correct, as the law requires
  - Most of the time, they barely glanced at the documents they signed

Ethics

- Aon Hewitt sued over fee scheme in Caterpillar’s 401(k) Plan, 2017
  - Violating ERISA by entering into a fee-sharing agreement with online investment adviser Financial Engines, Inc. (*Scott v. Aon Hewitt Financial Advisors LLC*, N.D. Ill., No. 1:17-cv-00679, complaint filed January 27, 2017)
  - Aon Hewitt devised an arrangement with Financial Engines for investment-advice services that resulted in collecting unreasonable and excessive fees at the expense of Caterpillar Inc.'s 401(k) plan participants

Ethics

- New Jersey broker pleads guilty to six-year elder scam*
  - Former Pruco and MetLife representative charged with bilking $1 million from clients
  - Mr. Martorana, 62, faces ten years in prison for what authorities had alleged was the theft of some $1 million from more than a dozen clients ranging in age from their late 60s into their 90s
  - Under the plea agreement, the state will recommend that Mr. Martorana be sentenced to ten years in prison, with no chance for release on parole before serving four years
  - Mr. Martorana has given $250,000 to his attorney's trust account to go toward restitution for the victims

***FINRA BrokerCheck, February 2017**

Ethics

- Jeffrey C. Bailey, et al., Plaintiffs, v. Shirley Bailey, et al., Defendants, United States District Court, S.D. Texas, December 13, 2016
  - In 2008, Jeffrey decided to buy the company from his parents
  - Jeffrey hired a CPA to organize the books
  - The CPA discovered that the company had failed to pay a "substantial" amount of payroll taxes for 2007 and 2008
  - When Jeffrey was informed of this unpaid tax liability, he told the CPA not to inform Roger or Shirley of it in connection with the sale. Jeffrey also instructed the company's bookkeeper and CFO not to discuss the tax issue with his parents. Finally, Jeffrey himself did not say anything to his parents about the unpaid taxes.

Ethics

- The Court found that Jeffrey, as an officer of the company:
  - (1) ***Owed a fiduciary duty*** to the company and to his parents, as its owners, to disclose the company's tax liabilities
  - (2) Intentionally withheld the information so they would sell the assets to him at a "seriously false valuation," and
  - (3) Thus fraudulently induced them to enter the asset purchase agreement
  - The Court also highlighted the mother and son relationship between Shirley and Jeffrey and found that Shirley, in particular, "***trusted*** Jeffrey to take care of the company and to tell her about its problems" and yet Jeffrey "hid the truth from Shirley"
  - The Court noted that the company owed the IRS over $3,000,000 in unpaid payroll taxes and an additional ***trust fund penalty*** of more than $2,300,000

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Poll Question #1

What are your thoughts on Enron?

A. Enron was okay in misleading auditors, they tried
B. The auditors should have pushed back to obtain correct information
C. Arthur Andersen, when pressured, should have recused itself
D. Arthur Andersen should have notified authorities

Ethics

- Principles-based
  - Provides guidance, Codes of Ethics, that can be applied to the infinite variations in circumstances that arise in an adviser’s practice
  - Can cope with rapid changes of the modern business environment
  - Prevents the use of legal loopholes to avoid compliance with guidance
  - Focuses on the spirit of the guidance and encourages responsibility and the exercise of professional judgement, which are key elements of any profession

Ethics

- ASPPA is committed to encouraging every retirement plan professional to achieve and maintain the highest levels of technical competence and integrity. To this end, each member of ASPPA must abide by certain professional and ethical standards set forth in the ASPPA Code of Professional Conduct (ASPPA Code).

Ethics

- Rules-based
  - Compliance with rules are easier since the requirements are prescriptive and leave little room for misunderstanding
  - Easier to enforce

Ethics

- Sarbanes-Oxley Act resulted from Enron
  - Increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders
  - The act also increased the accountability of auditing firms to remain unbiased and independent of their clients
- The Dodd-Frank Wall Street Reform and Consumer Protection Act resulted as a response to the 2008 financial crisis
  - Massive piece of financial reform legislation passed in 2010

Ethics

- Department of Labor
  - While many investors think that their financial adviser already is required to act in their best interest – like their doctor or their lawyer – the law hasn't always required it
  - Financial companies often pay advisers more to promote certain products rather than to recommend what is best for their customers. That incentive creates what is known as a *conflict of interest*. And conflicts of interests sometimes can cause advisers to give bad advice.

