RECORD OF SOCIETY OF ACTUARIES
1993 VOL. 19 NO. 4B

PROFESSIONAL ETHICS

Recorders: MARY HARDIMAN ADAMS
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- This session will cover current issues in the area of professional ethics as it relates to pensions.

MS. MARY HARDIMAN ADAMS: I have retired from Buck Consultants where I was a consulting actuary for many years. I'm only somewhat retired, I guess, since I am a member of the Joint Committee on the Code of Professional Conduct and I am also Chairperson of the Pension Committee of the Actuarial Standards Board (ASB). Those are relative to the topics. I'm also one of the associate editors of *The Actuary,* and I have responsibility for two issues a year. On my left is Jim Murphy, who will tell you about himself.

MR. JAMES J. MURPHY: I'm executive vice president with the American Academy of Actuaries. I've been there for about five years now. Before that I was chief actuary at Northwestern Mutual Life and my total exposure to pensions was the home office pension plan. Since I have joined the Academy, I have had a lot of exposure to issues and developments in the area of professional ethics, so I hope I can bring some interest to this discussion. First we'll discuss an outline of issues and information that relate to the concept of professional ethics. Then we will discuss a set of four case studies. Our approach to the session will be to initially have Mary go through the outline with some comments from me on some pieces of it along the way, and then we will discuss the case studies. They're really quite brief. We'll just go through each one.

MS. ADAMS: The first thing we have to think about is the sources we have for guidance for our professional conduct -- guidance on what the ethics of being an actuary might be. Within the profession we have had many groups that have been very active in developing standards. They have provided the codes of professional conduct, standards of practice of the ASB, qualifications standards (which are issued by the Academy of Actuaries), and the Actuarial Board for Counseling and Discipline (ABCD). External to the profession, pension actuaries also have the regulations of the Joint Board for the Enrollment of Actuaries, ERISA, the Internal Revenue Code (IRC), and regulations under all of them. All of these internal and external sources provide guidance, but some also provide marching orders. I prefer to think of all of them as guidance. However in many areas the guidance is very specific, especially the Joint Board rules; you must follow them. You must have an awareness of this kind of thing.

One of the things to keep in mind is that the code of professional conduct stipulates that, if there is a conflict between the profession's rules and laws or regulations, the latter take precedence.

Consequently, you don't have to worry that, if a professional rule says something that is not exactly the same as what the law says, you might be expected to worry about breaking the law.

The codes of professional conduct (I call them the codes, it's really the code) have been adopted by all of the professional actuarial organizations in the U.S. In 1992, the organizations adopted codes that were essentially the same. We worked very hard over the past year on the Joint Committee on Professional Conduct to eliminate that word *essentially*. As of now, the last part of 1993, the codes are the same for the American organizations. The new code, which really doesn't change very much from the old one, does eliminate minor but sensitive differences that existed previously. I expect that for the U.S. organizations the new code will be included in the 1994 *Yearbook*. It's also of interest to note that the Canadian Institute, because of the laws of Canada, does not have an identical code. However, the rules of conduct in Canada are completely compatible with those in the U.S.

In the code of conduct, all kinds of topics relating to conduct are covered. In the pre-1992 codes, there were practice matters, and these have been moved into standards of practice. The items covered now are all conduct related. They include the need to abide by the code. (That was not in before, by the way, which surprises everybody; but it wasn't.) There is a definition of professional responsibility. What is it that you are really supposed to do? Other items are the need to observe qualification standards; the need to follow standards of practice; how to identify the actuary in an actuarial communication; a statement concerning the actuary's responsibility and the actuary's reliance on others (e.g., accountants and or lawyers); how to resolve conflicts of interest; confidentiality; courtesy and cooperation (mostly with other actuaries is the intent there). And the beat goes on: how to resolve differences of opinion; what is proper advertising; how to use proper titles and designations (and those are designations within the actuarial organizations, not with respect to the actuary's employer); how to communicate; and what the situations are when you should communicate with the ABCD.

Now to look at the standards of practice. This is the other project that I have been very much involved with, primarily, of course, with the pension standards. These are issued by the ASB. The process is that proposed standards are developed by a specialty committee of the ASB, such as the pension committee in the case of pension standards. When the specialty committee thinks that it has an acceptable document, the draft goes to the ASB for approval to expose it. Sometimes it takes several tries, by the way, before the committee can get the approval for exposure. After exposure there is a period for comments and, in the case of many standards, for hearings. Then there is revision, in accordance with the comments received by the specialty committee. Then the document goes back to the ASB for approval, and we hope there is a final document. However, that exposure process and hearing process may go on several times. Actually, the ASB's Pension Committee is in the process now of preparing a second exposure draft on the selection of economic assumptions.

With regard to pension standards, right now there is only one standard in existence for practical purposes. Actuarial standard of practice (ASOP) No. 4 has just been reformatted, and was approved by the ASB for recirculation. There really are no essential changes; but there is minor change to reflect the current thinking that the primary criterion for an actuarial assumption is that it should be individually reasonable on its own. Previously it was stated that the first criterion was that all of the assumptions should fit together and they should in the aggregate be reasonable.

Now the thinking is that they should be individually reasonable, and they should also be reasonable in aggregate. This slight change is noted in the transmittal of the reformatted standard.

