The Inescapable Advance of Fiduciary Practices

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Overview

- The focus of fiduciary role scrutiny
    - Stewards / trustees
    - Providers
    - Charity trends

- Consider practical implications

Investment Fiduciary Roles

Investor / Beneficiary

Steward	Trustee / Board

Governance

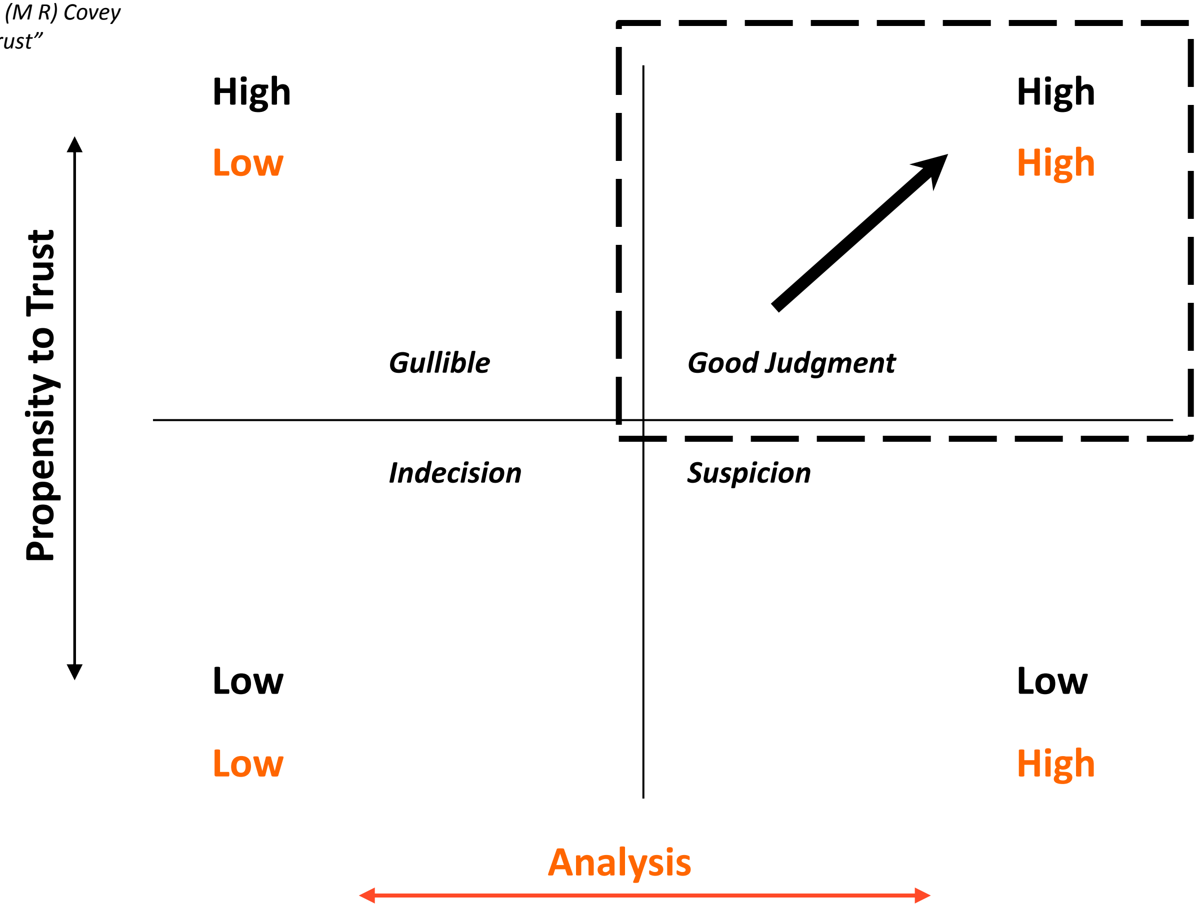
Advice and trading – 'experts'

Adviser	Adviser / Consultant
Investment manager	Fund Manager / Unit Trust/ Mutual Fund

