



# New Mexico State Investment Council

Fiduciary Responsibility Discussion

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# Agenda

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- General Trust Principles
  - Who Are Fiduciaries?
  - Limitations on Fiduciary Responsibility
- Basic Fiduciary Duties
  - Duty of Prudence
  - Duty of Loyalty
- Fiduciary Liability
  - Co-Fiduciary Liability
  - Avoiding Liability
- Summary

## Who Are Fiduciaries?

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- A fiduciary is someone that stands in a special relation of trust, confidence, or responsibility relating to certain obligations to others
- All Council members are fiduciaries, without exception
- All staff who deal with investments are fiduciaries
- Others may also be fiduciaries
  - Investment managers and consultants
  - Custodian banks (for certain functions)
- Usually those performing ministerial tasks are not fiduciaries

# Who Are Fiduciaries?

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- Fiduciaries are those who:
  - Exercise any authority or control (discretionary or otherwise) regarding management or disposition of the assets or have the duty to do so
    - all assets of an endowment, permanent fund, or trust fund
    - all investments and related expenses
    - all administrative expenses
  - Render investment advice regarding the trust assets for a fee or other compensation
  - Have any authority or responsibility to provide investment advice

## Limitations on Fiduciary Responsibility

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- A person's fiduciary duty is limited to the scope of responsibility delegated or assumed
  - entire organization (Council and State Investment Officer)
  - total portfolio (Deputy SIO and maybe general consultants)
  - asset classes (portfolio managers and maybe specialty consultants)
  - specific investments (investment staff and maybe others who advise)
  - certain due diligence activities (investment staff and maybe others outside)

# Basic Fiduciary Duties

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- Numerous fiduciary duties exist but most fall under two basic headings
  - The duty of **prudence** which requires expertise and more than a good faith attempt to do the right thing
  - The duty of **loyalty** which requires a steadfast commitment to stay focused solely on the interests of the beneficiaries of the fund
- The duties are simple to state, but not so simple to follow
- Fiduciary duty takes precedence over all other duties – fiduciary duty has been called the “highest duty imposed by law”

# The Duty of Prudence

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- The Uniform Prudent Investor Act applies to the management of all assets invested by the State Investment Council
  - “Prudent investors” must invest and manage assets by considering the purposes, terms, distribution requirements and any other relevant circumstances of the funds invested
  - A prudent investor must exercise reasonable care, skill and caution
  - Investment decisions are to be evaluated in the context of the portfolio as a whole and as part of an investment strategy having risk and return objectives that are reasonably suited to the fund
  
- Prudence standards evolve over time, getting higher as more complex investment issues and opportunities arise
  
- Prudence requires good judgment and informed decision-making
  - Adequate preparation for meetings
  - Questioning “experts” on staff or from the outside
  - Considering advice that you may not want to hear from those advising you (investment staff, attorneys, consultants, etc.)

# The Duty of Prudence

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- The Uniform Prudent Investor Act recognizes that trustees may be investing assets pursuant to an agreement with another party that imposes investment parameters that would not otherwise comply with the Act
  - For example, an agreement may require that trustees make economically targeted investments
  - Trustees owe a duty to exercise “reasonable care to comply with the terms” of the agreement
  - The fiduciary responsibility is more narrow than in circumstances where trustees have complete authority over trust assets

## The Duty of Prudence

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“The test of prudence is one of conduct and not a test of the result of performance of the investment. The focus of the inquiry is how the fiduciary acted in his selection of the investment and not whether his investment succeeded or failed.”

-Donovan v. Cunningham

## Delegation by Fiduciaries (to Fiduciaries)

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- Council Members need not perform all functions of the SIC
- General trust law allows and even encourages the delegation of duties
- Delegation must be done with care to an adequate number of appropriately-skilled agents
  - Consider internal and external agents
  - Consider necessary tools and resources
- It is best to have clear, understandable, written position descriptions, meeting minutes, investment policies, contracts, performance criteria, etc.
- Ongoing monitoring by the Council members is necessary
- Council members have a duty to take action and make changes if their agents are performing poorly

## Final Points about the Duty of Prudence

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- Council members and those who work for them are expected to be careful and thorough
- From a legal perspective, a good decision-making process is more important than a good outcome
- Council members and other fiduciaries are not expected to be perfect, but are expected to be prudent
- Prudence requires more than a “good heart and an empty head”

# The Duty of Loyalty

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- The Uniform Prudent Investor Act also requires Council members to invest and manage the assets solely and exclusively in the interest of the beneficiaries
- The duty of loyalty has remained rigid over time
- Historical interpretation of loyalty:
  - Fiduciaries can “**only wear one hat**”
  - The law has been very clear about the requirements of loyalty
  - Courts have been strict and consistent in their rulings
  - Council members are not to balance interests of outside parties

## Interpretation of Loyalty

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“Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. **A trustee is held to something stricter than the morals of the marketplace.** Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. **Uncompromising rigidity** has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd.”

Justice Cardozo, 1928

## Practicing Loyalty

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- Avoid conflicts of interest, or even the appearance of conflicts
- If avoidance is impossible, disclose your conflicts promptly and manage them to the best of your ability
- Sometimes this means recusing yourself from votes or forgoing other actions you would like to take
- The “court of public opinion” is extremely critical of fiduciaries who have conflicts of interest
- The laws are complex so if in doubt about whether or not you have a conflict of interest, seek legal advice

## Final Points about the Duty of Loyalty

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- An unwavering commitment to act solely for the benefit of the trust is expected of Council members and other fiduciaries
- Council members are not to let secondary interests influence their decision-making
- Violations of the duty of loyalty create headline risk
- Disappointing others outside the fund is not as serious or costly as violating the duty of loyalty

# Fiduciary Liability

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- Activities that may result in liability:
  - Personal actions violating the trust
  - Breaches of loyalty or prudence
  - Criminal actions
  
- The consequences of those activities can be severe
  - Personal liability for losses
    - Restoration of profits
    - Other equitable or remedial relief
    - Loss of reputation
  - Potential criminal liability

## Co-Fiduciary Liability

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- **You are your brother's keeper**

- If you **know** of a violation and do nothing about it, you are breaching **your** fiduciary duty
- Council members have a duty to remedy the fiduciary breaches of other fiduciaries
  - Some affirmative action, going beyond mere abstention from a vote or resignation from the Council, may be required
- It is important to have a good process in place for these situations

## Avoiding Liability

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- A thorough orientation and continuing education on fiduciary responsibility
- A good understanding of common scenarios where fiduciary duties come into play
- A pure, thorough and scrupulous decision-making process with clear documentation of actions and rationale
- Expert advice from the staff, legal counsel, and others, when needed
- Good governance policies including clear accountability
- A commitment to ongoing oversight activities

# Summary

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- All Council members are fiduciaries and have stringent legal requirements imposed upon them
- Council members may delegate certain duties but they cannot abdicate their overall fiduciary responsibility
- The duties of prudence and loyalty are of paramount importance
- When in doubt, seek advice about fiduciary issues
  - Evan Land is a valuable resource for these questions
- The consequences of breaching fiduciary duties are severe