With ASOP No. 4 there are problems. First, the concepts were developed in the 1970-80s. They're sort of old. They were issued by the interim standards board in the early days of that interim board. They really are the old recommendations and interpretations put in a different format. The background of ASOP No. 4 the original or the reformatted version was from way back in the 1970s, when we were trying to get involved in coping with ERISA. That's a long time ago. The reformatting without further updates has been accomplished and should be issued around the end of the 1993, wouldn't you say, Jim?

MR. MURPHY: Definitely.

MS. ADAMS: Just to give you an update on the exposure draft on the selection of economic assumptions, we had an absolutely fantastic response. At first we were delighted. There were 51 written comments. We thought -- wow, people are really reading this. This is just great. When we started to analyze them, what we realized was that, with regard to taking just one sentence, you have one person saying, "This is the heart of the matter." Then you look at the very next response and it was, "What in the world are you talking about?" Then you have somebody else say, "This is ridiculous, get rid of it." You have to count up the number of ridiculous and the number of goods and bads and try to figure out what to do with it to make sense of the whole thing.

The comments came from individuals, they came from the pension committees of the various actuarial organizations, and they came from representatives of a lot of the large and middle size and small consulting firms representing the views of that organization. The quality of the responses was superb. It's just that it would take about 190 pages to publish them, so we're not going to do that. Really, it was great. The situation right now is that we're about halfway through developing material, based on what we heard, for a second exposure draft. We do not anticipate a final statement by any matter or means; it probably will have as much controversy as the first one. By the way, some of the comments were, "Boy, were you people brave pension actuaries even try to publish a standard on economic assumptions." Others said, "Brave, no; insane." That's where that whole situation is.

What we are planning to do is, when we get through the selection of economic assumptions as a separate standard, we will then prepare a separate standard on the selection of demographic assumptions. That's in very early drafting. We want to have a liability valuation cost methods standards as a separate entity and that, again, would be developed from ASOP No. 4. We also want to have actuarial asset valuation methods in a separate standard. Then when that is all completed, ASOP No. 4 will be redone as a master document to put all these others together. That is our long-term plan.

We anticipate that there will be conceptual differences from ASOP No. 4, but as they come along, they will be very carefully delineated so that everyone will be aware of them.

That's where we are on the standards of practice and on the code of conduct. I think, Jim, you might want to talk about the qualifications standards.

MR. MURPHY: The qualifications standards, another type of standard that you are required to follow by the code of conduct, just as the standards of practice, are promulgated by the American Academy of Actuaries, by its Committee on Qualifications and following exposure and then approval by the Academy Board.

Essentially in the world of pension practice, your initial qualification standard for most of the, at least, ERISA-based work is, in the U.S., the enrollment status. All of you, who practice in this area, are fairly comfortable and know what that's all about. As you know, you have some continuing education requirements for that designation that are administered by the Joint Board. Certainly, if you have questions about those later, we will be glad to try to respond, but we will not try to speak for Mr. Shapiro, nor would he want us to.

But you're not always doing just ERISA work when you're dealing as a pension or employee benefits consultant. Therefore, you still need to consider in any particular assignment whether or not you qualify. That is the basis of the precept in the code of conduct and the basis of the qualification standards of the Academy, because the codes of conduct apply to all organizations and members of all the organizations practicing in the U.S. including Canadians, who may choose to come down and practice in the U.S.

There are two types of standards: general qualifications standards and specific qualifications standards. You're not apt to run up against specific qualifications standards in pension work, but those relate specifically to annual statement opinions that actuaries provide to the NAIC in life and health and casualty areas. The general qualification standard, on the other hand, applies to you, whenever you are making a public statement of actuarial opinion. That is the essence of the qualifications standards. You must meet those standards if you are making a public statement of actuarial opinion. Public statements of actuarial opinion are statements required by law or regulation or required by the standards or required by quasi-regulatory bodies such as FASB and Governmental Accounting Standards Board (GASB), so that's what you need to keep in mind.

The qualifications standards are fairly simple. They involve basic education requirements, usually fulfilled through the education/examination systems of, in your case, the SOA. Also, in some cases those adult educational qualifications can be met through alternate means, particularly when someone who is a qualified actuary is switching gears and changing his area of practice. Of course, for the Enrolled Actuary (EA), you know what those education requirements are. There's also an experience requirement, relevant recent experience in the area of practice, in the area of doing the project. Finally there are continuing education requirements, typically defined as 12 credit hours with at least half being from organized activities such as we're attending, and that 12 hours is counted on sort of a rolling two-year basis. Every two years you look back and see if you have a total of 24.

MS. ADAMS: Those are called disorganized.

MR. MURPHY: Disorganized hours, but you need to get some of them from an organized basis. You can get them in unorganized ways by listening to tapes of sessions such as this, as long as you sort of keep a record. The whole system is honorary. You keep your own records, but you should be prepared if asked to defend your qualifications. All three bases are experience, education, and continuing education. That's a quick summary of the qualifications standards.

MS. ADAMS: The next thing on our list is the ABCD. I think you probably know more about that than I do.

