# Reclaiming Fiduciary Duty Balance

**James Hawley, Keith Johnson, and Ed Waitzer**

*James Hawley is Director, Elfenworks Center for the Study of Fiduciary Capitalism, and Professor, Saint Mary's College of California, School of Economics and Business (United States). Keith L. Johnson is Program Director of the University of Wisconsin Law School's International Corporate Governance Initiative and chairs the Institutional Investor Services Group at Reinhart Boerner Van Deuren s.c. (United States). Ed Waitzer is a Professor, holder of the Jarislowsky Dimma Mooney Chair in Corporate Governance, and Director of the Hennick Centre for Business and Law at Osgoode Hall and the Schulich School of Business, York University, Toronto (Canada).*

*Fundamental fiduciary principles have survived intact for centuries, yet their interpretation has been dynamic. Given changes over the past few decades in global economic, capital management, and market structures, we appear to be at another inflection point in the understanding of fiduciary principles. Years of focus on the fiduciary duty of prudence has generated myopic investment herding behaviors, undermined intergenerational pension equity, and disrupted attention to the fiduciary duties of loyalty and impartiality. Reclaiming fiduciary duty balance between prudence, loyalty and impartiality is critical to sustaining pension promises. It would encourage better alignment of pension service providers' supply chain interests, adoption of fit-for-purpose pension fund governance practices, and implementation of precautionary risk management policies.*

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## The Dynamic Nature of Fiduciary Duty

Fiduciary duty is grounded on a relatively stable set of legal principles that have survived for centuries. However, interpretation of fiduciary principles can be quite dynamic. We are again at an inflection point, where our understanding and appreciation of fiduciary duty is evolving rapidly. In response to recent changes in financial markets, economic changes, and changes in the asset management industry, fiduciaries are examining the continued appropriateness of norms and beliefs carried over from the twentieth century.

Trends of the past three decades have produced a concentration of capital managed by fiduciaries on a global basis, often against similar short-term and market-relative benchmarks. Increased market complexity has generated a longer and more conflicted chain of service providers that have growing influence over governing fiduciaries. Despite a series of unexpected market shocks, prevailing theories and practices have not been fully adjusted to reflect systemic and long-term risks that threaten to undermine the security of the pension (and other retirement savings) plan "promise."

These developments present a compelling case for evaluation of how fiduciary principles and practices might be better aligned to promote sustainable pension (and other retirement investment) success. Such a process is likely to be an extended journey of discovery rather than a single event of enlightenment. This article identifies recent changes and fundamental issues for examination in the quest to reclaim fiduciary duty fundamentals.[1]

## Changes in the Market and Risk Environment

The extent of change since the mid-twentieth century in global financial markets, regulatory frameworks, economic theory, risk management, and the role played by mandatory savings plans has been remarkable. For pension fiduciaries, the most important transformations have included the following:

- ***Growth of Pension Funds:*** Assets under the management of pension fiduciaries have grown from an insignificant part of economies to huge pools of capital. Total pension fund assets now exceed national GDP in the Netherlands, Switzerland, and Iceland. Across all countries in the Organisation for Economic Co-operation and Development

(OECD), the average ratio of pension assets to GDP in 2009 was 67%. In the United Kingdom, it was 81%; in Australia, 82% (OECD 2010). Institutional investors collectively own 73% of stock issued by companies in the Fortune 1000. Pension funds alone hold the largest ownership block, with almost 30% (Tonello and Rabinov 2010).