Broker

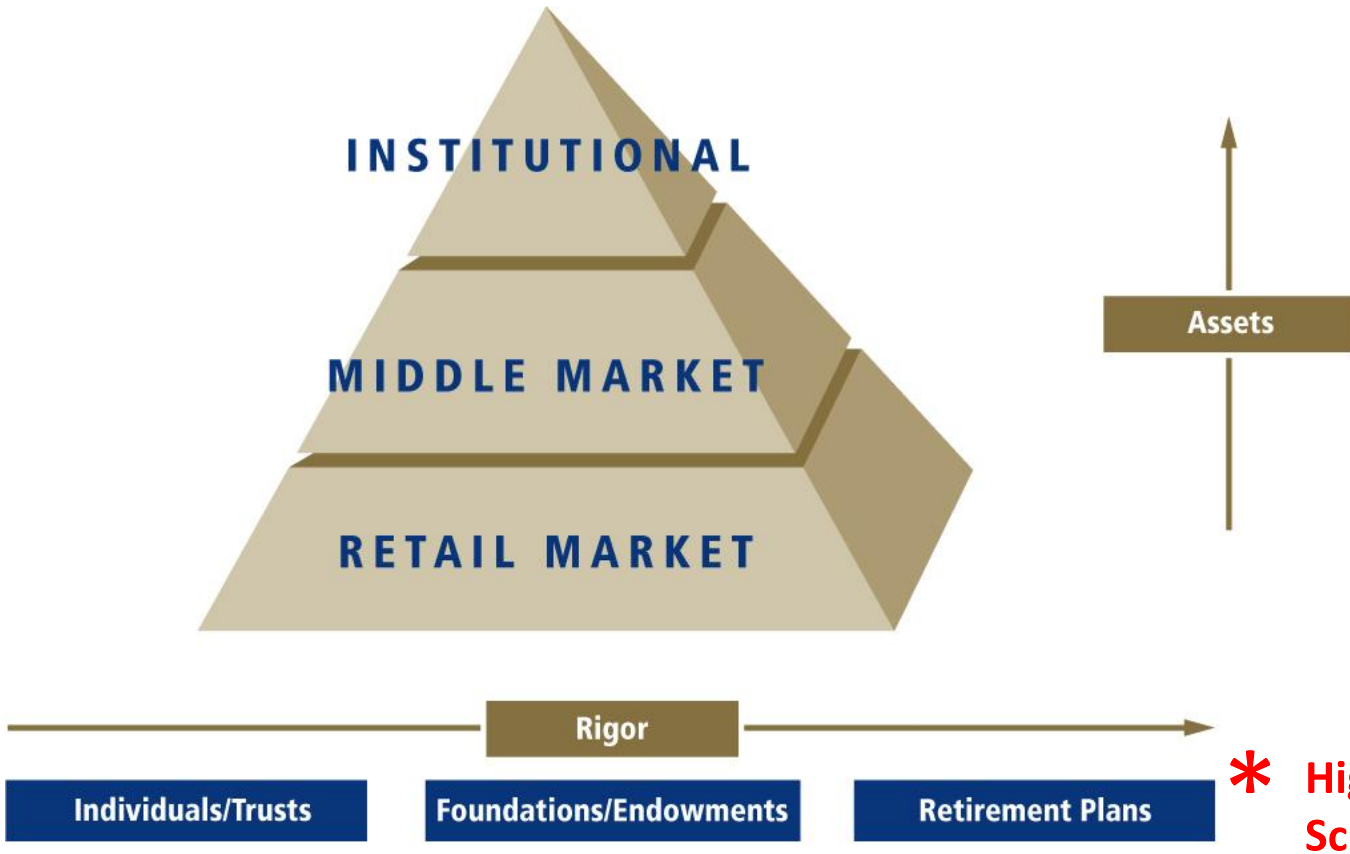
Governance – justified Trust

Source: Stephen (M R) Covey
"The Speed of Trust"



TRUST *= INTEGRITY +* *<u>COMPETENCY</u>* *+ DOING THE RIGHT THING*

Hierarchy of Scrutiny



* Highest Scrutiny

Drivers of closer scrutiny

- Privileged role
  - *Legislated dominance of sector*
  - *Tax breaks*
  - *Compulsory investment*

- With this comes
  - *A fiduciary obligation*
  - *Principles to meet*
  - *Scrutiny*

Difficulties in meeting fiduciary obligations

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- Time
- Knowledge and skill sets
- Education needs
    - *Investment or governance skills*
- Justifying trust in specific provider(s)
- Regulator trend to greater definition of principles to meet

Australian Super- example

MYSUPER

Optimising Australian superannuation

REVIEW INTO THE GOVERNANCE, EFFICIENCY, STRUCTURE AND OPERATION OF
AUSTRALIA'S SUPERANNUATION SYSTEM

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$1.6 trillion; 360+ funds > $50m

1. Default schemes…80% of investors

   …trustees of MySuper products will face higher performance requirements which will be enforced by the Australian Prudential Regulation Authority (APRA) …
   …An additional $29.9 million over four years (from 2011-12) will be provided to APRA and the Australian Securities and Investments Commission (ASIC) to implement and monitor the new arrangements. - Stronger Super Review

2. SMSF- Individual Superannuation Entities….huge growth

   More than 815,000 SMSF (Self Managed Superannuation Funds) trustees….