MR. MURPHY: The ABCD is a body somewhat like the ASB that is housed within the Academy, but provides counseling and discipline investigation for all of the U.S. bodies and in fact would do investigation of cases of Canadian actuaries, should they be practicing in the U.S. The ABCD members want to emphasize very much the "C" in the ABCD. They are not just out to hang people, and in fact, they haven't the authority to hang anyone. When it comes to discipline of a public nature, their authority is to provide recommendations to the member organizations and the member organizations then act on the ABCD's investigations and recommendations, but the ABCD cannot discipline anyone. But the ABCD members do a lot of counseling, either as a result of a case being brought to their attention and the decision being that the best way to deal with it is to have a chat with the actuary about the practice. Alternatively, individuals can seek counseling for themselves if they're in a situation in which they are not quite sure what the right answer is for dealing with the situation. The ABCD is there to help you, and I urge you anytime you have a question either about someone else's actuarial practice or your own, feel free to call our general counsel at the Academy office or the chairman of the ASB. The ASB has been in existence since January 1992. It inherited a number of cases. I believe its members have looked at a total of somewhere in the neighborhood of 60 cases. It has taken only one case to hearings so far, and I understand the organizations will be hearing about the recommendations from that hearing soon. Other cases have been either dismissed because there was insufficient evidence of wrongdoing or have been counseled about the situation or in some cases, an ombudsman is appointed because a lot of the cases involved interprofessional relationships. It's really not a question of right or wrong practice. It's a question of a situation that needs to be resolved and a third-party impartial ombudsman can often bring that about. The rest of the cases are currently either awaiting appointment of an investigator or have just had an investigator appointed. I'll leave it at that as background on the ABCD. One other thing maybe is important, so you know. The ABCD is a board of nine members of the profession. They are appointed to three-year terms by a selection committee made up of the presidents and presidents-elect of the five U.S.-based actuarial organizations. They are broad-based. They're intended to represent or be representative of a broad reflection of the profession and its various practice areas as a whole.

We didn't mention this, but the ASB is similarly appointed by this same group with nine-member boards appointed for three-year terms.

MS. ADAMS: I think the last element of the sources of guidance for pension actuaries is the regulations of the Joint Board for the Enrollment of Actuaries. Those regulations include information as to when you're eligible to perform services, enrollment procedures, standards of performance which are listed on the outline. They also

cover the methodology for suspension and termination of enrollment, which is a due process situation. They provide general information. I think we've really covered what's out there for actuaries who have a problem or want to have guidance when they have to make a decision in their practice.

I think now it would be fun to go to these case studies. This, I consider the fun part of this whole session.

MR. MURPHY: Let's hope so and we're hoping that you will contribute to this fun by taking each of these four cases. We'll go through them one by one and see what questions they raise in your mind, perhaps some modification of the situation as addressed here will raise a different issue, so let's spend a little time on each of them. I'll read the case study out loud, and that way we're all at the same base. When we're done, we can look at the questions as they are posed.

Case Study No. 1: Actuary Jones was a consultant who prepared annual filings for the Acme Corporation's Pension Plan based upon census and financial data he received from the plan's trustee. When the time came to begin work on the annual filing, Jones noticed the census data provided by the trustee appeared to be identical to that provided the previous year. The list of employees in the plan was also unchanged, reflecting no new hires or terminations and employees' salaries appeared to be the same as they had been the previous year.

Jones further noted that Acme's asset statement reflected that a participant loan to Acme's President and majority stockholder had been fully repaid during the year. However, the statement of trust receipts and disbursements for the year did not provide any evidence of this repayment.

What are Jones' obligations on the code of professional conduct, which includes a requirement to observe the standards of practice of the ASB? I can briefly identify the code issues that seem to come up here, but if someone wants to ask some questions first and then we'll address them as they go, that would be fine.

MR. SOL J. BORGER: I just wanted to ask, how big is this corporation? If it's only a small corporation of three to five employees, it's quite possible that the census data would remain the same and that there would be no raises, but if it's 100 or 200 or 1,000 employees, then the question is obvious that there is something wrong.

MS. ADAMS: My personal experience was that I had a relatively small client who had about 50 employees. We received a data statement that had exactly the same people as the previous year and so I called the client and told him of this. He said, "Oh, it's ridiculous." His secretary picked up the wrong piece of paper and sent it to us. Does anybody else have a problem regarding the president? Did you know the CEO had a loan? It could be illegal, you can't have a loan from a defined-benefit plan. You can take a loan from a profit-sharing plan or a defined-contribution pension plan. But not only was it a participant loan from a defined-benefit plan, but it was taken by the chief stockholder. My advice there is, call your lawyer; then call the client and say, "You'd better call your lawyer, because I believe that's an infringement."

MR. MURPHY: Prohibited transactions is the statement.

MS. ADAMS: Yes, it is, but that was sort of subtly thrown in there. It says there was no record of the repayment, but there wasn't any record either, I guess, of the borrowing procedure. Back to the data problem, other than the situation where there might be only one or two employees there possibly could be a situation where you wouldn't have a change in data, but we would expect that would be wrong and the actuary would be responsible. There's also the new standard on data, which indicates that you have to have a reasonableness check on any data that you receive.

MR. GRADY C. CATTERALL: Regarding the loan to the majority stockholder, clearly something illegal is going on here. Is the actuary in any way required to play the policeman and report this to the Labor Department or whoever, or is it just his professional responsibility to talk to the client and say, this is not legal and you need to resolve this problem?

MS. ADAMS: That's why I said the first thing you do is call your lawyer. The actuary calls his lawyer and says, "What do I do now?"

MR. MURPHY: There's an issue on confidentiality as well as breaking the law.

MS. ADAMS: I really wouldn't know and if I ever had that situation, I can assure you, I would first go to my own lawyer and say, "Here's how I read the law. Here is what appears to me to have happened," and then get in touch with the client.