- ***Expansion of Service Provider Influence:*** Innovation in the creation of financial instruments, products, and services has produced a far more complex investment marketplace. Nearly every aspect of investment management now requires specialized expertise. This has generated a vast new industry of service providers upon whom pension trustees rely.
- ***Exposure to Systemic and Extra-Financial Risk:*** Use of indexed investing has skyrocketed. Furthermore, Ibbotson (2010) reports that 75% or more of a typical portfolio's returns now come from general market exposure (beta) rather than benchmark outperformance (alpha). The recent financial crisis illustrates this phenomenon, which produced an unexpected global correlation of risks that lopped $5.4 trillion (20%) off global pension assets in 2008 alone, accelerated the closure of defined benefit (DB) pension plans, and ravaged retirement security for millions of plan participants (Yermo and Severinson 2010).[2]
- ***Focus on Short-Term Returns:*** The average holding period for shares listed on the New York Stock Exchange has gone from over five years in 1970 to less than one year today (Conference Board 2003).[3] Mercer and the IRRC Institute (2010) report that nearly two-thirds of portfolio managers have higher annual portfolio turnover than claimed, some by as much as 200 percent. The CFA Centre for Financial Market Integrity and the Business Roundtable Institute for Corporate Ethics studied investor time horizons and concluded, "The obsession with short-term results by investors, asset management firms, and corporate managers collectively leads to the unintended consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance" (Krehmeyer, Orsagh, and Schacht 2006).[4] The World Economic Forum (2011b) warns that short-termism is being fostered through the adoption of regulatory frameworks that constrain the ability of investors with long-term liabilities to use long-term investment strategies.

## Evolving Investment Theory Assumptions

Modern portfolio theory (MPT) became accepted as the dominant approach for prudent investment and risk management practices toward the end of the twentieth century. It transformed the legal framework governing fiduciaries. However, recent developments in economics and behavioral finance have built a substantial critique of many assumptions underlying MPT and related academic theory.[5] An adjustment in prevailing investment theory is likely to follow, particularly with respect to the following:

- ***Understanding of Risk:*** MPT assumes that investment risk falls into four main types: market, credit, liquidity, and operational. The rapid growth of financial instruments has led to underestimation and mispricing of risk, primarily because of market complexity and interactions among various risk types. Uncertainty (risk that is neither necessarily known nor calculable) has not been considered, though its effects have become evident (Knight 1921; Bookstaber 2007).
- ***View of Markets:*** MPT assumes that (i) investors are rational; (ii) information is symmetric, cost free, and immediately actionable; (iii) if markets are temporarily inefficient, they will revert to being efficient with the help of arbitrage; and (iv) returns are statistically stochastic and have been widely interpreted as following a normal bell curve distribution.[6] The growing dominance of large institutional investors using similar investment strategies and risk management techniques has produced returns that are increasingly linked. The resultant herding and cascading effects reflect the failure of MPT to take into account the effect of its own success and widespread adoption.
- ***Beliefs about Investors:*** MPT also presumes that investors (i) are risk averse; (ii) make decisions based on expected utility; (iii) have linear and consistent preferences; and (iv) are price takers who cannot individually affect a security's price. MPT concludes that the overall risk of a portfolio depends on the risk of each asset in the portfolio, the proportion of the portfolio in that asset, and the correlations among different portfolio assets. In critical instances, each of these assumptions (and conclusions) has not held.
- ***Systemic Risk:*** From the original formulation of MPT, Sharpe (1964) introduced concepts of systemic and idiosyncratic risk, beta, diversification, and the linear relationship between beta (a measure of portfolio risk) and expected return. The critical point for contemporary risk management is the assumption that idiosyncratic (asset specific) risk can be diversified away (including through leverage), increasing portfolio return and / or decreasing portfolio risk, beta. Left unexamined was the impact of systemic risk, which Sharpe held as independent of idiosyncratic risk and which he argued (correctly in our view) could not be diversified away. Systemic risk was seen as strictly exogenous.[7]

The ideological power of "labeling" financial markets as "efficient" (i.e., asserting that they do not cause or amplify economic instability) or "rational" has been undermined. This has implications for the application of fiduciary norms and merits the attention of institutional fiduciaries.[8]

