SPONSORED STATEMENT

In good faith

What does it mean to be a fiduciary in transition management? *Jamie Cashman*, *Mark Dwyer*, and *Wim de Ruijter* of Mellon examine the benefits.

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ALTHOUGH STILL in its infancy, the 21st century has witnessed a considerable amount of turmoil. Naturally, the financial industry has not been exempt from upheaval over this period. Accounting irregularities and - in some notorious cases, fraud - have spawned numerous regulatory initiatives around the world, and more stringent compliance pressures have prodded investors to reconsider the role of the fiduciary throughout the investment process.

At the same time, disappointing returns in many conventional asset classes, increasing liabilities due to low interest rates, and unfavourable demographic trends have forced many institutional investors to go back to the drawing board in recent years as they struggle to meet the return objectives of their beneficiaries. This difficult investment climate has prompted a renewed focus on managing costs and risks throughout the investment process. Consequently, many institutional investors have enlisted the expertise of dedicated transition managers to help make asset restructurings more efficient.

In recent years, as the utilisation of expert transition managers has become more commonplace, the marketplace has changed dramatically. Soon after the global equity market peaks of early 2000, a flood of would-be transition managers, in response to heightened demand for this service, threw their hats into the ring. Over the years, as the initial proliferation of providers first plateaued and then thinned, institutional investors have been faced with the renewed challenge of separating the wheat from the chaff. In many cases, the differentiating levels of fiduciary oversight that transition managers may offer has given investors a basis for comparison.

Almost all developed markets recognise the importance of showing good faith in investment dealings. Many countries have closely regarded precedents through historical case law to illustrate the role of the fiduciary. Nevertheless, few regulatory bodies have codified this responsibility in any unequivocal way, and there seems little global consensus on what exactly it means to be a fiduciary in investment matters. If this is the case, we should not find it surprising that there is a considerable amount of uncertainty amongst investors on what it means to be a fiduciary with respect to a nascent industry such as transition management.

Nevertheless, many clients and consultants are recognising that clarifying the services offered by fiduciaries is a critical aspect of any transition management search. To this end, we endeavour to shed some light on the role of the fiduciary from the perspectives of three different frameworks: that of the US, the UK, and the Netherlands.

The US

In the US, virtually every discussion about being a fiduciary in investment matters will at some point make reference to the standards of the Employee Retirement Income Security Act (ERISA). This officially governs every qualified private employee benefit plan in the country, but given its comprehensive scope, it casts a large shadow over all types of pensions. Even plan sponsors who would otherwise be exempt from ERISA find, in this landmark legislation, excellent guidelines for any trustee or fiduciary.

ERISA Section 3(21)(A) defines a person as a fiduciary if he or she:

i) Exercises any discretionary authority or discretionary control with respect to the management of the plan, or exercises any authority or control with respect to the management or disposition of plan assets;

ii) Renders investment advice for a fee or other compensation, direct or indirect, with respect to any plan asset or has any authority or responsibility to do so;

iii) Has discretionary authority or discretionary responsibility in the administration of the plan.

Under ERISA, fiduciaries are obligated to act with the skill and care of a "prudent person" and solely in the best interests of the plan's beneficiaries. In addition, the Department of Labor, under whose auspices ERISA falls, considers the voting of proxies to be an integral part of the management of plan investments.

What you mustn't do

ERISA prescribes a number of minimum requirements that fiduciaries must fulfill as part of their obligations to plan beneficiaries. Among these are to refrain from prohibited transactions including many forms of self-dealing and conflicts of interest. This includes prohibitions on the fiduciary to:

(i) deal with the assets of the plan in his/her own interest or for his/her own account,

Must the transition manager be a fiduciary?

PROS

1 Protection for plan sponsor and beneficiaries

2 Transparency of transition fees

3 Proxy voting

CONS

1 Can't commit capital for trading

(ii) in his/her individual or in any other capacity act in any transaction involving the plan on behalf of a party (or represent a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries, or
(iii) receive any consideration for his/her own personal account from any party dealing with such plan in connection with a transaction involving the assets of the plan.