MR. MURPHY: Essentially if you think just in terms of your code of conduct and what your obligations are, there's really three that apply here in total. The first is Precept 2, which requires you to do your job with integrity, skill, and care. That gets back to just checking things like this carefully. The second is that you are required to file a standard of practice. As Mary already mentioned, we now have a standard on data quality that you can refer to, but it certainly requires you to make sure that the data you're working with is reasonably accurate and certainly this question is here. Finally, Precept 9 refers to, "An actuary shall not perform professional services when the actuary has reason to believe that they may be used to mislead or to violate or evade the law." As a minimum, the actuary may have to pull out of this situation. Perhaps it is appropriate to investigate it, but it may still be appropriate, at a minimum, to pull out. Then you may have the confidentiality issue to deal with, and that's why I think Mary's advice is right, talk to your lawyer.

MS. ADAMS: When in doubt. I think Lauren Bloom, who is counsel for the Academy would be thrilled to hear me say, "Call a lawyer," because I always say you really don't want to get the lawyers involved. We'll have to let her listen to this tape.

MR. MURPHY: Yes, I'm sure she'll like it. Any other thoughts about this case as you look at it, or does it raise thoughts of similar kinds of cases involving data where you're not sure about a client's activities?

MR. DAVID M. WELSH: I have a question about the loan to the chief executive officer of the sponsoring organization. Is that necessarily a criminal act by him or does it merely call into question the continued qualified status of the plan?

MS. ADAMS: I believe it is the continued qualified status of the plan. However, it's wrong, you don't do it. Certainly something would have to be done that would rectify the situation.

MS. MARGARET M. WARNER: When I was reading this case study, I noticed that it said corporation's pension plan and then I saw that there was a loan, so I immediately assumed it was a money purchase pension plan, in which case the loan is fine if everybody else can get loans, because it is a participant loan.

MS. ADAMS: We took it in the sense that it was a defined-benefit plan.

MR. MURPHY: That's certainly a valid point.

MS. ADAMS: That's a valid point, yes.

MR. MURPHY: Any other thoughts that come to mind as we look at this case before we move on to the next?

MS. SIMCHE MARGULIES: Why do we have to assume that he intentionally did something wrong? He might have thought that he is allowed to do a loan from a defined-benefit plan.

MS. ADAMS: That's right. That's why he should call his lawyer.

MR. CLAUDE B. SISSON: Rather than the propriety of the loan itself, I guess I'm very concerned about the fact that the money seems to have disappeared somewhere. This is where we should be concentrating on looking for criminal activity, if we're going to look for it, I think. It's entirely gone. Perhaps it was just an oversight, but we certainly need to put something in writing to the client saying what happened here and just start, as you say, to talk to our lawyers and protect ourselves a little bit, too, because this is a very serious situation.

MR. MURPHY: And ultimately potentially pull out from under this case and refuse to do any work for the client.

MR. SISSON: You might even need to go further than that.

MR. MURPHY: You're right, further than that. But you have to at least consider that. Shall we move on?

MS. ADAMS: I think so.

MR. MURPHY: Case Study No. 2: Actuary Smith was hired by the XYZ Company to complete the pension valuation work for the company's defined-benefit pension plan for the 1991 plan year. After studying the plan's five-year investment history and reviewing its asset portfolio, Smith decided that a 7% interest assumption for the funding was appropriate. The resulting contribution required to meet minimum funding standards was $1 million for the 1991 plan year. In preparing to complete the January 1, 1992 valuation, Smith noted that the company had not yet made any contributions to the plan for the previous year and did not reflect any contribution

accruals on the plan's balance sheet. After sending the company a request for this information, Smith received a phone call from the company's chief financial officer. He was told that the $1 million minimum contribution for the 1991 plan year was unacceptable. The company insisted that the 1991 valuation be recomputed using an interest assumption of 8%. Should Smith agree to recalculate the filing using the more favorable assumption? Can Smith do so in compliance with the code of professional conduct, which includes the requirement to observe ASB standards of practice? Anyone want to jump in there and give some reactions to this one?

MS. ADAMS: I'll start. I think the first thing you should do is look at where his 7% advised interest rate came within a reasonable range of what you could use. You're looking at on January 1991, when say a U.S. government security methodology could show you that the lowest interest rate you could use (I'm making up numbers) was 6.9%, but if you took into account the distribution of different kinds of investments and so forth, you could be comfortable with a range of 6.9-8.9%. Why did the actuary choose 7%? Is it because of poor management of money? For what reason? The other thing is that the actuary should explain to this client the implications of changing an interest rate. For example, if this plan should be a final average pay plan and the client says we go up 1% on the interest rate, you say, we'll do that, and we go up 1% in the salary scale assumption. Make the assumptions fit. Don't forget, it is a minimum contribution and the effect of assumption changes could contain surprises. If you imagine that your total projected liabilities would go up by a certain percent and you take out a slice for the current service cost and if you assume that perhaps the unfunded prior service cost is being funded over a 25-year period, you can get funny answers. The answer while likely to be smaller might be bigger because of the funding on a level basis over a 25-year period. Thus I think that the next thing you should do is say, "You're just saying 8%. Do you know what the implications of 8% are? Instead of a million dollars your contribution might be $999,000, or it might be way down or it might be up." I think those are two things to think about. Now I've started, who is going to continue?

