By Eelco Fiole

REGULATION

Understanding fiduciary responsibility

When it comes to the management of others' finances, fiduciary responsibility cannot be underestimated.

Upon arrival at an airport recently, a border control official who was checking my passport asked me routinely what my profession was. My response: "I'm a fiduciary." His reply: "What's that?"

I began to wonder if he knew the people who manage and overlook his life savings in his pension fund. I didn't even try to answer the question in full, and told him that I sit on investment boards. He seemed satisfied with that.

Given the many flaws of governance we read about in the news on a very frequent basis – in whatever part of the world – the well-documented principal-agency problem is becoming prevalent. It's everywhere – many people act as an agent for somebody else (the principal), sometimes without even knowing it.

The principal relies (in many cases with no other choice) on an agent. And, often, people do not have the same information as the people they interact with. It becomes clear that the agent, in turn, should not benefit from their informational advantage. Any compensation should be agreed with the principal and should not result in a conflict of interest.

The issue of agency can be a minor and trivial issue, but also a major one. For example: a doctor operating on a patient. The information asymmetry between doctor and patient makes it almost impossible to put both parties on equal footing. In effect, patients have no choice other than to trust the medical professional.

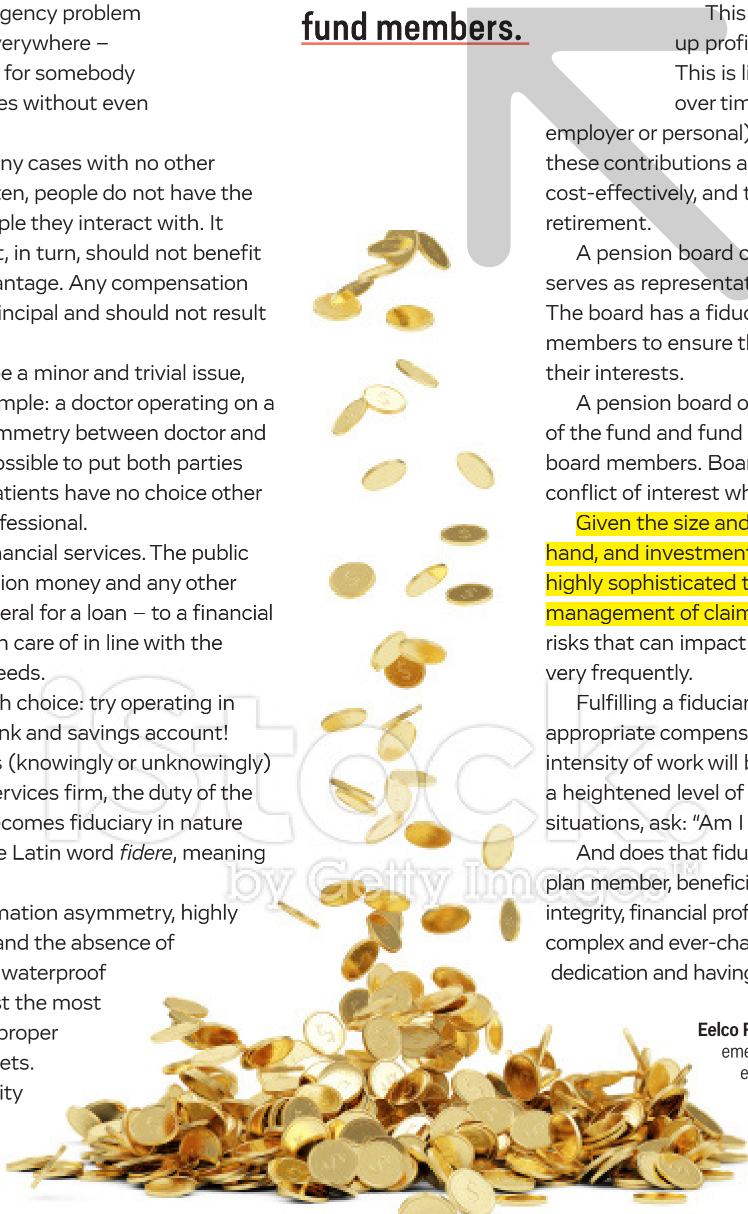
The same holds true in financial services. The public entrusts its life savings, pension money and any other assets – sometimes as collateral for a loan – to a financial services company to be taken care of in line with the client's characteristics and needs.

The client hasn't got much choice: try operating in modern society without a bank and savings account!

Given the trust the clients (knowingly or unknowingly) have to place in a financial services firm, the duty of the firm towards these clients becomes fiduciary in nature (fiduciary stemming from the Latin word *fidere*, meaning "to trust").

The combination of information asymmetry, highly important financial matters and the absence of the possibility for completely waterproof control measures makes trust the most important ingredient for the proper functioning of financial markets. Especially given the complexity of today's financial products and the time lag between financial and investment decisions and the realisation of financial outcomes.

A pension board oversees the pension fund and serves as representation for the pension fund members.



Indeed, why would anybody allow somebody else to manage financial matters if there is no trust?

Fiduciary duty then means, anything else held constant, a duty to place the client's interests before the firm's.

This is a difficult challenge, given the many pressures financial services firms are facing.

However, it is also a noble duty: you are being trusted to handle other people's financial affairs – one of the most important elements in their lives!

This doesn't mean a firm should give up profits. Let's consider a pension fund. This is like an empty bucket, which is filled over time through a scheme (government, employer or personal). The pension fund's aim is to take these contributions and invest them profitably, risk- and cost-effectively, and then pay out to members during retirement.

A pension board oversees the pension fund and serves as representation for the pension fund members. The board has a fiduciary responsibility towards fund members to ensure the pension fund is acting in their interests.

A pension board often consists of representatives of the fund and fund members, as well as independent board members. Board members are to act without conflict of interest when it comes to making decisions.

Given the size and complexity of claims on the one hand, and investments on the other, this board must be highly sophisticated to be effective in overseeing the management of claims and investments, certainly as new risks that can impact the value of the investments emerge very frequently.

Fulfilling a fiduciary duty is real work, which requires appropriate compensation. Different levels of quality and intensity of work will be compensated accordingly; so will a heightened level of care and diligence. As in all business situations, ask: "Am I getting enough bang for my buck?"

And does that fiduciary's work cover what an investor, plan member, beneficiary, owner really requires: proven integrity, financial professionalism, tacit knowledge of complex and ever-changing financial matters, relevant skills, dedication and having no conflict of interest. ■

Eelco Fiole is a fiduciary alternative investment and emerging-market expert with more than 20 years' experience. He is founding partner of Alpha Governance Partners.