   …knowledge and competency requirements will be developed for SMSF service providers. ASIC (Regulator) will develop a mandatory SMSF specialist knowledge component of Regulatory Guide 146

Australian Law - example

AUSTRALIA

July 2013

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Prudential Standard SPS 530 Investment Governance

Investment governance framework……

9. An investment governance framework is the totality of systems, structures, policies, processes ……

10. The Board is ultimately responsible for the investment governance framework.

11. An RSE licensee's investment governance framework must, at a minimum, include:

(a) investment objectives for each investment option offered by the RSE licensee;
(b) a methodology for determining investment reporting measures;
(c) the investment strategy for the whole of each RSE and for each investment option …
(d) all Board policies relating to investment activities;
(e) role statements that include the details of each role's responsibilities and reporting structures for all roles…
(f) structures, policies and processes for investment performance and risk measurement, assessment and reporting; and
(g) a review process to ensure that the investment governance framework remains effective.

NZ Trust Law Change - example

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Appointing investment managers

P20 (1) New legislation should authorise trustees to appoint investment managers and give them authority to make investment decisions.

(2) The appointment of investment managers should be subject to the following legislative safeguards:

(a) trustees must act honestly and in good faith and exercise reasonable care when appointing an investment manager, and must review the investment manager's performance periodically;

(b) trustees must create a written policy statement that gives guidance as to how investment functions are to be exercised by an investment manager setting out the general investment objectives, and require investment managers to agree to comply with the policy statement; and

(c) trustees are liable for any default of the investment manager where the trustees have failed to act honestly and in good faith and exercise reasonable care when making the appointment of a manager or monitoring the investment manager's performance.

Providers – Alignment matters

The Trustee/Steward

Provider

Credibility

- Articulate governance awareness
- Have a fiduciary framework to apply

"Justified Trust"

Regulation for Providers

- Global ramping up of minimum standards
  - Desire to be a ‘profession’ with unique rights
  - Continued lack of confidence – investor surveys
  - Resistance to change value propositions and practices

United Kingdom changes

New rules for financial advisers from 2013

Many of us have no real understanding of how financial advisers get paid or how much their service costs us when they sell us a financial product – or of whether their advice is unbiased. The new rules are designed to set this right and put the consumer back in the driving seat.

DID YOU KNOW?

Since 31 December 2012 all financial advisers must make it clear if the advice they offer is restricted or independent.

Example

January 2013

FSA
Financial Services Authority

Financial advice changes 1–2–3

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1. No initial commissions from product providers
2. Ongoing commissions no longer allowed
3. Upfront fee clarity and agreement
4. Clarity whether advice is ‘independent’ or ‘restricted’
   - *‘Independent’ means an adviser can offer ALL products*
5. Tougher qualification standards

Philippines – Example

BANGKO SENTRAL NG PILIPINAS
Pananalaping Matatag, Bansang Panatag

BSP Circular 2012 – Trust officers…

"The trust officer who shall be appointed shall POSSESS ANY OF THE FOLLOWING:

a. At least five (5) years of actual experience in trust operations;

b. At least three (3) years of actual experience in trust operations and must have 1) completed at least NINETY (90) TRAINING HOURS in trust, OTHER FIDUCIARY BUSINESS, OR INVESTMENT MANAGEMENT ACTIVITIES acceptable to the BSP OR 2) COMPLETED A RELEVANT GLOBAL OR LOCAL PROFESSIONAL CERTIFICATION PROGRAM; OR

c. At least five (5) years of actual experience as AN officer of a bank/NBFI and must have: 1) completed at least NINETY (90) TRAINING HOURS in trust, OTHER FIDUCIARY BUSINESS, OR INVESTMENT MANAGEMENT ACTIVITIES acceptable to the BSP OR 2) COMPLETED A RELEVANT GLOBAL OR LOCAL PROFESSIONAL CERTIFICATION PROGRAM."

