Independent office of the trustee:
a model for managing conflicts in financial institutions?

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INTRODUCTION

An "independent office of the trustee" model might assist in effectively managing conflicts in a financial services conglomerate.

Trustee companies in a financial services conglomerate typically use the resources and services of related companies for the trust-based financial products offered by them under the conglomerate's brand. This model is not a step back to the two-tiered trustee and manager structure of the past. Instead, it is a model that conglomerates may consider as appropriate today for managing (and being seen to manage) their related party dealings.

NO PROFIT AND CONFLICTS RULES

As the trustee company is in a fiduciary relationship with trust beneficiaries, it must generally account for any benefit gained at the expense of those beneficiaries as a result of its position as trustee. This is known as the "no profit rule".

Likewise, the trustee must not place itself in a position where there is a real sensible possibility that its personal interest or duty to a third party may conflict with its duty to act in the best interests of the beneficiaries of the trust. This is known as the "no conflicts rule".

For a corporate trustee, the directors are also subject to the no profit and conflicts rules, however, they owe their duties to the company shareholders.

These rules have their origins in the equitable jurisdiction of the courts and have been restated in various forms in the Corporations Act 2001 and the Superannuation Industry (Supervision) Act 1993, but without abrogating from the rules under the general law. More recently, ASIC and APRA have published their own views on management of conflicts by holders of AFSL and RSE licences.

EXCEPTIONS TO RULES

The restrictions imposed by the no profit and conflicts rules may be modified or excluded by the express provisions of the constitution of the trustee company or the trust deed of the trust. Another exception to these rules is to obtain the fully informed consent of the company shareholders or the beneficiaries of the trust, respectively.

For the trust, this is usually done through proper disclosure to prospective beneficiaries in the product disclosure statement or information memorandum.

BUILDING CAPTIVE PRODUCTS

Historically, these exceptions to the no profit and conflicts rules have been relied upon in setting up trust based products (particularly super funds) where the trustee is required to deal with related companies for the provision of resources and services in relation to those products.

An example is where the trust deed of a superannuation fund expressly states that the trustee can only invest in investment policies issued by a related life insurance company. Another example is where the constitution of a responsible entity only permits it to invest in related wholesale funds. The amendment power in the trust deed may entrench such provisions by prohibiting any amendment to them.

Taking it one step further, the investment policy issued by the related life company may expressly give the life company the unilateral power to determine the investment objectives and strategy for the fund. The fees payable to the related companies will usually be set out in the trust deed or the investment policy issued by the related company, to take advantage of the exception to the no profit rule.

Even if the trust deed does not expressly lock in the trustee in the above sense, the disclosure made to prospective beneficiaries may clearly state that the trustee will be investing in "in-house products" and that related companies may be providing resources and services to the trustee for a fee.

With proper drafting of express provisions in trust deeds and company constitutions and full disclosure to prospective beneficiaries, the law generally permits these dealings between related companies without a liability to account to the beneficiaries of the trust. This has been the case for some time and the law has not changed in this regard, despite recent statements by the regulators to the contrary.

However, it is not uncommon for the trustee to retain some discretion under its trust deed in relation to various aspects of the administration, investment management and even custody of the assets of the trust. It is also possible that some products may have been built as captive products and then amended to give the trustee broader discretionary powers.

ROLE OF THE TRUSTEE

The way in which the product is built and promoted, and the extent of the trustee's discretionary powers, will determine the role and responsibilities of the trustee in relation to related party arrangements.

The role of a trustee in many conglomerates is not to develop new products or set targets for funds under management or drive initiatives to rationalise or change product design. These initiatives are usually driven by the relevant business unit.

Often, the trustee acts as a compliance policeman. That is, the trustee's role is to make sure that:

- new products are built and administered in compliance with the law; and
- any decision to change or rationalise a product is made in the best interests of the beneficiaries of the trust based product as a whole.

Regardless of the extent to which the trustee uses resources and services provided by related companies, the trustee remains responsible for the management of the trust based products under its charge.

In particular, the trustee will continue to have a duty to act in the best interests of the beneficiaries in monitoring the provision of resources and services by the related companies in relation to those trusts (ie. monitoring the performance, and exercising and enforcing any rights, under related party agreements). There are persuasive arguments to suggest that the trustee of a captive product has potentially a more onerous duty in its monitoring of related companies, especially if it is clearly locked into dealing with them for fees which are not negotiable.

