

## The ABCD and Actuaries Who Wear Two Hats

**F**OLLOWING IS AN EXCHANGE OF LETTERS between a pension actuary and the Actuarial Board for Counseling and Discipline (ABCD). The actuary sought guidance on whether a certain activity might violate the Code of Professional Conduct. This exchange is reprinted with permission of the actuary.

The activity in question involved the receipt of compensation from the vendor of financial products the actuary had recommended for use with a client's retirement plan. This activity would leave the actuary wearing two hats: the hat of a consultant and the hat of a salesperson. It could lead the actuary into violation of at least two code provisions.

The first is easily avoided. It involves Precept 6. This requires that the actuary tell a client about all direct or indirect compensation from a third party in connection with service to the client.

The second presents more difficult problems. It involves Precept 7, conflict of interest. The ABCD response discusses this second problem in considerable detail.

The problems involved when an actuary wears two hats aren't restricted to the pension field. This exchange of letters may provide useful guidance to all actuaries, regardless of their fields of practice.

Responding to requests for guidance is just one of the ABCD's functions. But it's a very important one. Most of the ABCD's activities are shrouded in an extremely broad cloak of confidentiality.

For example, the board never divulges details of its investigations to anyone not directly involved unless the actuary under investigation grants consent. Quite understandably, the actuary almost never grants consent.

A request for guidance is a different matter. Publication of formal guidance can be a useful way to inform the entire profession, as well as those outside the profession, of the board's views on issues of broad



concern. Publication never occurs without the consent of the requesting actuary. And the actuary is free to decide, after obtaining the ABCD's response, whether to authorize publication. Even when consent is granted, the board prefers not to identify the name of the actuary.

Requests for guidance are often handled very informally. The actuary is put in touch with one ABCD member. They discuss the issue, and the board member makes it clear that his or her opinions aren't necessarily those of the entire board. However, an actuary is always free to request something more formal. If the board agrees to respond, it will give the actuary written guidance, presenting the view of the entire board.

The ABCD welcomes and encourages requests for guidance, either formal or informal. One easy way to initiate a request is to call Tom Griffin, the ABCD's staff attorney, at 202-223-8196.

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**ED BURROWS** IS A CONSULTANT LIVING IN BOSTON. HE IS A MEMBER OF THE ABCD.

November 26, 2001

Robert W. Sturgis  
Chairperson  
Actuarial Board for Counseling and Discipline  
1100 Seventeenth Street, NW, 7th Floor  
Washington, DC 20036  
RE: Request for Guidance

Dear Mr. Sturgis:

I work as a consulting actuary in the defined benefit area. I am writing you with reference to three hypothetical practices that a firm such as mine could adopt. Actuarial firms sometimes assist their pension clients in purchasing non-participating annuities from insurance companies for their qualified, defined benefit pension plans. There are three practices that could potentially cause problems for such a consulting firm. The following are the three practices for which I am seeking clarification:

1. A consulting firm sometimes engages the help of an independent broker to complete the purchase of annuities from an insurance company. The broker discloses to the client that he will be paid a commission. The consulting firm sometimes has an agreement with the broker that the broker will receive a percentage of the commission, or some fixed dollar amount if larger, and the consulting firm will receive the remainder of the commission. For example, the total premium for an annuity purchase would be \$2,000,000 with a 3 percent commission. The broker would receive the larger of 1 percent of the commission, or \$10,000, and the consulting firm would receive the remainder of the commission. In this case, the consulting firm would receive \$40,000 from the broker as a result of the annuity sale. The consultant firm does not disclose to his client that he will receive any compensation as a result of this transaction. I believe this violates Precept 6 of the Code of Professional Conduct.
2. In some instances, a consulting firm may act as the broker for an annuity purchase. In these cases the consulting firm is paid a commission and discloses the amount of the commission to the client. Sometimes, however, the consulting firm also receives additional compensation from the insurance company in the form of an "Expense Reimbursement Allowance," known as an ERA. Using the example noted above, the consulting firm would receive a commission of 3 percent, or \$60,000, due to the sale. It would also receive an ERA of 1/2 percent to 1 percent, or an additional \$10,000 to \$20,000. The consulting firm does not disclose the ERA to the client. Although this example is not as clear-cut as the first example, I also believe this practice violates Precept 6 of the Code of Professional Conduct because the amount of the compensation is material and it is not disclosed.
3. Some insurance companies offer ERAs and some do not. When the consulting firm assists a client in purchasing annuities for a pension plan, and one of the insurance companies involved in the bidding process offers an ERA, the consulting firm may attempt to steer the client to choose this insurance company as the insurer. This fact is not disclosed to the client. I believe this violates Precept 7 of the Code of Professional Conduct, because the firm is performing services where there is a conflict of interest and this conflict has not been disclosed to the client. The conflict is that the consulting firm has a vested interest in choosing one of the insurance companies over the others.