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Example

New Zealand – new adviser regulation

- New Code of Conduct; Regulator and Authorisation process
    - *Principle based !*
    - *Fiduciary standard of care (onus of proof on adviser)*
    - *Single regulator with larger audit function and budget*
    - *Minimum education and CPD lifted significantly*
    - *Disclosures in mandatory format*
    - *All advisers including brokers*

- All this in 2 years!

Compliance Rules are Minimums

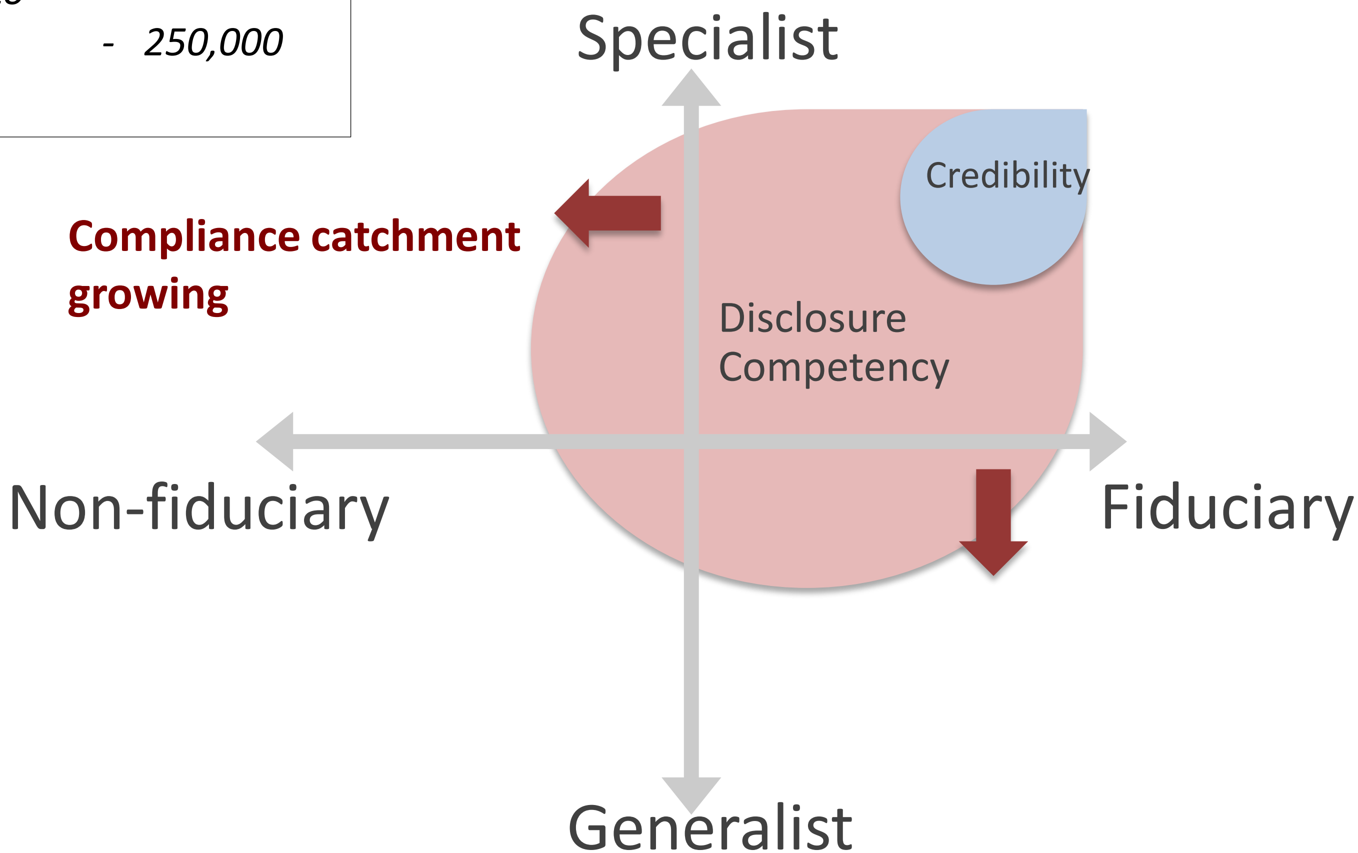
- Strong Disclosure Element
    - Steward risk increases if not acted on
    - Not easy to understand or compare
- But, weak evidence that provider has a fiduciary framework
- Not enough to justify trust when delegating responsibilities
- Focus is on retail investors
- Boards / Trustees are assumed to be competent / sophisticated
    - Implication – is your adviser acting as a fiduciary?

