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GUEST FEATURE: FIDUCIARY STANDARDS – WHERE NEXT?

Rosalyn Breedy
Partner, Forsters Solicitors

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Could the US secure a significant competitive advantage in extending the fiduciary standard? Ethics are clearly moving to the top of the agenda in G20 countries, with Mark Carney and Mary Jo White addressing the subject recently. Now that the restructuring of the financial service business environment has been substantively addressed to deliver efficient markets, attention is turning to the retail investor.

Rosalyn Breedy, an expert in financial services regulation and wealth management law, examines the implications of an extended fiduciary standard within the UK and the US.

In chairing the G20 financial stability board at the Inclusive Capitalism conference (May 27, 2014), Mark Carney, governor of the Bank of England raised the issue of a broader responsibility: "Just as any revolution eats its children, unchecked market fundamentalism can devour the social capital essential for the long term dynamism of capitalism itself. To counteract this tendency, individuals and their firms must have a sense of their responsibilities for the broader system."

He went on to say that "market fundamentalism - in the form of light touch regulation, the belief that bubbles cannot be identified and that markets are always clear - contributed directly to the financial crisis and the associated erosion of social capital".

This follows a speech entitled Protecting the Consumer, by Mary Jo White, chair of the US Securities Exchange Commission, to the Consumer Federation of America (March 21, 2014) where White reiterated the SEC's three-part mission "to protect investors, to ensure fair and efficient markets and to facilitate capital formation. Each part of the mission circles back to the first - to protect investors - because if our markets are not fair and safe they will not attract investors to provide the capital companies are seeking."

Historically, confidence in investment markets has been broadly split between mature or emerging markets. Could the broader adoption of a fiduciary standard lead to a premier league of investment destinations for international wealth?

Breedy advises UK wealth management professionals to monitor closely what is happening in the US. The issues addressed also apply in the UK, and failure to address them could put the UK at a disadvantage.

The SEC now has a broad authority to impose a uniform fiduciary standard for broker- dealers when providing personalised investment advice about securities to retail investors, under section 913 of the US Dodd-Frank Act. This would be new for broker-dealers, who previously have not seen themselves in a role of a fiduciary, compared to investment advisers who have long been held to this standard.

The practical and financial implications for broker-dealers would be substantial. A fiduciary standard of care means to act in the best interests of the customer without regard to the financial or other interest of the broker, dealer or investment advisor providing the advice. Legally, this is much more onerous than having an ordinary duty of care or simply complying with contract terms. Consequently there will be significant implications in the event of claims and litigation.

The adoption of the fiduciary standard is seen as important in the US because of the very high proportion of retail investors. The SEC has reported that over half of Americans, either personally or jointly with a spouse, own a stock directly or through investment vehicles, like a self-directed 401 (K) or individual retirement account. Similarly, over 44 per cent of Americans, including most retail investors, invest in a mutual fund. The SEC also identified millions of other households that are counting on a pension or another source of income that is dependent on the securities markets.

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White emphasised that “the retail investor must be a constant focus of the SEC - if we fail to serve and safeguard the retail investor, we have not fulfilled our mission”.

The issue was raised in the UK in the 2012 Kay Review* which criticised the UK equity market, concluding that “investment chains were too long, with growing numbers of intermediaries between an investor and the company in which they invest”. Kay argued that this led to increased cost, misaligned incentives and reduced trust.

Kay saw the UK central problem as “short-termism,” in which many investment managers traded on the basis of movements in share price rather than investing for the long term on the basis of the fundamental value of a company. Furthermore, shareholders did little to control bad company decisions.

In his conclusion, Kay set out ten principles which should guide the UK equity market. Notably, principle number five states “that all participants in the equity investment chain should observe fiduciary standards in their relationships with clients and customers.”

He elaborated: “Fiduciary standards require that the client’s interests are put first, that conflict of interest should be avoided, and that the direct and indirect costs of services provided should be reasonable and disclosed. These standards should not require, nor even permit, the agent to depart from generally prevailing standards of decent behaviour. Contractual terms should not claim to override these standards.”

The financial services consumer protection approach in the UK has traditionally provided for retail products to be regulated; for intermediaries to be subject to rules regarding conduct of business; for a minimum protection and redress scheme; and for the application of fiduciary duties to those who had voluntarily taken them on such as pension fund trustees. It was thought that this broadly worked because so much of UK investment was made through intermediaries who were subject to fiduciary duties. For example, in 2012 defined benefit pension schemes controlled £1,031 billion of assets compared with £697 billion ($1.2 trillion) of assets in defined contribution schemes (invested by individuals).

However, the proportions are changing rapidly. It is predicted that auto-enrolment of pensions will mean between six and nine million individuals will enroll in defined contribution schemes by 2018, and by 2022 there may be more assets in defined contribution schemes than defined benefit schemes.

In light of this changing investment profile, and the international dynamic, the UK government needs to consider whether a fiduciary standard should be adopted. The Law Commission has just closed its consultation* on this matter and is analysing responses. A final report will be presented to the Government by June 2014.

The practical implications of the adoption of a fiduciary standard would indeed be costly. In many cases, it would require proper client classification, re-drafting of contracts, disclosures to be made, fee structures to be reviewed and potential disaggregation of integrated businesses. It would undoubtedly put further pressure onto already stressed operating models.

Given the international flow of investments, the UK wealth management industry should resist the temptation to consider the adoption of a fiduciary standard as an aberration or as a temporary irritant. There are strong policy reasons driving the attention of the UK and US governments. It is viewed as part of the social contract necessary to permit capitalism and of critical importance where so much investment lies in the hands of the individuals.

There is a risk that if the global financial services sector does not look at the issue of ethics holistically it could be adopted by countries in a piecemeal fashion. This risks creating an uneven playing field which can be arbitraged with technology – so, should the G20 financial stability board consider developing a common solution?

Meanwhile, industry players who adopt the fiduciary standard as universal, even for non-retail customers, may find that they really do profit in the long term as customers’ confidence influences the flow of funds towards the safest investment environments.

**J Kay, The Kay review of UK equity markets and long term decision making: Final report 2012.*
*** The Law Commission Consultation paper no 215 “Fiduciary duties of investment intermediaries”.*

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