Ethics

- Aspirational
  - “The ultimate goal of enacting the Code is to serve the public interest”*
  - The purpose of this Code of Professional Conduct (“Code”) is to identify the professional and ethical standards with which a Member must comply, in order to fulfill the Member’s responsibility to the American Retirement Association and its affiliate organizations, other Members, and the public. Members are required to adhere to the high standards of conduct, practice, and qualification set forth in this Code.**

* Society of Financial Service Professionals, Code of Professional Responsibility

** American Retirement Association, Code of Professional Conduct

Ethics

- Common theme in Professional Codes of Conduct
  - Maintain knowledge
  - Comply with all applicable laws
  - Not knowingly participant or assist in any violation or such laws and codes
  - Preserve confidentiality

Poll Question #2

We should only have regulation, as laws can better regulate the adviser, because:

A. More rules make doing business more complex
B. Over time principles deliver more consistent behavior from professions
C. If professions were more rigorous enforcing Codes of Ethics we wouldn’t need regulation
D. We need regulation to enforce professional Codes

Poll Question #3

You're an adviser working with the client establishing a Profit Sharing 401(k) Plan. You always work with the same TPA, although there are several in the area. You like the TPA, occasionally they provide you with tickets to sporting events, dinners, and gifts for special family occasions.

A. This is okay since the TPA is known and does a good job
B. You should disclose to the client this relationship and continue
C. You should tell the client to look elsewhere
D. You should disclose this relationship and assist the client in considering other alternatives

Poll Question #4

You're an adviser with a practice that focuses on, and specializes in, assisting clients with college funding for their children. Your client, a good source of referrals, approaches you to review their existing estate plan and trust documents.

A. You proceed, you want to keep this client happy
B. You agree, you've taken an advanced planning course and can easily get up to speed in this area
C. You decline, explaining this is not your area of expertise but are willing to assist in searching for a competent professional with expertise in that area
D. You agree, and explain to the client that you'll make some calls

Poll Question #5

You've done personal planning for a wealthy business client. The client has run the business for over 20 years with over 70 long-time employees, and has now asked you to review his retirement plan. He brings you a SEP-IRA document with over $500,000 in it and tells you he and his spouse are the only ones covered because the adviser that sold it to him stated "a SEP is for owners only." What do you do?

A. There is over $500,000 in the SEP, you accept it because you handle everything else for the client
B. You tell him you can't handle this type of account but tell him you can work with the broker on the account
C. You explain to him the rules of SEPs and the fact that there is a violation that needs to be fixed before you take it over
D. You explain to him the rules of SEPs and explain he needs to seek competent legal counsel versed in IRS correction matters before you take it over

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Fiduciary Duty

- Equitable principles stretch back to the Ancient Greeks in the work of Aristotle*
- Over the 20th century, trusts came to be used for multiple purposes beyond the classical role of parceling out wealthy families' estates, wills, or charities
- Pension trusts are the most economically significant kind of trust

*Aristotle, Nicomachean Ethics (350 BC) Book V, pt 10

Fiduciary Duty

- Possibly the most important aspect of good trust management is to have good trustees
- The core duty of a trustee is to pursue the interests of the beneficiaries, or anyone else the trust permits, except the interests of the trustee

Fiduciary Duty

- In general, to date, the concept was avoidance
  - Avoid ERISA fiduciary status
  - This is not to say that advisers were not and are not acting in their client's best interest, but being an ERISA fiduciary was to be avoided.