But - not all advisors exceed minimums

USA example:

Advisors held to fiduciary standard - 275,000
BUT…includes those dual registered as brokers who may only have to meet the suitability standard - 250,000

Compliance catchment growing

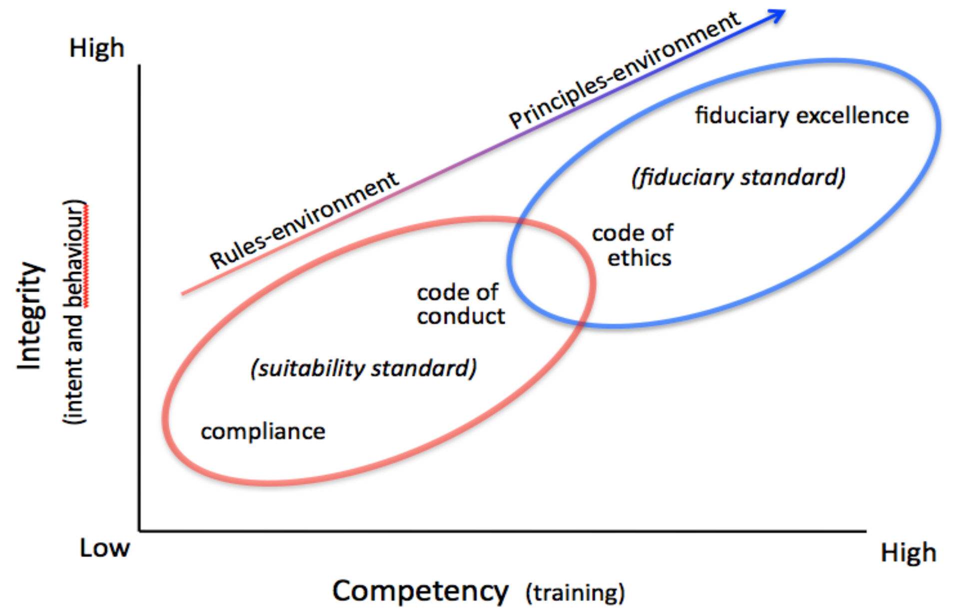


Fiduciary Adviser Opportunity

- Adopt a Defined Fiduciary Standard
- Embed into operations
- Demonstrate to Stewards your alignment
  - *Your understanding of their responsibilities*
  - *How your process meets governance obligations*

Trustee Governance

- what do they need ?



A Principles Based Environment…

•**Code of ethics**
•*– defined broad principles governing conduct*

•**Fiduciary standard**
•*– defined by principles, precepts, specific practices and case law*

•**Fiduciary excellence**
•*– combination of integrity, competency and implemented practices*

A Fiduciary framework elevates your profile

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Components of a ‘Standard’ or framework

Practices and Criteria

3.3 PRACTICE — PRACTICE 3.3

STEP 3 : IMPLEMENT

IMPLEMENT

PRACTICE 3.3

Decisions regarding investment strategies and types of investments are documented and made in accordance with fiduciary obligations of care.

CRITERIA

3.3.1 A documented due diligence process, consistent with prudent practices and generally accepted investment theories, is used to select investments and third-party Investment Managers.

3.3.2 Decisions regarding the selection of investments consider both qualitative and quantitative criteria.

3.3.3 The documented due diligence process used to select investments and third-party Investment Managers is consistently applied.

3.3.4 Regulated investments are preferred over unregulated investments when all other characteristics are comparable.

3.3.5 Investments that are covered by readily available data sources are preferred over similar investments for which limited coverage is available when all other characteristics are comparable.

3.3.6 Decisions regarding passive and active investment strategies are documented and made in accordance with obligations of care.

3.3.7 Decisions regarding the use of separately managed and commingled accounts, such as mutual funds, unit trusts, exchange-traded products, and limited partnerships, are documented and made in accordance with obligations of care.

3.3.8 Decisions to use complex investments or strategies, such as alternative investments or strategies involving derivatives, are supported by documentation of specialized due diligence conducted by individuals who possess knowledge and skills needed to satisfy the heightened obligations of care.