MR. CATTERALL: I would ask the CFO if he thinks that 8% is theoretically better justified than 7% or if he is just looking for a lower contribution. If he is looking for a lower contribution, then you just have to say, I can't shop for the best contribution for you. If he doesn't agree, then you just can't continue on that case. If he thinks that theoretically justified, that 8% is more reasonable than 7%, then you can ask him to make the case for that. Regarding whether that implies a higher salary scale, that just depends on whether he thinks 8% is better because inflation is about to shoot up or if he simply thinks that the portfolio will in fact have a higher real return than what you're assuming. If it's the latter case, then you don't necessarily have to increase the salary scale along with the investment return. Do you have any thoughts on that?

MS. ADAMS: I don't know. The old Ibbottson-Sinqfeld studies indicated that over a long period of time, the inflation in the investment return and the inflation reflected in cost of goods and the inflation reflected in salaries, not year to year but over a long period of time, would run close. Thus, if you raise your interest rate by 1%, your salary scale probably should go up by something akin to that. This can be a debatable point, but in my own personal practice, I always did that. Again, I'm not saying it's perfect, but that's what I did; people will debate it, but it's a good point to raise.

MR. MURPHY: From a professional responsibility requirement basis, I think what you described is just about what needs to be done. The actuary needs to communicate with the chief financial officer, in this case, and say, "I had reached a conclusion that 7% was appropriate. What information can you give to me that would suggest I was wrong -- or that you're right?" Admittedly there are reasonable ranges available in making these decisions, and it's not one number and one person could get a different number than another, but they ought to be reasonable and in the same ballpark. Whether or not this case would meet that requirement remains to be seen, but the responsibility is not; you don't just sit back and say, "I'll do it." You have a responsibility under the code of conduct and under the standards of practice to investigate this question, and ultimately, as you said, perhaps you just can't honor this request.

MS. ADAMS: Just to go back to our good old economics problem, in the exposure draft for the standard we had said that what you do first is look for a range of logical numbers that probably would be suitable for any client. You get a range at any valuation date, and then you hone in on the one for that particular client. In the exposure draft, we raised the question as to whether actuaries agree that this is the logical way to approach it. It's the only way I can think of approaching it, because we all know we could have a set of examples and out of all 80 people in this room, who are all pension actuaries, could very easily come up with 20 different answers. They may be only ten points apart, but we probably would chose differences because of our own personal biases and because of the way we read a situation. This is one of the difficulties of writing a standard. How can you say that there is this range, and still write a standard that people are going to accept? One of the comments on this, I think it was only one, came from a person who said he could not see how at any one valuation date an actuary, no matter how many clients he had, could come up with other than one answer. This was not an academic, this was someone in the real world. I just couldn't believe somebody would say that. However, that person looking at this problem would say, I said 7%, that's what it's going to be.

MR. MURPHY: Do you have a comment?

MR. BERNARD PACKER: Since I don't ever face this dilemma, I am going to look at it from the viewpoint of one who does. Many of these points occur in my type of operation, regulatory, overlook, whatever. The first thing that I noticed about this is that it is a phone call. That would immediately raise the hairs on the back of my neck. Why didn't I get a response in writing? I think you've alluded to that. The first thing I would want is a response in writing with all the reasons that the company's CFO could raise to show why his position is clear. The second thing I would have to know is, who am I in my organization? Am I a one-man operation? Then I could afford to be independent, presumably. However, if I work for a consulting actuary and I am Joe Schmoe, low on the totem pole, I might be losing a valued client with a bad decision. Presumably after I have received something in writing and I say, "I have this dilemma. I have this in writing from the company. The company is maintaining that it can earn 8%, yet my knowledge is that I should use 7% or if I change from 7% to 8%, I have to make other assumptions so that all of my assumptions will be reasonable." Whatever the rule happens to be in that case. If my boss tells me to go ahead, I will accept that, and I will then write a memorandum to file and advise people who work for me, to do the same thing because this situation

comes up all the time, where the manager has to make the decision for someone working for him. The company has a viewpoint, rather than the individual in the company. If you don't like that viewpoint, then you have to look elsewhere, but it becomes an important part of the decision making. Making the decision is the easy part. Backing it up is harder. Later on, if something was done and it turns out to be unethical, I think you have to be able to show that your part of it was ethical.

MR. MURPHY: I think you raised an interesting point there, and I agree with your analysis and expending. I think you raise a very interesting point in terms of someone who works for an organization encounters something like this, maybe they're young and inexperienced and they discuss it with someone else, their boss presumably, and their boss decides to go ahead and do it. To what extent does the individual still feel it was wrong and then what is his or her obligation under the code to bring that to the attention say of the ABCD and that gets into issues of confidentiality. Under the new code that will be effective the first of the year, there is the option of at least trying to resolve the issue to your satisfaction with the individual. Ultimately there is that question, not only of protecting yourself as you say by memo to file, but also have you done all that you're responsible for doing in terms of letting the profession know that there is somebody, albeit maybe your boss, who is not acting responsibly as a professional. There are a whole lot of things we don't know about this case, so we don't know where it goes. But it is something, I think, that the individual in a situation such as you describe has to resolve. Not only then, do they have the question of whether to do the work for the client, they have the question now that presumably someone they know is willing to do the work for the client and is that work professionally responsible? It's an interesting situation.

MR. ROBERT L. NOVAK: Reading through this, I guess a couple of thoughts come to mind. First of all, based on, I think, experience over the last two and a half years, I think many of us have lowered our focus as to what is an appropriate interest rate. I would find it incredible, back on January 1, 1991, if an actuary would find 8% unreasonable though. I suppose there could be some mitigating circumstances in this case. I mean, clearly if a client is putting pressure on you to use what you think is clearly an unreasonable assumption, say 15% or something in that area, I think ultimately you have to define it. Whether you're out on your own or working for a larger organization.

