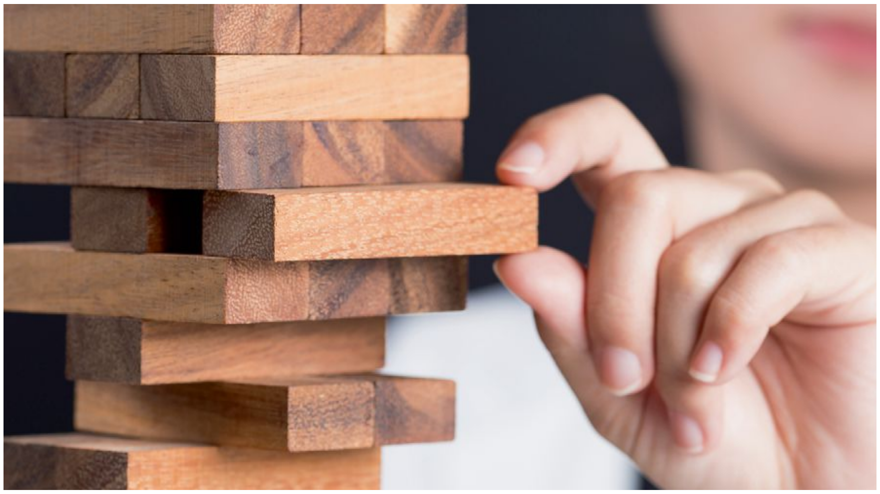
Legislation, Regulation and Your Risks

By Mitchell K. Smith

If everything appears to be going well, most likely you are not aware of everything that is going on.



Let's face it – being a professional in this era has become increasingly complicated and laced with rules and regulations that many are simply not aware of. The financial services industry as a whole is constantly under attack from state, federal and other authorities to create, what they believe to be, more protection for the consumers.

It has become clear that under the regulations, CPAs are considered fiduciaries; hence, with great power comes great responsibility. A fiduciary is someone who must legally put the client's interests first, even before his or her own interests. This also includes lawyers, trust officers, RIAs, CFPs and more.

The confusion and ambiguous nature of this has blurred what everyone's responsibilities are, and the legal community continues to litigate within the boundaries of this massive rulebook. Let's look at this "at 10,000 feet." One who has discretion over someone's assets and/or manages property for the benefit of another – this includes any individual who oversees or acts as trustee – implies that a breach of responsibility can occur when underlying assets of any kind do not behave as expected in comparison to certain benchmarks.

Overconfidence and the belief that you have this knowledge may put you and your firm on the wrong side of compliance. To deal with these issues, firms must master several areas of regulation/compliance: services provided, licenses required, disclosure and recordkeeping. There are many concepts and details in regards to these items to understand, but this article will focus on the trustee or fiduciary responsibility of assets within trusts or under your purview. We will specifically focus on life insurance regarding the remarkable amount of poor advice in the markets and lack of professionalism by the underlying brokers, as well as the responsibility of the CPA. As a standard, firms should keep meticulous records to document that all of the work on a particular transaction was conducted within the guidelines. It's best to make all insurance records part of the client's permanent file and/or easily accessible in a separate file. Keep records of all discussions for each client meeting concerning insurance; include who was there, topics discussed, conclusions reached and recommended actions. Upon completion of the transaction, CPA firms should create a comprehensive closing document. It should include details of the entire process, its intended purpose, compliance documents and filing dates. This file will run the entire term of the policy.

The closing document should include an appendix containing signed copies of all related legal agreements: the policy itself, illustrations, trusts, assignments, loan and financing documents, payment schedules, tax dates and tax opinions, if necessary. When laws change, a policy may no longer be a viable option. A proper recordkeeping system will enable CPAs to quickly identify those clients to whom the new change applies, notify them immediately and arrange a meeting to consider if any modifications are required.

Most of the guidelines for trust-owned life insurance fall under the Uniform Prudent Investor rules. We find it is very rare that most insurance agents, legal and accounting professionals have specific fiduciary training or knowledge of these guidelines. Insurance agents simply sell the policy, whether properly or not, and walk away.

In a recent lawsuit against a division of Goldman Sachs for a breach of advisory duties, the plaintiff was awarded $14.2 million for the disappointing performance of its life insurance. The clients initially paid over $4 million for $95 million in coverage, but they were forced to cancel the policies and paid $26 million in order to replace what they had initially purchased.

Two reputable firms with credible backgrounds calculated the premium required to maintain the same benefits, using the same information, and yet their calculations differed dramatically. This is an obvious example of the vulnerability caused by relying on prevailing life insurance industry practices now considered "misleading" by the chief regulatory body of the financial services industry. Had the advisers applied prudent investor principles widely accepted in other segments of the financial services industry, the result would potentially have been very different.

If consideration had been taken for policy expenses and reasonableness of performance expectations, instead of comparing hypothetical illustrations, the plaintiff most likely would have paid more initially but less in total for the policies, and the advisers could have defended the prudence of their recommendation without litigation.

In the most significant part of this story, the plaintiff was the former CEO of Qwest Communications (since taken over by CenturyLink) who had been convicted of insider trading in 2007; he served five years in prison and paid fines of $70 million.

The moral of this story: if a convicted felon can successfully sue one of the industry's most respected and sophisticated financial services firms, what would happen to everyone else whose clients don't have the credibility issues of this plaintiff?

Times have changed, and those who haven't will not survive this new age.

There are solutions to handling these responsibilities – cleaning up your books and dealing with future clients by outsourcing some of these compliance guidelines.

What if the accountant serves as a "business advisor?"

Example: An accounting firm agreed to serve as a business advisor to recommend improvements in internal accounting controls, operating controls and policies. The plaintiff argued that the accountant breached fiduciary duties by failing to disclose that it lacked the expertise necessary to perform the services for which it was retained, and that it lacked expertise to make final decisions on technical issues.

Trustees and other fiduciary professionals can delegate investment and management functions and, when properly delegated, are generally not liable for the decisions or actions of the agent to whom the function was delegated. That being said, it is integral the outsource arrangement is with someone who is independent under the rule and can actually provide this service. So of course, be careful with relying solely on the selling or servicing agent/broker for advice. While many agents/brokers market themselves as independent, most are not and instead have duties to promote their employer's interests and/or are limited by terms of their contracts with some limited number of insurers. They may also have a conflict of interest with regard to policy replacement, and are often not trained in financial analysis or fiduciary principles or law.

We believe it is another shining light on why you should be working with and maintaining professional relationships with firms who understand the law and ethical standards of practice. Times have changed, and those who haven't will not survive this new age. ◆

Mitchell K. Smith*, managing principal of Universal Insurance Services LLC/Vanbridge LLC, has partnered with* ***Dierdre Collins*** *of Harbor Insurance Strategies for years to provide insurance planning techniques, policy design and advice to CPAs and their clients with the intent to reduce the eroding effects of taxes where ever possible. Contact him at* ***Mitch@uiservices.com****.*