## The Origins of Fiduciary Norms

Fiduciaries face the same challenges whether they oversee funds structured as trusts, mutual benefit societies, foundations, contractual pools of segregated assets, or joint stock companies. While the following discussion tracks the evolution of fiduciary duty applicable to trusts in common law jurisdictions, the same fundamentals apply to civil law regimes and contractual pension schemes.[9]

Fiduciary duty has its roots in Germanic, Roman, and Islamic trust law (Avisheh 1996). The contemporary trust developed as a means to overcome feudal restrictions on the transfer of land and was imported to English common law from civil law structures (Lupoi 1999). The essential concept was that underlying assets were held in trust, under separate title from the designated beneficiaries, and managed by the trustee on behalf of designated beneficiaries (Langbein 1997). Trustees initially had few powers or managerial responsibilities and were most often unpaid. The trustee's role has evolved dramatically over time.

## Quantitative Standards

Following the collapse of the "South Sea Bubble" in the early eighteenth century, English courts of equity required trustees to restrict their investments to government debt and well-secured mortgages. This was the genesis of the "legal list" approach, which restricted the range of permitted trustee investments (Keeton 1971).[10]

In the United States, *Harvard College v. Amory* (decided in 1830) took a different approach. The court articulated an objective behavioral standard for trustee investment practice, focusing on conduct and imposing duties of care and loyalty, rather than prescribing permitted investments. While it admonished against speculation, it recognized that risk is inherent in investment decisions.

However, the flexibility of this approach was quickly circumscribed. For example, in *King v. Talbot* (1869), the court determined that it was imprudent for trustees to invest in corporate stock and limited them to investments in government bonds and mortgage-backed instruments. The New York legislature followed suit in 1889, enacting legislation that restricted trust investments to government bonds and mortgages, unless otherwise allowed by the trust creator. As recently as the 1970s, stock investments were widely viewed as imprudent for trust fiduciaries.[11]

## The Prudent Person Standard

Over time, the changing market environment made this restrictive approach impractical. Statutory expressions of a "prudent person" rule for trustee investment began to supersede the legal list approach by the mid-twentieth century (Friedman 1964). The need for trustees to effectively hedge against inflation and the superior performance of equities (and foreign securities) also led to the introduction of baskets for securities that fell outside of legal lists, to facilitate diversification.

With growing acceptance of MPT in the 1970s and after, the abandonment of prescribed investment categories became common. The *Employee Retirement Income Security Act* (ERISA), adopted in 1974 to govern American private pension funds, illustrates this legal paradigm shift from restricted trustee powers to one that confers broad managerial discretion on trustees, within the bounds of overarching fiduciary obligations. Most American public pension plans also adopted similar standards.[12]

ERISA also repealed the prior rule against delegation of investment responsibilities, in response to the growing complexity of managing financial assets and the need for trustees to rely on delegation to professionals to discharge their obligations. This evolution was subsequently reflected in modifications of the Restatement (Third) of Trusts (1992, §171).

Some variation of the prudent person rule has now been adopted in most common law and civil law countries with mature capital markets. It is generally effected by contract in civil law jurisdictions.

## The Prudent Investor Standard

One variation of the *prudent person* standard was the shift to a *prudent investor* standard in the 1992 revisions of the Restatement of Trusts and the *Uniform Prudent Investor Act* of 1994, as well as the British *Pensions Act* in 1995. These changes reflected a recognition that, in accordance with MPT, prudence should be measured on an overall portfolio basis, rather than by discrete consideration of each particular investment. MPT also elevated the prudence standard by recognizing that managing pension fund assets requires significant levels of professional expertise beyond that of the common person.