I wanted to bring up the issue, suppose this were a discount rate issue under Financial Accounting Standard (FAS) 87 where the pressures and the requirements of the actuary are a little bit different, might the response be a little bit different as well?

MS. ADAMS: Well, under FAS 87, they are management numbers. I think that if you should be asked to do them in the current environment at say 12.5%, you'd say, "This is ludicrous," and the client could say, "This is what I want." The actuary acts as a number cruncher, but don't forget this is subject to external audit. That's where I think it would be hit.

Furthermore, on that particular question, there is that letter from the SEC to FASB late in September 1993. For the discount rate, we had been told by FAS 87 to use "a settlement rate." The SEC has now indicated that it is appropriate for pension plans to use the same as the discount rate as applicable for FAS 106 calculations; this is

the rate for high quality bonds, which would be AA or higher. That's conceptually different from a settlement rate. I think you would have a hard time showing that you could make a projection of the current level of high quality bonds to be much more than 7%. It is going to be very interesting. I think the auditors are going to have to sit hard on that one.

MR. MURPHY: Another element here, I don't know if this fits or not, but *FAS 87* comes under compliance guideline rules, and you're doing something that is required by law or quasi-regulatory requirement that may differ from what you would do under the standards. You may have an obligation to disclose that difference, which sort of raises a red flag for the auditor.

MS. WARNER: That's what I was going to say. On *FAS 87*, I think you do have an obligation to disclose that you think the rate doesn't comply with *FAS 87*. On the funding issue, I guess I think this would be a better example if it was 7% versus 10% or something. Personally, I think that a range is the best we're going to do on interest rates. Actuaries are actuaries. I don't think that many of us are economists. I just wonder how much honing in you can get on an interest rate. Can you really say that 7% is the only rate or is the best rate, that you've looked at everything? Can we really analyze these sorts of portfolios? I'm not sure that actuaries are that specialized and that trained in investments that you could really now range down that much.

MR. MURPHY: Again it gets back to what we know about this case, and if the actuary had set a range where his maximum was 7%, then the issue is raised, but if he had set a range that was 6-9%, then the issue is less serious. We don't know all of the facts here.

Are there other comments on this case? Just to summarize from the code of conduct point of view, the things that come up are Precept 2, integrity, skill, and care. Consider what you do in Precept 4, following standards, particularly as they evolve, that is, the pension economic standards and ASP No. 4. Perhaps a little bit of the issue of Precept 9 is involved again, if you think your services are going to be used to mislead or evade the law. Plus, as we talked about, there is an element of the disclosure. That's all just common sense.

We'll go on to case study No. 3. This one is sort of fun, though not as pension oriented as others, perhaps not at all. Actuary Brown's wife was the chief executive officer of a large corporation. At dinner one evening, Brown's wife mentioned that her company was about to close a confidential deal with another company that would vastly increase the value of her company's stock. Brown purchased several hundred shares of stock in his wife's company. The deal was consummated, the stock soared in value and several months later, Brown was convicted of insider trading, which is a felony. Although Brown was trained as an actuary, he also had a law degree and had worked as general counsel of a large investment company for several years. Two weeks prior to his trial on the insider trading, Brown authorized his firm to implement an employee education program that discriminated against minorities. One disgruntled minority employee, who had been excluded from the program, successfully sued the company for employment discrimination. It became apparent through the course of the employee's suit that Brown, distraught over his

pending trial, had not researched employment discrimination law before approving the program. The questions raised here are, was Brown's failure properly to research the law a violation of the code of professional conduct, and under the professional code of conduct, what are the consequences of Brown's criminal conviction for insider trading? Anybody care to jump in on this one? Shall I start and see what happens this time?

Perhaps I'll discuss the second question first. His felony conviction clearly according to the current code and an annotation of the new code, brings him under the investigation of the ABCD. There's just an obligation to investigate this situation. Perhaps the ABCD question may relate to the relationship between this felony conviction and his practice. In this case, it's a felony but it was at home. It didn't relate to his work as an actuary. That might affect the sentencing that the ABCD might come up with, but I don't think it would affect the decision that some disciplinary action is probably warranted here. I shouldn't judge, but I would think a public reprimand would be the minimum. It's hard to believe that counseling would be enough in this case, but the issue here would be one of, what's the right sentence, not whether or not the ABCD should be looking at the case, because it is indeed a felony and for that matter, it's a financially related felony. It does have relationship. That's the quick look at that question.

The other question is perhaps a little harder, and it gets down to the question of, what are professional services? There's an attempt to define that in the code, in the annotations. When are you acting as an actuary, and when are you not acting as an actuary? In this case, it's clear, Brown is probably not acting anywhere near to his function as an actuary by researching a legal issue for the employee program. Chances are we don't have an issue to go after him there, except perhaps to the extent that this thing gets blown out of proportion, hits the newspaper and the next thing we know, his actions are being toted as the actions of an actuary. His actions have had some impact on the reputation of the profession. That may make it a little different. Also, if he were doing something more closely related to actuarial advice, legal work related to investments or investment decisions or employee benefit plans and benefits, that might also affect whether we're looking at something that is beginning to look more like professional services of an actuary, or activity that impugns the profession in total. There are some questions there that the ABCD may very well have to look at. Some of them are a little gray, and we may need to know more about them. Anybody want to comment?