My interest in this matter is to avoid violating the Code of Professional Conduct. Will you please present these examples to the ABCD and ask them to provide me with a written response as to whether they would violate the Code of Professional Conduct. If it is their belief that they would violate the code, will you ask them to provide me with guidance on how to avoid these violations?

Sincerely,



Actuary X

January 25, 2002

Dear Actuary X:

This responds to your letter of November 26, 2001, seeking guidance relative to three hypothetical situations. We attach your letter as an exhibit to this response. Additionally, we include a request of you at the end of this letter.

Our references to precepts are to the Code of Professional Conduct effective as of January 1, 2001. Our statements that conduct in hypothetical situations would apparently violate the Code should not be taken as assertion that any specific practitioner violated the Code. Determinations regarding individual actuaries can be made only within the context of ABCD proceedings and after careful consideration of all relevant information presented in such proceedings.

You state your belief that in situations 1 and 2 there has been a violation of Precept 6. We agree.

You state your belief in situation 3 there has been a violation of Precept 7 "because the firm is performing services where there is a conflict of interest and this conflict has not been disclosed to the client." We agree that this appears to violate Precept 7. However, it would be incorrect to imply that disclosure is, by itself, adequate to avoid a violation of Precept 7. This precept states three requirements for avoidance of a violation. One is that there be no impairment of the actuary's ability to act fairly.

In all three situations, possible factors not mentioned in your letter could be additional sources of violations. Without attempting to offer a complete list, we offer just two examples:

- 1) With many insurance and investment products, the broker has discretion over the amount of commissions or fees to be paid. The broker's decision is reflected in the charges borne by the buyer—either through the product's price or through operation of an experience rating mechanism. If this factor were present in either of situations 1 and 2, a simple violation of Precept 6 could expand into issues related to conflicts of interest.
- 2) In a retirement plan, decisions on selection of an insurance or investment product can affect the welfare of participants.
  - a) An overpriced annuity contract benefiting one participant can mean too large a charge against plan assets, weakening the security of expectations of remaining participants.
  - b) An investment or variable annuity contract with too heavy an expense loading can mean unreasonably low ongoing benefits for the participant.
  - c) An investment or variable annuity contract selected with an eye toward commissions rather than an eye toward expected investment performance can mean unreasonably low ongoing benefits for the participant.
  - d) An annuity contract obtained from an insurer that ultimately becomes insolvent can jeopardize remaining benefits of a participant/annuitant.

Ordinarily, the principal will be a fiduciary with a duty to avoid decisions on selection of an insurance or investment product that adversely affect the welfare of participants. Presumably, the principal is depending on the actuary for guidance on avoiding any such breach of fiduciary responsibility. For these reasons, all three of the situations in your letter could involve conflicts of interest in which it could be difficult to avoid violating Precept 7, regardless of the amount of disclosure.

Your letter requests guidance on how to avoid violations in the situations you describe. Clearly, disclosure is a major element. Beyond this, all three situations force the actuary to play two roles simultaneously. In one, the actuary is functioning in a practitioner-client relationship where the client expects the practitioner to behave in the client's interest. The relationship may develop in a manner that causes the principal to reasonably repose trust and confidence in the actuary and reasonably expect the actuary to exercise scrupulous good faith and candor. At this point, the law may deem the actuary a fiduciary.

In the other role, the actuary is functioning in a seller-buyer relationship where it is reasonable to expect that the seller might place the seller's interest above that of the buyer. This dual role almost always involves difficult conflict of interest issues. In some fact situations, the only way to avoid violating Precept 7 will be to avoid the dual role. In others, the role may be manageable provided there is no question about the actuary's ability to act fairly.

The issues you raised may be of concern to others in the profession. Accordingly, we request your permission for us to publish a version of your letter along with our guidance, wherein your name, title, and address would be deleted from both. If you have questions regarding this request, please contact staff member Tom Griffin or ABCD member Ed Burrows.

For The Actuarial Board For Counseling And Discipline  
Robert W. Sturgis, Chairperson