The *Uniform Prudent Investor Act* (National Conference of Commissioners on Uniform State Laws 1997b) was adopted to facilitate implementation of the standards for prudent trust investment advanced in the Restatement (Third). It made five major alterations in prudent investing concepts by

(a) Focusing on the total portfolio, rather than individual investments
(b) Defining the fiduciary's central concern as the trade-off between risk and return
(c) Removing all categoric restrictions on types of investment
(d) Prescribing diversification as integral to prudent investing
(e) Reversing the non-delegation rule with respect to investment and management functions

It also confirmed a "prudent professional" standard, to clarify application of a higher standard of care when a trustee is an expert or professional with a higher level of skills (e.g., investment professionals).[13]

## Fiduciary Duty Is a Dynamic Concept

This evolution of fiduciary duty demonstrates that fiduciary law is not a static concept, nor is it tied to a single investment theory. Rather, it is a flexible set of principles that have been subject to varying interpretations over time.

When explaining rejection of prior interpretations of fiduciary duty in the early 1990s, the Restatement of Trusts (Third) aptly observed, "Trust investment law should reflect and accommodate current knowledge and concepts. It should avoid repeating the mistake of freezing its rules against future learning and developments" (1992, §227, Introduction).

Fiduciary duty is a process-oriented standard which guides rather than dictates investment decisions. However, a generation of investment professionals has spent entire careers in a legal environment shaped by MPT. This has encouraged the view that fiduciary duty mandates a single approach to making investment decisions. Absent a broadly accepted prescriptive alternative, there remains strong cognitive resistance to a dynamic understanding of the legal standards.

## Pension Fiduciary Duty Today

While the exact formulation of fiduciary duty varies between jurisdictions, the main concepts are relatively consistent.[14] Fiduciaries are generally required to discharge their duties

(a) Solely in the interest of participants and beneficiaries
(b) For the exclusive purpose of providing benefits
(c) Impartially, taking into consideration differing interests of various participant and beneficiary groups
(d) With the care, skill, and prudence exercised by similar fiduciaries, including as to diversification of investments
(e) Incurring only costs that are appropriate and reasonable
(f) In accordance with governing law and documents[15]

Duties (a) through (c) are often referred to as the *duty of loyalty*, while (d) is called the *duty of prudence or standard of care*. All must be grounded in the specific context – that is, the nature of the pension promise and success in delivering on it.[16]

## Pension Fiduciary Standards Are Stricter Than Standards for Corporate Directors

Though often compared to corporate directors in terms of statutory duties, pension fiduciaries are held to a higher standard of conduct that has different legal roots.[17] If a trustee's conduct is not prudent, s/he may be liable to the beneficiaries.[18] Also, the duty of loyalty owed by pension fiduciaries is to the actual human beneficiaries, not to the legal entity. There is not the same ambiguity as may be inherent in corporate law, which imposes a duty to act in the best interests of "the corporation." Pension fiduciaries need not concern themselves with raising capital, so there are few market-based (or other) checks to discipline their conduct. Beneficiaries do not enjoy the liquidity of capital markets or (typically) the ability to oust trustees.

The governance remit of fund trustees is also different from that of corporate directors. The essence of private enterprise is risk taking; in contrast, the history of fiduciary standards for investment of pension fund assets is singular in its focus on preserving trust property by risk mitigation and cautious investment behavior (Sitkoff 2004).

## Devolution of the Pension Fiduciary Standard of Care

The standard of care (also known as the duty of prudence) encourages pension fiduciaries to adhere to practices followed by similar institutional investors (Galler 2002).[19] However, with growth in pension assets over the past few decades and increased investor focus on short-term investing, herding can function like an economic wave generation machine (Johnson and de Graaf 2009). Collectively, pension fund investors can *create market volatility and undermine sustainable wealth creation* when they invest with the same short-term bias and follow each other around the markets.

Excessive reliance on peer comparisons has also produced a shift toward using relative performance metrics rather than measuring performance on a risk-adjusted basis and against the best interests of beneficiaries. Perceived liability exposure increases for fiduciaries that are out of step with common practice (and results). Courts can easily compare their performance to that of a similar portfolio or a recognized index to evaluate prudence and assess damages. This often distracts fiduciaries from focusing on the interests of plan participants and is likely to distort efficient markets (Del Guercio 1996; Thomas and Tonks 2001).