MR. WILLIAM M. BUCHANAN: I read the code here and it says, "An actuary shall be deemed to have contravened the code of professional conduct and shall be subject to professional disciplinary procedures if the actuary pleads [guilty] to or is found guilty of any misdemeanor related to financial matters or any felony." It doesn't seem to relate to his work, necessarily.

MR. MURPHY: That's the point. The ABCD has to look at this; the question is, what is the sentence going to be?

MR. BUCHANAN: With respect to the other point, there's nothing that says an actuary can't be wrong or make a mistake, and it looks like the lawyers are really involved in this one more than the actuary.

MS. ADAMS: As an actuary you should be upset about sloppy work, which it was.

MR. MURPHY: Just as a side point here, in the current code is annotation 14, which Bill just read to us. That doesn't appear as a separate precept, Precept 14, in the new code that will be effective the first of the year. One of the difficulties the organizations had was putting a handle on what code precept had really been violated when you are found guilty of a felony or a misdemeanor. Ultimately, you'll find in the new code and this has helped us to get a little more agreement from all the organizations, this particular language appears as an annotation to the first precept of the code. The first precept of the code is, "An actuary shall act honestly and in a manner to uphold the reputation of the actuarial profession and to fulfill the profession's responsibility to the public."

When you're found guilty of a felony or a financial misdemeanor, that's really the code precept that you're violating, so this language about a felony appears as annotation 1.2 of this old Precept 1, "An actuary pleads guilty to or is found guilty of any misdemeanor related to financial matters or any felony, shall be presumed to have contravened Precept 1 of this code and shall be subject to professional counseling and discipline procedures." They then have sort of a code precept that is related to the profession that we hook this potential conviction to. Any other thoughts about this case?

MS. MARGULIES: How would this get to the attention of the ABCD if he's not at all practicing as an actuary? Does somebody read the rap sheets of all felonies and find out if they are actuaries?

MR. MURPHY: That, too, is just an ongoing implementation problem that the ABCD is not all-knowing and it needs help. If other actuaries or individuals or entities are aware of the conviction of this actuary for a felony, we would hope that they would bring it to the attention of the ABCD, and that's really the only way you are going to find out about it and it in fact does happen. Some cases, of course, are bigger than others and they get more people who see them and who knows, maybe a member of the ABCD is going to see it himself as an article in the paper about someone. I know that fellow. He's an actuary. The ABCD does rely very much on the members of the profession and the public the profession works with for input, for raising issues with it, be they individual cases or be they individual or broader situations. We are looking in the Academy at the possibility, there is a sense of obligation to investigate, for example, insolvencies. This doesn't relate to pension work, per se, but it actually can because a lot of your work may relate to investing in company products and the solvency of companies is an issue. But where there is indeed an insolvency, does the profession have an obligation to just go in and look and make sure that the work of the actuary was not at fault and contributing to that insolvency. In a sense the ABCD wants to take a proactive approach, the profession does, but you can't always know. It's a good point.

MR. WELSH: This use of the term *felony* is probably going to create some implementation problems along the way also, because some kinds of conduct are defined by laws in some states as felonies and they are misdemeanors in others, so that is far from a neat dividing line there. The second question I had, related to whether there was any kind of a statute of limitations beyond which, or effectively a statute of

limitations beyond which failure of the ABCD to do anything renders a situation so stale as to be beyond its reach.

MS. ADAMS: I can do the first part. I was in the group that drafted this code, and there was considerable discussion about the differences in the definition of felonies, such as in some states if you shoot a buffalo, it's a felony. We felt that there was no other way to describe what we had in mind other than the word *felony*. We certainly assumed that the ABCD would not put a discipline charge to somebody who shot a buffalo in the middle of Wisconsin or something irrelevant to the case in point. *Felony* was the single term that would come across as covering the majority of what we thought was bad conduct. Regarding the statute of limitations, I haven't heard anybody talk about it, have you?

MR. MURPHY: No, and certainly these percepts have been in existence for only a little over a year now so I haven't had to deal with that issue. I suppose it is a factor and it may also depend that within that period of statute of limitations if an individual has also paid a price for the crime. In this case, the man was convicted. He is presumably going to pay fines, go to jail, who knows what and at some later time has paid society for his wrongdoing, that becomes at least mitigating circumstances should the issue be brought before the ABCD again. These kinds of issues come up in applying for membership to the organizations or for reinstatement to the organizations where, at least there is a question, I believe, on most organization application blanks about whether you have been disciplined or found guilty of the felony or these kinds of things in the past. I think time becomes a mitigating circumstance in any event and what happened in that intervening time. To give you more of a precise answer, there's just no way to judge at this time, but it is a good point.

MR. BORGER: Would the ABCD take action against an actuary who holds unpopular political opinions that could cause embarrassment for the profession such as when you see a headline, "Actuary leads KKK march," or something like that?

MR. MURPHY: This is when I wish Lauren was here.

MS. ADAMS: Yes, I do, too. She is next door. I have no idea of what the answer is.

MR. MURPHY: I couldn't say either. I suspect, first if someone brought that to the ABCD attention, it would look at the issue. My gut feeling is that something like that might lead to some counseling about, "You have a right to your own political views, but you should recognize that you should separate your professionalism from your politicism," and that's about the most you would expect and whether it would even go that far, I don't know. These become things of degree and when is the profession's reputation really harmed as opposed to the individual's reputation? It's hard to call that one. Any other thoughts on this case or related issues? That was good discussion.