CONFLICTS REMAIN AN ISSUE

As stated above, captive products operate under exceptions to the no profit and conflicts rules. However, it is not uncommon for a conglomerate to find itself in a position where the dealings between related companies may still result in potential breaches of those rules. There are two types of circumstances in which this may arise.

The first is where the trustee is not truly locked into using the services of its related companies because the product has not been built properly or it has been amended to give the trustee more discretionary power to choose other service providers. This situation creates conflicts at the legal entity level (ie. between the trustee and its related service providers).

These conflicts may be managed through proper disclosure and revisiting the discretionary powers given to the trustee and are not examined further in this article.

The second relates to the personnel who are involved in the dealings between the related companies. The following is an examination of two scenarios where these dealings may result in breaches of the no profit and conflicts rules.

Scenario One – When something goes wrong

The first scenario is where the trustee of a financial product (such as a super fund) has outsourced the administration function (including unit pricing) to a related company, which may be a related life company or service company.

Conflicts generally arise when:

- The related service provider discovers that something has gone wrong in the administration or operation of the trust product, such as a unit pricing error;
- It adversely affects the interests of beneficiaries; and
- The conglomerate has to compensate the beneficiaries of the trust or otherwise use shareholder funds to fix the problem.

Conflicted executives

A duty or duty conflict may arise where an executive director of the service company is also a director of the trustee. Where a unit pricing error occurs, the executive director has a duty to look after the interests of the service company on the one hand, and a duty to the trustee, which has a duty to look after the interests of the beneficiaries of the trust, on the other. The law does not allow the executive to serve two masters in these circumstances, without having appropriate conflicts management procedures in place.

A conflict of interest may arise if the same executive director holds valuable share options in the listed parent company. In this case, the executive may have a material personal interest in resisting spending shareholder funds in order to fully compensate the beneficiaries of the trust, because this may result in a reduction in the value of the share price and, consequently, the value of the director's share options. This personal interest will invariably conflict with the director's duty to the trustee, which must serve the interests of the beneficiaries of the trust.

The same executive may also have key performance indicators and a potential financial incentive aligned to the service company achieving certain profit levels, which may be at risk if the service company has to pay large amounts of money to remediate the unit pricing errors.

It is not uncommon for the majority of the directors sitting on the boards of the trustee and the service company to be potentially conflicted in the above senses. The law requires caution and action to be taken to manage these conflicts.

Conflicted in-house teams

It is common practice for the same internal legal, actuarial or audit teams to be advising both the trustee and the service company in relation to the unit pricing errors. These people may also be fiduciaries in their professional capacities and have a duty to avoid conflicts.

The same risk and compliance team may have been involved in identifying and analysing the errors and be responsible for formulating and implementing the remediation plan for the errors on behalf of both the trustee and the service company.

These teams are also effectively serving two masters, whose interests may not be aligned. The service company may be seeking to curtail the costs of the remediation (and, for example, may be pushing for a materiality threshold in compensating beneficiaries) and the trustee may be duty bound to seek full compensation.

These people may be placed in an uncomfortable position of trying to serve these competing interests, all the while trying not to upset either "master", which may jeopardise their career development or job security. Again, the law requires caution and action to properly manage each of these potential conflicts.

Scenario Two – Product rationalisation or design change

The second scenario is where the business unit is driving an initiative to rationalise or change the design features of a trust based product. An example is a proposal to terminate an in-house (legacy) trust and transfer the assets and beneficiaries to another in-house trust within the conglomerate (eg. a successor fund transfer between related trustee companies).

Commercial drivers for change

There are usually commercial drivers behind these initiatives, which seek to improve the profitability of the business unit. However, the trustee must act in the best interests of the beneficiaries.

Duty or duty conflicts may arise if the executives of the business unit are directors of the trustee. If the executives have bonuses and share options which are tied to the profitability of the business unit, they may also have a duty/interest conflict.

If the proposal is to rationalise two in-house trusts, duty or duty conflicts may arise if the trustee companies have common directors. Each trustee is duty bound to act in the best interests of the beneficiaries of the trust under its charge. If elements of the proposal are not in the best interests of the beneficiaries of one of the trusts, a conflict of competing duties arises for the common directors. Again, the law does not allow the common directors to "serve two masters" in these circumstances, without having appropriate conflicts management procedures in place.