The word "prudence" derives from the Latin term for "foresight" and means "acting with or showing care and thought for the future."[20] Peter Drucker argued this 35 years ago in *The Unseen Revolution* (1976), warning that pension funds would face the twin challenges (and opportunities) of becoming dominant owners as aging and longevity became key social, economic, and political issues. In an epilogue to the 1996 edition (in which he noted that no book of his had been more on target or more totally ignored), Drucker argued in favor of a shift away from short-term thinking in favor of a focus on defining performance (and results) as "maximizing the wealth-producing capacity of the enterprise" (1996, 218).[21] This, he argued, should define the role of institutional investors (and managerial accountability more generally).

## The Duty of Impartiality

A recent Bank of England study found that "investment choice, like other life choices, is being re-tuned to a shorter wavelength," leading to irrational investment decisions – particularly with respect to projects of longer duration, which often yield the highest private (and social) returns (Haldane and Davies 2011). Their data suggest that in the United Kingdom and the United States, 10-year-ahead cash flows are valued as if received 16 or more years ahead, and little or no value is ascribed to cash flows more than 30 years ahead. Haldane and Davies found that this myopic discounting is on the increase and is distorting efficient capital allocation by diverting investment capital away from future growth, despite the associated risks.

However, the duty of impartiality, which is part of the duty of loyalty, requires that fiduciaries balance short-term and long-term considerations.[22] They must identify and impartially consider the conflicting interests of different beneficiary groups, including those of current and future retirees (Restatement of Trusts, Third, 1992).[23] While impartiality does not mandate uncompromising equality, it does apply across all trustee duties. It requires that "conduct in administering a trust cannot be influenced by a trustee's personal favoritism … nor is it permissible for a trustee to ignore the interests of some beneficiaries merely as a result of oversight or neglect" (Restatement of Trusts, Third, 1992, §79, Comment (b)).[24]

Most importantly, the duty of impartiality imposes "procedural" duties. Not only must actual results reflect due regard for different beneficiaries' interests, but the "process of administration itself," including communication with beneficiaries, must be impartial (Wakeman, Franklin, and Ascher 2006, §17.15).

## The Duty of Impartiality Requires Attention to Long-Term Issues

For many plan participants, pension management results have become unfair, particularly from an intergenerational perspective.[25] While these outcomes may not present legal problems under the duty of prudence – common management approaches and poor results may be widely shared – the duty of impartiality presents a more clouded picture. In hindsight, at least, it is no surprise that widespread adherence to investment practices focused on producing short-term results (at the expense of longer-term earnings and capital growth) comes with "consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance" (Krehmeyer et al. 2006, 1).

The duty of impartiality assumes competence with respect to long-term value creation and risk mitigation. To be clear, the issue is not that a short-term outlook is wrong but, rather, that a deliberate balance should be struck between mission and risk-adjusted returns, including related opportunity costs. Fiduciaries must ensure that their decision-making processes balance allocation of capital between near-term needs and future wealth creation and consider the potential transfer of risks between participant generations. Intergenerational wealth maximization requires active consideration of a range of factors beyond narrow financial criteria.

## Dilution of the Duty of Loyalty

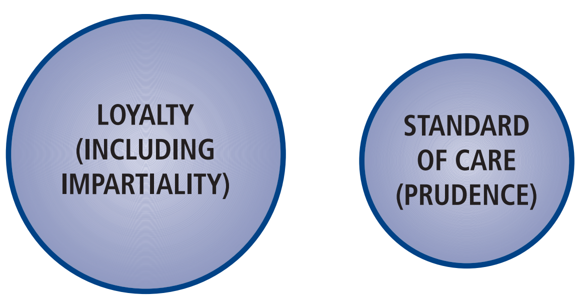
Pension trustees have an overriding "duty to administer the trust solely in the interest of the beneficiaries" and are "prohibited from engaging in transactions that involve self-dealing or that otherwise involve or create a conflict between the trustee's fiduciary duties and personal interests" (Restatement of Trusts, Third, 1992, §78 and Comment (b)).[26] Uncompromising rigidity of this rule is not just a formality, and applies to both defined benefit and defined contribution plans.[27] "The courts have consistently held that this inflexibility is essential to its effective operation … First, the courts have acknowledged that it is difficult, if not impossible for a person to act impartially in a matter in which he has an interest … Secondly, the courts have realized that fiduciary relationships lend themselves to exploitation