Fiduciary Duty

- Standard of Care
  - Under the Investment Company Act of 1940
    - An adviser recommending a particular security, the adviser:
      - Must have a ***reasonable basis*** for believing that the recommendation is ***suitable*** for the client
      - In making this assessment, the adviser must consider income and net worth, investment objectives, risk tolerance, and other holdings

Fiduciary Duty

- Under the fiduciary standard of care the adviser is held to a much greater standard
  - "…a fiduciary shall discharge his or her duties with respect to a plan ***solely*** in the interest of the participants and beneficiaries…"
- Acting as a fiduciary carries a much higher standard of care, and a greater liability, ***personal liability****

*ERISA §409

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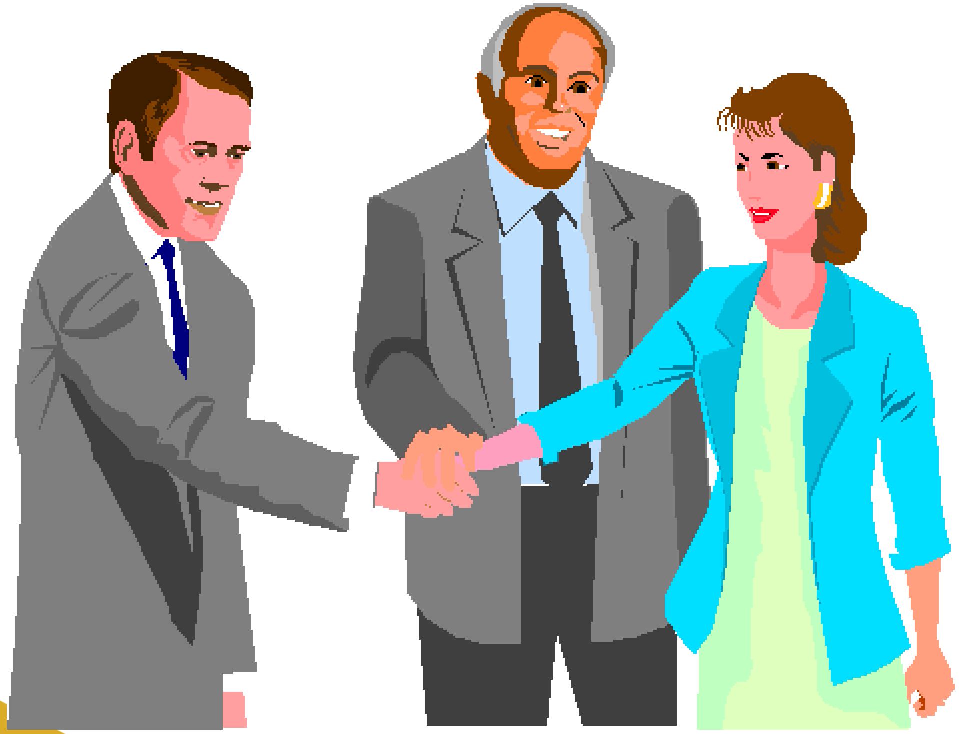
Fiduciary Duty

- Acting as a fiduciary, protecting the customer from harmful conflicts of interest
  - Not all conflicts are harmful



Fiduciary Duty

- Provide prudent advice
  - Satisfy a professional standard of care when making investment recommendations
  - Act in a like capacity and familiar with such matters
  - Consider all appropriate factors

Fiduciary Duty

- Be loyal
  - Put the customer's interest first when making recommendations
  - Act solely in the interest of the client
  - Defray reasonable expenses
  - Charge no more than reasonable compensation
  - Follow the terms and conditions of all governing Plan documents

Fiduciary Duty

- Full disclosure
  - Avoid misleading statements about conflicts of interest, fees, and investments
  - "This duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful"*

*Bixler v. Central Pennsylvania Teamsters Health & Welfare Fund, 12F 3d 1292, 1300 (3rd Cir 1993

Fiduciary Duty

- Procedural due diligence
  - A complete description of the investigative process related to the decision

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Poll Question #6

You're out to dinner with your spouse. You're in the mood for fish. Applying diligence skills you:

A. Ask the waiter if the fish is fresh
B. Request to inspect the kitchen, and speak with the chef
C. Interview surrounding customers who purchased the fish
D. Order the fish because it is the fish of the day on the special menu

Impartial Conduct

- To ensure that plan and IRA investors receiving investment advice are consistently protected by impartial conduct standards, regardless of the particular exemption upon which the adviser relies