We're ready for Case Study No. 4. Actuary Green was a consultant employed by a number of small companies to perform work on their pension plans. Green maintained an ongoing relationship with Easy Money, Inc., an investment firm that offered a variety of investment products for small pension plans. Easy Money, Inc. pays

Green a finder's fee of 3% of the amount invested each year by each of his clients with an annual trailer commission equal to 0.5% of the net amount under investment at the end of each plan year. Green routinely recommended Easy Money investment products to his clients and made it a practice to disclose to his clients that he would receive a commission on any investment product they purchased from Easy Money. However, although Green disclosed the formula upon which his commission would be based, he generally did not disclose the precise amount of the commission he would be paid. What are Green's obligations to disclose his commissions under the code of professional conduct? Anybody want to jump in on this one? There's plenty of issues in it.

MS. ADAMS: More issues on what wasn't asked than on what was asked.

MR. FRANK TODISCO: He has disclosed the commissions, but I would see a problem. Green is really not acting in the client's best interest because that's really just taking too much money away from the client.

MR. MURPHY: That's one of the points that was raised. It says, "Routinely recommended," is that the only thing he recommends? Does he recommend other things as well? Does he sort of treat it on a par with other things or does he really push it? That raises questions of integrity and other issues, perhaps conflict of interest. You're right, that's real questionable.

MS. ADAMS: With regard to the question that was really asked, I think that it is probably to give the basis for the commissions because it's really not very difficult to take 3% of a number and 0.5% of something else. However I think it would be more clean-cut if he disclosed in dollars, since most clients think in terms of real dollars, and I think perhaps in the small plan situation, the real dollars are very important. I would be more concerned about the fiduciary responsibility of actually hooking into an investment company.

MR. WELSH: Does he have the qualifications to recommend organizations like this to anybody? Isn't that something we're supposed to think about when doing anything, whether we are qualified to perform a particular kind of work? Being an actuary doesn't mean he is qualified to represent as an investment counselor.

MS. ADAMS: That was our point in saying, "Is this the only one that he's pushing?"

MR. WELSH: Whether he's pushing other ones or not, he can be pushing five or six, but he may not be qualified to push any of them. That may be beyond his scope of knowledge or ongoing education or what have you.

MS. ADAMS: True, but what I suspect is that in the small plan situation there are certain investment companies that really specialize in small plan investment in the same way that there are actuaries who specialize in small plan valuations. This is an assumption, but I agree, there is a question as to how he can evaluate that particular company.

MR. CATTERALL: I just wanted to note that aside from the issues regarding the code of professional conduct, what the actuary is doing by recommending

investments is he is crossing the threshold from being a nonfiduciary advisor to a fiduciary of the plan, so that also has ERISA implications. He is now liable for damages under ERISA if something should go wrong, if a participant should bring action based on what happens to those investments, so there's also that issue.

MS. ADAMS: It does say that Easy Money offers a variety of investment products. It's not that he necessarily is recommending an investment, per se, but there is question of the integrity of Easy Money.

MR. MURPHY: At one extreme you have him including Easy Money as a corporation along with some others that the plan may want to get in touch with for investments. At the other extreme you have, Easy Money has this investment which is just right for you and that's where you ought to put your money. It seems to me that somewhere in between there is probably appropriate, more at what I put over here, than what I put over here. Then he is really crossing the bounds, probably, as you described it. The conflict of interest comes into play as well as the legal issues.

MR. THOMAS NEAL TAYLOR: What I'm hearing suggests that it may be improper for him to recommend Easy Money, Inc. at all. Rather is it proper to recommend any investment company at all? Is it just saying the fact that he is being compensated by Easy Money is not really relevant, or would that put him under more scrutiny?

MS. ADAMS: I would expect that he would be responsible if he's getting money for it.

MR. MURPHY: It may be. These cases all raise questions that we don't know the answer to. Maybe he's a qualified investment advisor of some sort and has all the qualifications to do these things, and then the only issue is really disclosure and conflict of interest. On the other hand, if he's not qualified and he's doing some things that raise the issues raised earlier about shifting from one role to another, you may be right, that he really shouldn't be doing anything at all.

MR. WELSH: I'm envisioning that many actuaries have clients ask them to make recommendations, which they do casually to their favorite trustee, and they are endangering themselves.

MR. MURPHY: Even without commission.

MS. ADAMS: What strikes me as very unusual is that I personally have never been involved in soft fees, but I was always under the impression that, if you had some kind of an arrangement where you received a soft fee, this was a soft fee that was offset against the client's bill for providing the service. The whole concept seems just a little bit weird to me, that they're not using it as a soft fee, he's just getting the money. It's not a bad deal, really.

MR. MURPHY: A lot had to do with this case being clearly small employer oriented, where I think the actuary often is the only professional who is giving a whole lot of advice.

MR. DANIEL H. KALISH: We've had this conflict where we've placed annuities after looking over market and everything else and we've placed annuities in terminating plans. We've disclosed the size of our fee and everything else, the commissions from the annuities, and we've taken the stand that we have to do work as part of getting these commissions. We've been willing to offset client fees up to 50% of the amount of the commissions, and we thought that was fair, because we do a certain amount towards those, which is extra and above the client fees. But this is an area that you're always going to have problems with because there are various products around, there are various life insurance products. I get people calling me up and asking me to tie in very, very often. I've refused to. This is around and will always be around.