… Finally, the courts have made much of the fact that disloyal conduct is hard to detect" (Hallgring 1966, 808–11).

This focus on process and alignment of interests makes the duty of loyalty a demanding standard. "The fact that the [trustees] might have properly decided to choose the same course of action had they engaged in an unbiased and adequately informed process does not excuse how they went about reaching this course of action" (*McNeil v. Bennett* 2001, 213).

Figure 1 provides a visual representation of the relative priority of the duty of care and duty of loyalty. "When duties of loyalty and care collide, courts generally resolve the conflict in favor of the duty of loyalty representing minimum conduct to which the fiduciary must adhere" (Laby 2004, 78). Given primacy of the duty of loyalty, greater allocation of fiduciary time and resources to implementation of loyalty principles may be required.

### Figure 1: Relative Priority on Conflict of Main Fiduciary Duties




## Service Providers and Loyalty

Increasing financial market complexity, along with the resultant growth and influence of the advisory service supply chain, has eroded the protections afforded to beneficiaries by the duty of loyalty. In the United States, the Government Accountability Office reports that pension consultant conflicts of interest appear to be associated with lower investment returns (Jeszeck 2009). In response, the Department of Labor has proposed new regulations under ERISA to bring within the definition of *fiduciary* certain consultants, advisors, and appraisers who "significantly influence the decisions of plan fiduciaries, and have a considerable impact on plan investments" (US Department of Labor 2010).

A CREATE-Research survey of European pension fund executives and asset managers offers insight into the practical ramifications of these conflicts of interest, concluding that "there is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals" (Rajan 2008).

By delegating duties to qualified experts, trustees in many jurisdictions can shift liability risk to the delegates. This can create perverse incentives for trustees to delegate responsibility while the delegates try to avoid liability by providing advice but not making final decisions – or seeking indemnity (Stewart 2009). The result can be a circular system in which no one takes responsibility and the interests of agents trump those of pension beneficiaries. Nevertheless, the duty of loyalty assigns to governing fiduciaries the ultimate responsibility for oversight of supply-chain management conflicts of interest (which have become the norm in most commercial sectors).

## Pension Board Governance Practices

Implementation of the duty of loyalty presents particular challenges at the governing fiduciary level. Studies of pension fund governance practices have shown that good governance is associated with increased returns (Ambachtsheer, Capelle, and Lum 2008). However, recent findings suggest that many pension funds do not have the governance capacity to adapt their practices for better success or to distinguish between (let alone act upon) the differences between short-term issues and long-term commitments (Clark and Urwin 2010).

Ambachtsheer (2010) goes further in identifying key "success drivers" for tomorrow's pension funds:

- Aligned interests (conflict free)
- Good governance (requisite skills and accountabilities)
- Sensible investment beliefs (focusing on long-term wealth creation and effective risk management)
- Right-scaled institutions (big enough to be internally competent and competitive)
- Competitive compensation (to attract the best)

Again, as the empirical support for the relevance of such factors becomes compelling, it is arguable that failure to consider them has fiduciary duty implications.