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Impartial Conduct

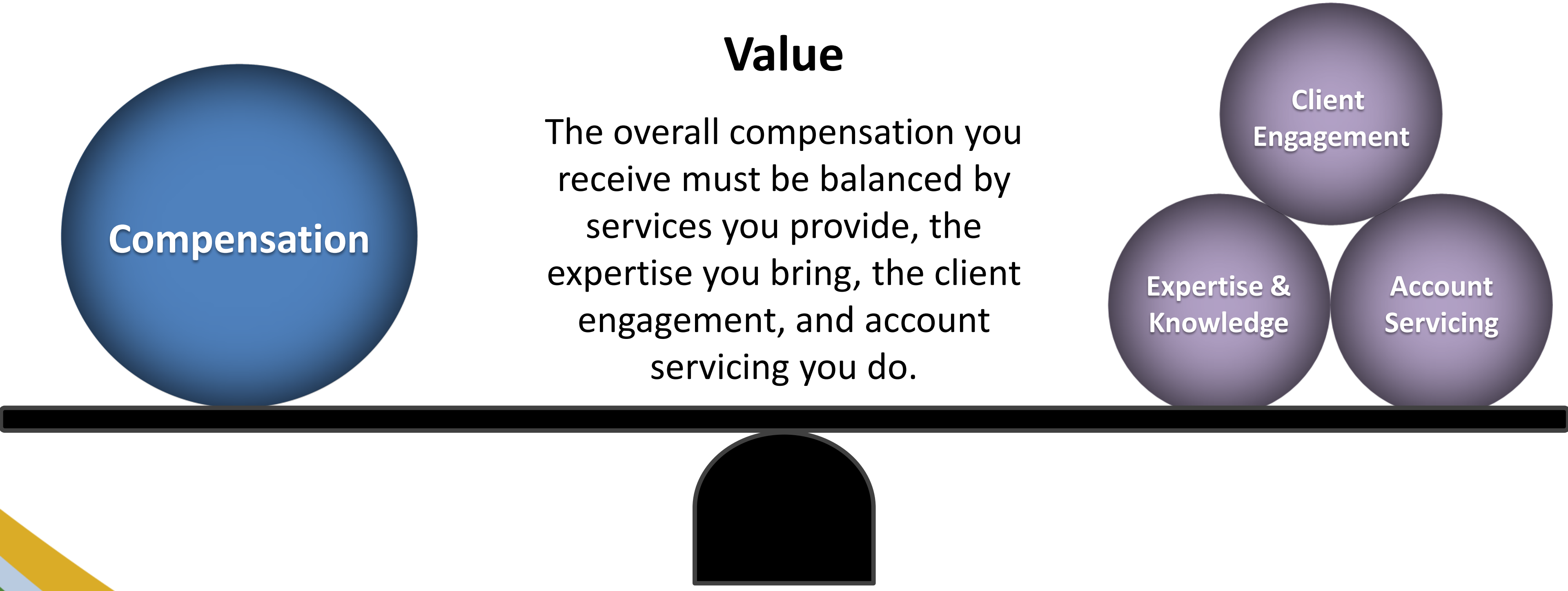
- The standards specifically require advisers and financial institutions to:
  - Give advice that is in the "best interest" of the retirement investor. This best interest standard has two chief components: prudence and loyalty
    - Under the prudence standard, the advice must meet a professional standard of care as specified in the text of the exemption
    - Under the loyalty standard, the advice must be based on the interests of the customer, rather than the competing financial interest of the adviser or firm

Impartial Conduct

Charge no more than reasonable compensation

Value

The overall compensation you receive must be balanced by services you provide, the expertise you bring, the client engagement, and account servicing you do.