3.3.9 When socially responsible investment strategies are elected, the strategies are implemented appropriately.

The primary focus of this Practice is the implementation of the investment strategy with appropriate investment vehicles. By appropriate, we mean the strategies and products are suitable for the portfolio and in line with generally accepted investment theories. The term "generally accepted investment theories" refers to practices considered to be effective in producing the desired outcomes by academics and the community of professionals in the investment field. Given that the state of the art and science of investing evolves over time, generally accepted theories also change to reflect advances in the field. As an investment fiduciary, suitability is also implied under a duty of care.

It is important for the Investment Steward to be familiar with (or engage professionals who are familiar with)the universe of investment options (i.e., mutual funds, exchange-traded products, separately managed accounts, and alternative investments), prudently select them, and document the process for no one implementation structure is right for all occasions. ERISA's prudence requirement is generally comprised of two components – "procedural prudence" and "substantive prudence." The former refers to the process involved in making decisions for a plan, whereas the latter refers to the merits of the decision made by the fiduciary. The prudence requirement focuses on the fiduciary's conduct in arriving at the decision, not on its results, and asks whether a fiduciary employed appropriate methods to investigate and determine the merits of a particular decision. However, the failure to investigate alone may withstand scrutiny where the investment decision nonetheless was objectively prudent. This means that even if a fiduciary failed to conduct a sufficient investigation before making a decision (procedural prudence), he or she probably avoids a fiduciary breach if a "hypothetical prudent fiduciary" would have made the same decision anyway (substantive prudence).

SUBSTANTIATION

Employee Retirement Income Security Act of 1974 [ERISA]
§404(a)(1)(B); §404(a)(1)(C)

Regulations
29 C.F.R. §2550.404c-1(b)(3)(i)(C)

Case Law
Metzler v. Graham, 112 F.3d 207, 20 E.B.C. 2857 (5th Cir. 1997); *Marshall v. Glass/Metal Ass'n and Glaziers and Glassworkers Pension Plan*, 507 F. Supp. 378 (D.Haw. 1980); *GIW Industries, Inc. v. Trevor, Stewart, Burton & Jacobsen, Inc.*, 10 E.B.C. 2290 (S.D.Ga. 1989); *aff'd*, 895 F.2d 729 (11th Cir. 1990); *Leigh v. Engle*, 858 F.2d 361, 10 E.B.C. 1041 (7th Cir. 1988), *cert. denied*, 489 U.S. 1078, 109 S.Ct. 1528, 103 L.Ed.2d 833 (1989)

Other
H.R. Report No. 1280, 93rd Congress, 2d Sess. (1974), reprinted in 1974 U.S. Code Cong. & Admin. News 5038 (1974)

Uniform Prudent Investor Act [UPIA]
§2(a); §3; §3 Comments

Uniform Prudent Management of Institutional Funds Act [UPMIFA]
§3(e)

Uniform Management of Public Employee Retirement Systems Act
§7(3);

Other Trends

- Charities
    - *Recognition of community role*
    - *Registration (Charity Commissions)*
    - *Special Tax concessions*
    - *Inescapable……fiduciary scrutiny*

- Regulator Capability and Resourcing

Pacific Example

Australian Government

Australian Charities and Not-for-profits Commission

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- 60,000 registered….540,000 other NFP's, 940,000 staff; $30b funding
- Private Ancillary Funds (PAF's) and Public Ancillary Funds (PuAF's)
- Tax breaks - drive to attract funds for registered charities

The ACNC's approach to implementing the governance standards is based on two main points:
1. minimum standards – these standards set out minimum requirements for governance of your charity…
2. principles-based standards …high-level (general) principles, rather than as precise rules. In other words, your charity can generally choose how to comply, as long as it can demonstrate, should it be required to do so, that this is appropriate

"the ACNC may warn charities that they are not meeting their obligations and explain what action the ACNC may take (warnings) …) make arrangements with charities about what they need to do to meet their obligations - these arrangements can be enforced by a court (enforceable undertakings)…"

In Conclusion…

- More scrutiny of Fiduciary Practices is inescapable for all…
  - *Stewards/trustees*
  - *Consultants / Advisers / Managers*
- Evidence of a fiduciary framework is the key to aligning roles
  - *Specific training is essential beyond current skill sets*
  - *Consistent application creates the evidence of sound process*
- Justifiable trust is the objective
- Compliance reforms for providers focus on retail investors
  - *Fiduciary Stewards need to be vigilant*