For example, recent research has identified good governance practices that are linked with pension fund success, including

- Selection of governing Board members with relevant skills and knowledge
- Development of a Board self-improvement culture
- Clear understanding of the Board's mission and its investment beliefs
- Sufficient fund size to allow cost-effective management of assets

- Competitive staff compensation to permit acquisition of internal expertise
- Insulation from conflicting political or third-party agendas
- Clarity of Board and staff roles about delegation of management responsibilities[28]

While some of these factors can be beyond the control or influence of governing fiduciaries, most of them are not. Failure to consider material factors in the success of fiduciary governance raises concerns about the alignment of process with beneficiaries' interests and compliance with the duty of loyalty.

## Management of Service Provider Conflicts

Similarly, governing fiduciaries have an obligation to ensure that procedures are in place to identify and manage conflicts of interest in their service provider chain. Regulatory initiatives are beginning to refocus on this duty, but regulation is no substitute for process and contract changes to improve management of conflicts. Attention to the development of an effective program for managing conflicts could include the following components:

- ***Imposition of Fiduciary Liability Throughout the Supply Chain:*** While ERISA states that fiduciary liability attaches to anyone exercising discretion over plan assets (s. 3(38)), trustees have tended to view delegation as a shield (rather than a sword).[29] Even in jurisdictions where asset managers and consultants are not treated as fiduciaries, they could be contractually required to put beneficiaries' interests first through the use of selection process and contract requirements.
- ***Use of Conflicts Screening in Selection of Service Providers:*** The legal obligation to view conflicts of interest from beneficiaries' perspectives and focus on avoiding conflicts rather than monitoring them argues for selecting service providers without conflicts whenever practicable.[30]
- ***Alignment of Service Providers' Interests with Those of Fund Participants:*** As noted above, contract mandates and fee structures could be more clearly aligned with the duty of impartiality to better incentivize service providers to achieve goals that serve the short-term *and* long-term interests of various beneficiary groups in a balanced manner.
- ***Reporting to Fund Participants on Management of Conflicts:*** Given the opacity of risks associated with conflicts of interest, transparency with respect to identification and management of conflicts is particularly important. This includes not only service provider conflicts of interest but also efforts to balance the divergent interests of different beneficiary groups.
- ***Monitoring of Conflicts and Enforcement of Standards:*** More attention could be paid to contractual mandates for reporting and ongoing oversight of areas where service providers are likely to have conflicts. For example, there may be situations in which providers have competing interests that complicate compliance with the duty of impartiality, as when a manager with a short-term strategy votes proxies on matters relating to systemic risk exposure over the long term or a manager votes proxies involving executive compensation matters at a company with which it also has a business relationship.

## Precautionary Risk Management

Future value creation and management of risks for sustainable delivery of the pension promise depend on a range of interconnected social, environmental, and economic factors which, until recently, were often viewed as too remote or speculative to take into account and report. Contemporary interpretations of fiduciary duty have proved ill suited to taking an integrated view of and actively managing them. The fact that they now present systemic risk issues, however, also recalls the precautionary principle – the duty to focus first on *doing no harm* and to take impartial account of the interests of beneficiaries to whom fiduciary obligations are owed when developing an investment approach.[31] Indeed, a trust fund beneficiary's "first claim is that the fiduciary must refrain from causing harm … 'Do no harm' is the clarion call of every fiduciary" (Laby 2004, 149).

Loyalty to the interests of beneficiaries may require consideration of and response to their varying views on appropriate levels of risk exposure (including, perhaps, efforts to help inform such views). Ignoring the views of beneficiaries (or the interests of other key stakeholder groups) could have long-term ramifications with respect to support for, and consequently, sustainability of the pension promise. Attentiveness to and management of stakeholder expectations can be as important to sustainable success as investment management decisions.

These considerations (as well as the need to build governance capacity) suggest that trustees should be sensitizing themselves to the interests of beneficiaries (future and present), both directly (i.e., through efforts to consult and to inform) and by looking to evolving universal norms as a proxy therefor (Richardson 2010). This, in turn, requires implementation of processes for engagement that identify and consider externalities associated with management practices.