Conflicted in–house teams

The same issues arise in this scenario as in the first one for the in-house teams who are advising both trustee companies, whose interests may not be aligned. The potential for conflicts will be compounded if the in-house teams are also advising the business unit, whose commercial drivers may not be in the interests of the beneficiaries of the affected trusts.

Consequences of breach of the no profit and conflicts rules

The law requires caution and action by trustees, directors, executives and the in-house teams who may also be fiduciaries, to properly manage potential conflicts. A successful action for breach of the no profit or conflicts rules may result in an order to fully compensate beneficiaries for any damages suffered as a result of the breach. An order may also be made to account for any profit or other advantage gained in breach of those rules.

The directors of the trustee also risk criminal and civil liability as a result of proceedings commenced by the regulators for breach of statutory formulations of these rules. The directors may also face disqualification actions or other professional sanctions, which may threaten their careers (regardless of whether they are successful).

Alternatively, a regulator may take enforcement action such as by seeking to extract enforceable undertakings or issue directions against the trustee or a regulated service company, which may far exceed what is required to compensate affected beneficiaries of the trusts.

There is also the potential for brand damage and the loss of the trust and confidence of the investors in these trusts, which strike a sensitive nerve with any chief executive.

INDEPENDENT OFFICE OF THE TRUSTEE – A POTENTIAL MODEL

As is evident from the above discussion, conglomerates face many potential conflicts in their dealings between related companies. The consequences of a failure to properly manage conflicts in accordance with the law can be significant in both financial and personal terms for not only the trustee but the corporate group on a whole.

In our view, there is no one-size-fits-all solution and any strategy for managing conflicts must address the particular circumstances of the trustee within the conglomerate.

However, in our discussions with industry, there is an emerging model, whose features may help address many of the concerns facing conglomerates. It is a hybrid governance model in the form of an Independent Office of the Trustee, which satisfies the regulated entity focus of the regulators but also recognises the conglomerate reality.

The features of this model are:

- A majority of independent non-executive directors on the trustee board – there are degrees of "independence". At a minimum, "independence" would require a director whose remuneration is not tied to the profitability of the relevant business unit and who is not an executive of a related service provider to the trustee;
- A minority of executive directors – the board must include executives of the business unit to ensure the board retains product knowledge and a proper understanding of the corporate context in which the trustee operates. However, the executive directors may need to abstain or not attend meetings at which issues arise relating to the business unit or related service provider. Other measures may include appointing an alternate director or delegating certain decisions to an independent consultant;
- A separate dedicated management team – this team should be led by a senior executive and should have clearly defined role descriptions which are directed to ensuring the trustee's duties are discharged on a day to day basis. Importantly, the team should not have any competing duties or roles within the business unit or related service providers;
- Access to adequate resources – the trustee must have access to adequate technical and financial resources, in its own right or under an enforceable arrangement, in order to ensure that it is properly resourced to fulfil its duties. This would include a financial budget to enable the trustee to instruct external advisers to advise on key issues with related companies, when a conflict arises;
- Appropriate key performance indicators and incentives for trustee staff – these should be aligned to fulfilling the duties of the trustee and not the profitability or commercial drivers of the business unit or related service providers;
- Access to separate internal legal, actuarial and audit teams – this does not mean separate teams for business as usual activities. Rather, separate teams may be needed in certain circumstances and for certain purposes to properly manage conflicts and issues involving related service providers. Alternatively, where the in-house teams are advising the business unit or related service provider, the trustee could consider instructing external advisers; and
- Regulated entity reporting lines – the reporting lines to the trustee in respect of the performance of its service providers should be on an entity to entity basis to reflect the legal obligations imposed on the trustee to monitor its service providers. Likewise, breach reporting to the regulators should be controlled by the trustee to reflect its legal obligations, rather than the business unit reporting directly to the regulator without the knowledge of the trustee.

WHAT LIES AHEAD?

It will be interesting to see how our industry and the regulators deal with the management of conflicts. We know that the regulators are increasingly focusing their efforts on conflicts. APRA in its recent FAQ on RSE licensing made a telling closing remark, which may give some indication of what lies ahead for our industry. APRA states that if the mitigants for the conflict of interest are thought by APRA to be insufficient, APRA may impose specific licence conditions to deal with the conflict. As you know, ASIC also has the same power in respect of AFSL holders.