The UK

Although the UK doesn't offer an exact equivalent to ERISA, the comprehensive "Institutional Investment in the United Kingdom: A Review" offers an excellent foundation for considering fiduciary issues. Conducted by Paul Myners and released in March 2001, the Myners Report sets out a blueprint for change under "the belief that clearer incentives and tougher customer pressures need to be driven throughout the savings and investment industry". Myners makes frequent references to ERISA and US Department of Labor language on the responsibilities of the fiduciary in investment matters. The report advocates a better defined role for the fiduciary in the investment process with a focus on the "obligations of prudence and loyalty to plan participants and beneficiaries". In his recommendations, Myners sets out 10 principles that can be interpreted in transition management terms.

Transition management in a Myners framework

- **Effective decision-making:** Structure is essential for success.
- **Clear objectives:** Investors must identify investment targets and constraints.
- **Focus on asset allocation:** Investors should manage the macro issues efficiently.
- **Expert advice:** Investors should enlist the help of experts and be prepared to pay for that expertise.
- **Explicit mandates:** Investors should "have a full understanding of the transaction related costs they incur, including commissions".
- **Activism:** The voting of proxies and corporate actions is a duty of the fiduciary.
- **Appropriate benchmarks:** Investors must understand the cost and risks of different investment structures.
- **Performance measurement:** Investors need to regularly chart the efficacy of their investment decisions in achieving fund objectives.
- **Transparency:** Investors must strive for transparency not only in terms of strategies but also in terms of fees.
- **Regular reporting:** Investors must formalise and attribute performance.

The Netherlands

In many European markets, such as the Netherlands, the obligations of the fiduciary are only recently being formalised. Modest investment returns after a long period of contribution holidays have compelled the Dutch to take a good hard look at pending pension liabilities. The new pension regulatory regime, FTK (Financial Assessment Framework), looks to overhaul historical tax, funding and accounting approaches for pensions in an effort to shore up pension solvency.

While lacklustre capital markets have pressured the funding status of pensions, accounting irregularities and scandals have reinforced the need for better corporate governance. To this end, the Dutch are advocating more in the way of shareholder activism. Forums like Eumedion - Greek for good guardian - are providing a vehicle for Dutch institutional investors to enforce corporate governance guidelines (the Tabaksblat Code) outlined by regulatory bodies.

How this impacts transition management

Efforts like ERISA, the Myners Report and Eumedion were launched with traditional investment management in mind. Nevertheless, more clients and consultants are recognising the merits of using a fiduciary to oversee that period when the plan's assets are in transition. While this trend has obvious positive implications for a plan's beneficiaries, the focus on fiduciary status has become problematic for broker/dealers offering transition management services.

As trading commissions have declined in recent years, broker/dealers have increasingly looked to proprietary trading as a source of revenue growth. When running a prop trading book, the dealer looks to garner as much trading flow as possible against which it can selectively position itself. In many cases, the dealer will offer to trade at low or zero commission in order to increase its trading volume. To make this strategy profitable, the dealer must sell its inventory, on average, at a higher price than where it purchased it.

For reasons that should be clear, the role of the fiduciary with respect to plan assets is absolutely critical. Understanding the fiduciary's obligations to the beneficiaries of the plan (and conversely, being cognisant of what the fiduciary cannot do) as part of the investment process, is of paramount importance when investing assets. It should be no less important during the transition of assets when the transition manager assumes the role of interim fiduciary.

Yet not every transition manager will wear the fiduciary hat. To complicate matters, some transition managers will pay lip service to the importance of being a fiduciary without adhering to all of its incumbent responsibilities. For this reason, clients and investors need to press potential transition managers. What exactly makes them a fiduciary? Does their business model accommodate:
i) The ability to contract as a fiduciary?
ii) An articulated process for proxy voting and handling corporate actions?
iii) A focus on best execution in the context of the overall transition objectives and constraints?
iv) Full disclosure of all sources of revenue associated with the transition
v) An acknowledgement that the transition is to be managed solely in the best interests of the client?

If the transition manager can't commit to all of the above, should this matter? Ultimately it depends on the fundamental objectives and constraints of the investor. But as even the most sophisticated have discovered, hiring a counterparty instead of a strategic partner can mean unforeseen risks and very real costs.