CONFLICTS OF INTEREST

A fiduciary to an investment management account violates conflict rules if they:

1. Deal with the fund in his/her own interest
2. Represent anyone with an interest adverse to the plan or its beneficiaries in any transaction involving the plan
3. Receive consideration from any person dealing with the plan in connection with the plan or in connection with a plan transaction

The problems arise from dealing with “parties in interest”, such as the following:

Brokers
Investment Consultants
Money Managers
Lawyers
Accountants
Administrators
Other Service Providers
Named Fiduciaries
Employers
Owners
Officers
Any corporation or business owned primarily by a Party in Interest
AND any relative of any of the above

Take the case of the doctor, a serious art collector, who was trustee of his practice’s retirement fund and invested $100,000 of the $400,000 in the fund in paintings and sculpture. Since there were no suitable local storage facilities, the doctor built a separate refrigerated storage building on his property and charged the fund storage fees to pay for it. When the IRS audited his Form 5500 and demanded to see the storage facility receipts, they determined that he bought the artwork for his own use and that made the action a prohibited transaction. Trustees will always get into trouble by buying art with plan assets and hanging it in their houses or offices.

Also consider the doctor who was trustee of her firm 401(k) and invested it in certificates of deposit and money markets at the local bank. When she applied for a $14,000 loan at the bank, she got a preferential rate because she had good balances in the retirement account there. The problem with that is that she got a benefit (preferential rate) from the retirement account which has to be for the exclusive benefit of participants. The result is a prohibited conflict of interest on its face.

The Boondoggle: Consider the money manager who has lovely offices near the ocean and a prominent resort. Say the manager sponsors a “meet the portfolio manager” due diligence session and then invites financial advisors and investment consultants who have placed significant assets with them over the past year to attend with all expenses paid. Bring your spouse--they go free, too. Suppose the due diligence session consists of an office visit sandwiched between the beach, boat rides, golf, tennis, and lavish dinners with flowing wine. After the session, all attendees depart with an expensive “memento” of the trip like a $500 sweater, luggage, Cuban cigars or the like. Such an activity described above was routing not too many years ago and would now have great difficulty passing muster with IRS, the SEC, or the DOL.

Take for example, Secretary of Labor v. Carell (17 EBC, 1160) JWC provided administrative services to their Southern Council of Industrial Workers Health and Welfare and Pension finds. JWC sponsored trips to Hawaii and Naples, Florida, all expenses paid for attendees and spouses, including air fare, lodging, meals, refreshments, and entertainment. JWC defended their actions as a social event paid for by funds from other accounts at JWC, not the Industrial Workers’ funds. The Trustees didn’t go.

In USA v. Rosenthal, it was determined that an intangible could be a thing of value. David Solomon was head of Solomon Asset Management which, among other things, managed bonds. Solomon dealt regularly with Drexel Burnham Lambert’s High Yield Bond Department and admitted he spoke to a man named Michael Milkin about 30 to 50 times a day. On a call to Milkin, Solomon said he needed a tax write off that year. Milkin said there were no tax shelters available, but offered to sell Solomon, for his personal account, some securities and buy them back the next day for a lower price, generating a tax loss. The next year, Drexel would give Solomon some profitable trades to make up the losses. Milkin told Solomon to call the head of Drexel’s convertible bond department, Alan Rosenthal, tell him what he needed and Rosenthal would take care of him.

Solomon was a big customer of Milkin, placing 50-70% of their trades or $2.5 billion annually there. Drexel found itself in increasing competition for Solomon’s business. The personal trades in question (regardless of whether it falls within NASD pre-arranged trade prohibitions) were likely to ensure that Drexel would remain in Solomon’s favor. Rosenthal got one year in prison, three years probation, a $250,000 fine, had to do 300 hours of community service, and to top it off, paid $50 in court costs.