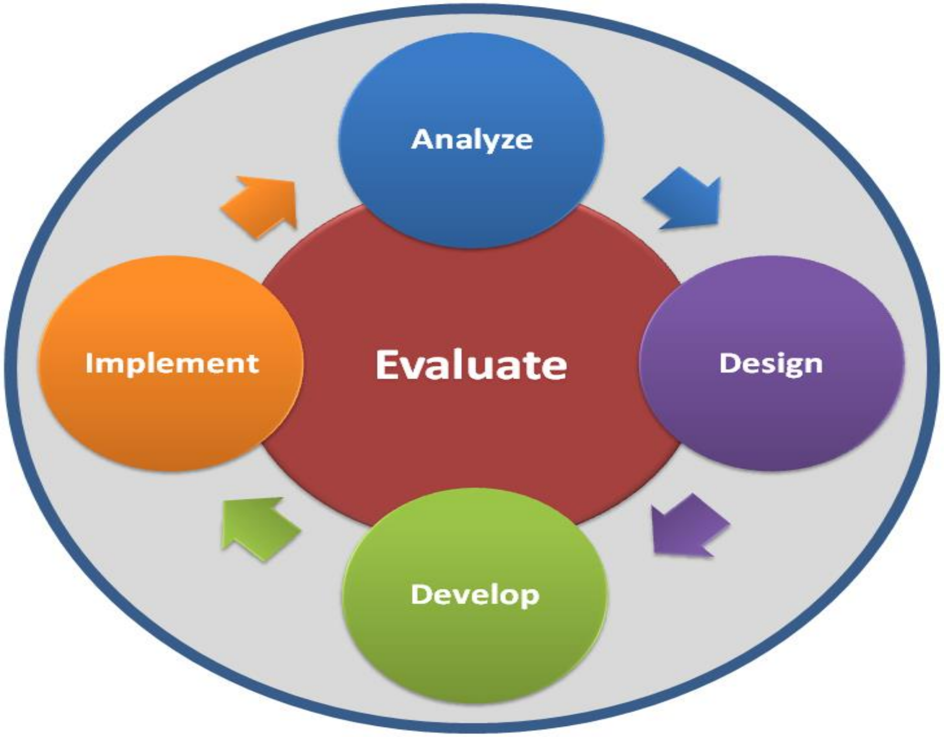


Impartial Conduct

- Make no misleading statements about investment transactions, compensation, or conflicts of interest

Practice Management: Avoiding Errors and Omissions

E&O insurance is not designed to preserve an adviser's goodwill, only prudent processes diligently followed will



Practice Management: Avoiding Errors and Omissions

- Who are you and what do you do?
  - Shift in the advice landscape
  - Adviser’s role from broker to financial adviser to holistic planning centric-wealth adviser
  - The client’s need/want from single-need, narrow focus to expecting more from the adviser to help them solve complex issues

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Practice Management: Avoiding Errors and Omissions

- The industry is requiring advisers to be clear about the value they deliver
- What differentiates you?
  – Competitive landscape has changed
    - Market is oversaturated with advice and the wealth management spectrum has become commoditized.
    - Advice being delivered by robo-advisers
  – Advisers who aren't incredibly clear about what they do, and what they get paid, will be weeded out

Practice Management: Avoiding Errors and Omissions

- Advisers have an opportunity to define:
  - What you stand for
  - How you serve clients
  - The value you deliver:
    - Benefits are deeper client relationships
    - Gaining greater business sustainability from clients
    - Receiving more qualified introductions to prospects

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Practice Management: Avoiding Errors and Omissions

- Your value proposition
  - What drives you to do the work that you do everyday?
  - Describe the way in which you and your team work with and interact with clients
  - What is your unique process or philosophy that you deploy?
  - Who are the clients you serve, or ideal clients you would like to serve in the future?
  - What are your core business values and beliefs?
  - Share a success story that highlights how you were able to bring your philosophy to serve the needs of clients

Poll Question #7

What comes to mind when you see these? (choose all that apply)

A. Quality
B. The best in their market
C. Feel good experience
D. Satisfaction

Poll Question #8

If a client were to see your name or logo, what would be their first impression?

