Fiduciary Conflicts of Interest

Gregory Lyons

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Debevoise & Plimpton

Fiduciary Duty

'The reason of the rule inhibiting a party who occupies confidential and fiduciary relations toward another from assuming antagonistic positions to his principal in matters involving the subject matter of the trust is sometimes said to rest in a sound public policy, but it also is justified in a recognition of the authoritative declaration that no man can serve two masters.'

SEC v. Capital Gains Research Bureau, 375 U.S. 180, 196, n. 50 (1963).

What are conflicts of interest in a fiduciary setting?

"Conflicts of interest are present whenever the interests of a bank, its affiliates, or inside parties differ from the interests of the beneficiaries of an account managed by the bank, or when the interest of one or more fiduciary accounts or beneficiaries are in conflict . . .

"The potential for conflicts of interest may result from a number of activities conducted by a bank that provides fiduciary and other asset management services"

Comptroller's Handbook: Conflicts of Interest, at p. 3.

Types of conflicts in fiduciary relationships

- Engaging in transactions with the fiduciary itself or related parties and interests (self-dealing)
- Employee compensation provisions giving employees an incentive to act other than in the best interest of fiduciary clients
- Unethical behavior by a firm or its directors, officers or employees
- Receiving compensation from parties to whom a firm has delegated fiduciary activities

Examples of conflicts in fiduciary relationships

- **Undisclosed fee income from affiliates**. While fiduciary banks are generally able to delegate tasks to affiliates, such arrangements, including fee arrangements, must be disclosed and otherwise comply with applicable law.

- **Loaning funds to purchase fiduciary assets**. Conflicts of interest could arise if a bank loans funds to a third party to purchase fiduciary assets. As such, a bank should exercise caution and consider seeking legal counsel.

Risks Associated with Conflicts of Interest

- **Operational**. Risks arising from employee and director misconduct and improper use of material inside information
- **Compliance.** Improper conflicts of interest may result in regulatory sanctions or costly, highly publicized litigation which can jeopardize a bank's present and future earnings
- **Strategic**. Improper conflicts of interest can make it difficult to cultivate and maintain a satisfied, loyal customer base which negatively impacts fee-based lines of business.
- **Reputational.** A firm's reputation can be negatively affected if the bank engages in, or appears to engage in, improper conflicts of interest or self-dealing with respect to its asset management activities.

Managing Risks Related to Conflicts

- **Active board and management supervision** including through appropriate audit committee procedures and management information systems.
- **Policy** that is detailed enough to address the activities the bank engages in, and including policies required by regulation
- **Processes** that identify and monitor conflicts on an ongoing basis
- Hiring and training and qualified **personnel**.
- **Control systems** including compliance and audit functions.

Engaging in conflicted transactions

- While some conflicted transactions are prohibited under all circumstances, firms may engage in certain conflicted activities subject to certain conditions (discussed below) and proper oversight.
- Depending on circumstances, fiduciaries may engage in certain conflicted activities when allowed by either:
  - Applicable law
  - The governing instrument
  - The informed consent of the beneficiary (i.e. through disclosure), if the transaction is fair and executed in the beneficiaries' best interest
- *Note that engaging in a conflicted transaction by relying on applicable law does not make a particular decision appropriate, prudent, or in the best interest of the fiduciary account*

(Excludes ERISA; see slides 11, 12)

Disclosure and conflicted transactions

- Fiduciaries can benefit from full disclosure, which, in connection with other appropriate procedures including consent, as required under applicable law, may allow fiduciaries to engage in otherwise prohibited activities.
- Disclosure may help eliminate a conflict that would otherwise be a breach of fiduciary duty.
- Failure to disclose or incomplete disclosure may be a breach of fiduciary duty

Some DO's and DON'Ts of disclosure

DO disclose appropriately

The SEC found that an adviser's failure to disclose service fees until years after the fees had been withdrawn was a breach of fiduciary duty. The SEC also found that the hiring of an affiliate "was a related-party transaction and created a conflict of interest" that should have been disclosed. The failure to disclose the conflict was a breach of fiduciary duty.

In the Matter of SLRA Inc., as successor to Liquid Realty Advisors III, LLC and Scott M. Landress (February 7, 2017).

DON'T make vague disclosures

For example, the SEC has said: "In order for disclosure to be full and fair, it should be sufficiently specific so that a client is able to understand the material fact or conflict of interest and make an informed decision whether to provide consent." Commission Interpretation Regarding Standard of Conduct for Investment Advisers, Investment Advisers Act Release No. 5248 (June 5, 2019) at 24.

DO differentiate between actual and potential conflicts

The SEC found that an adviser's disclosure that it "may" receive compensation and that those arrangements "may" create a conflict of interest constituted inadequate disclosure because the adviser actually was engaged in the arrangement, creating a conflict of interest.

(Excludes ERISA; see slides 11, 12)

Some conflicts cannot be cured: ERISA example

- The ability to “cure” conflicts, including through disclosure, may differ based on applicable governing law. Notably, **ERISA fiduciary duties cannot be waived or avoided with disclosure**.
- For instance, in a transaction involving plan assets, a fiduciary may not represent the interests of a party whose interests are adverse to those of the plan for which it acts a fiduciary.
  - As an example, if an investment firm serves as the manager of several funds, one of which is treated as investing plan assets subject to ERISA, the ERISA fund could not engage in a transaction with one of the other sponsored funds, which could – absent ERISA – be permitted with disclosure and consent. ERISA Section 406(b)(2).
- **Further, an arrangement that purports to exculpate a fiduciary from liability for breaching its duties – or an indemnity from a plan to the fiduciary against liabilities arising from any such breach – is simply void as against public policy.**
  - While a trustee or other commercial party may be exculpated or indemnified under a disclosed and agreed contractual arrangement, an ERISA fiduciary cannot be excused from complying with its duties. ERISA Section 410.

Thank you

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