A. Dependable
B. Honorable
C. Deplorable
D. Good person

World Economic Forum Report: *The Future of Jobs and Skills*

- Included a list of the top ten skills that will be valued most by 2020:
  - Complex problem solving
  - Critical thinking
  - Creativity
  - People management
  - Coordinating with others
  - Emotional intelligence
  - Judgment and decision making
  - Service orientation
  - Negotiation
  - Cognitive flexibility

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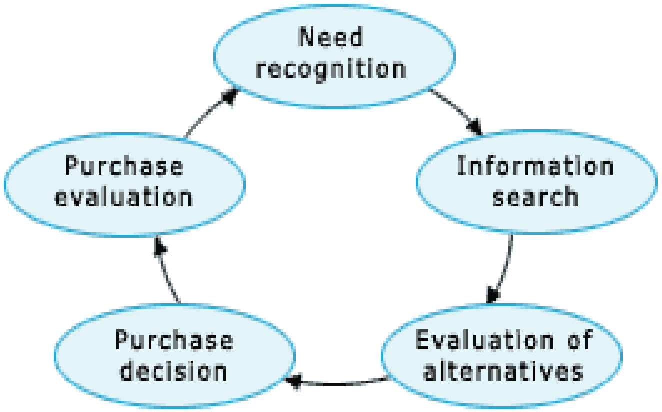
World Economic Forum Report: *The Future of Jobs and Skills*

- This list can be summarized in two words: behavioral governance
- What will matter most by 2020 — no matter the industry sector or domain — will be a person's ability to execute, infuse, and amplify a prudent decision-making process



Practice Management: Avoiding Errors and Omissions

Practice Management: Avoiding Errors and Omissions

- Defined client-service strategy
  - Having a defined approach to manage and monitor client relationships will help you define what you stand for as an adviser and help you stand out in overcrowded financial-advice and management market
  - This will allow you to develop a more personalized relationship with your clients, through which you can grow your business by capturing wallet share from existing clients or receiving referrals from those who are happy with your services

Practice Management: Avoiding Errors and Omissions

- Managing the client relationship
  - Periodically review life changes, both from a personal and an investment standpoint
  - Demonstrate that you are working for the client to improve their quality of life
  - Create touchpoints with your clients throughout the year to stay up-to-date with their lives and any changing needs they may have
  - Perform re-discovery on an ongoing basis to see what value you can add after the initial sale

Practice Management: Avoiding Errors and Omissions

- Client segmentation will help determine to which clients to dedicate the most time

Client Segmentation

- A's and others
  - Adviser’s focus on identifying the best clients in their current book, their "A’s"
  - A's are clients who have multiple products or services with the adviser and/or fit the profile of ideal clients, and/or are large core-product clients and have potential to work deeper
  - Adviser’s focus on re-framing him/herself with this group, setting new expectations, and elevating service levels
  - The number of clients in this segment could range from a small handful to 20 percent of a book
  - This method is appropriate for advisers who are "just starting out" or advisers who have traditionally done transactional business

Client Segmentation

- A's, B's, C's, and D's
  – Four-segment approach based on an "ideal" number of clients, for example 200.
    - *A's = top ten percent or 20-30 households*
    - B's = the next 20 percent or approximately 40 clients
    - C's = the next 30 percent or approximately 60 clients
    - D's = remaining 40 percent or everyone else
  – Most of the service focuses on the highest-tier client
  – B's, C's, and D's may be assigned to a junior associate or mentoree

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How Much Is a Good Client Worth?
A Client's Return on Investment (ROI)

	Commission and or Fee Income/# of Clients	$300,000/100
=	Average Income Per Client	$3,000
X	Number of Years Serviced	20
=	Lifetime Value of Client	$60,000
X	Number of Referrals	2
=	Lifetime Income Value Per Average Client	**$120,000**

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Practice Management: Avoiding Errors and Omissions

- Engagement letter
  - While it is important to identify the work you are going to do, it may be equally important to identify any work you are expressly not agreeing to perform
  - Outline roles and responsibilities
  - Set timelines

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Practice Management:
Avoiding Errors and Omissions

- Document decisions
  - Due diligence file:
    - Notes
    - Meetings
    - Documents
- Establish an Investment Policy Statement (IPS)
- Monitor

Prudence, Process, and Conduct: Discover, Determine, and Demonstrate

- Demonstrate a prudent decision process focusing on:
  - Investigating
  - Evaluating
  - Consulting experts when appropriate
  - Following plan documents
  - Monitoring

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Questions?