Application of the duty of loyalty, which mandates that procedures be impartially aligned with participants' interests, also has implications for resolving the *tragedy of the commons* paradox, wherein fiduciaries reject strategies expected to produce shared benefits while *free-riding* on the efforts of others.[32] Fiduciaries cannot simply ignore the interests of a group of beneficiaries because most other fiduciaries are doing the same and are unwilling to pursue cost-effective shared benefits.

Likewise, fiduciary responsibilities require that, in considering the interests of pension participants and beneficiaries, trustees measure and report on success in achieving the fundamental purpose of the pension trust – the provision of an independent mechanism for securing the pension promise and actual performance in so doing.

## Incorporating Sustainability Factors into the Investment Management Process

The assumption that risk can be managed solely or primarily through diversification was shown to be flawed by the recent economic crisis. For example, investors cannot avoid the risks associated with climate change by diversifying across asset classes; they must instead seek to diversify across sources of risk (Mercer Consulting 2011). Yet legal uncertainty has led to a view within the investment supply chain that integrating long-term risks and opportunities into the investment process is someone else's problem.

Signatories to the United Nations Principles of Responsible Investment (UNPRI) have now grown to more than 850 institutional investors with US$25 trillion under management – a signal that they are beginning to recognize the connections between a commitment to incorporate environmental, social, and governance (ESG) issues into their policies and practices and the fundamental fiduciary duties of loyalty and impartiality. ESG issues that might be of little concern to short-term traders can be material for long-term investors with obligations to manage assets impartially and in the interests of beneficiaries, so as to deliver sustainable pension benefits over several generations.[33]

Urwin (2011) has recently described the focus of "universal owners" on investment strategies and ownership practices (including collective action to produce network benefits) that integrate ESG considerations. Moreover, pension funds (along with other significant long-term investors) are uniquely positioned to benefit from investment opportunities that address unmet economic (and social) needs rather than simply investing in existing assets. To do so, fiduciaries need to overcome the tendency to allocate capital based solely on historical practices and approach sustainable investing from a forward-looking, risk management and value creation perspective (World Economic Forum 2011a).

It is also increasingly apparent that regulatory leadership will be required to motivate long-term fiduciaries (and their service providers) to effectively integrate ESG criteria into their investment decision making as part of effective risk management and regulatory compliance. Incentives should be aligned – by mandating appropriate fiduciary competencies, governance, and reporting practices that are designed to deliver sustainable retirement income security. Part of the challenge (again) is to rediscover and operationalize fundamental fiduciary norms, as well as adapt them to an evolving global investment environment.[34]

Stewardship codes for institutional investors are now in place or being considered in the United Kingdom, Europe, Canada, Australia, and elsewhere. South Africa has taken the lead by introducing, through regulation, several principles to be applied to investment institution fund assets. This includes a mandate that the investors, "before making an investment into and while invested in an asset, consider any factor which may materially affect the sustainable long-term performance of the investment, including those of an environmental, social and governance character." The preamble to these regulations squarely frames the duty of prudence (and, by implication, impartiality) as including proper consideration of these issues.[35]

## The Way Forward: Development of Key Performance Indicators

Business as usual is not likely to result in pension management practices that are designed to be unbiased and aligned with the interests of participants and beneficiaries; nor is it likely to provide suitable pension benefits on a sustainable and impartial basis. Yet that is the challenge today's fiduciaries face. We believe that plan sponsors, participants, beneficiaries, fiduciaries, and advisors could benefit from the development of key performance indicators to help guide pension management practices toward measurable success in meeting fundamental fiduciary goals. This article is intended to provoke an industry discussion focusing on that challenge.[36]

Table 1 provides an initial list of factors for consideration by fiduciaries in working toward the application of their fiduciary duties to contemporary challenges. It provides a starting point for discussing how developments in knowledge and changes in the circumstances faced by pension funds affect fiduciary obligations and practices. Such discussions would help to inform an evolving understanding of fiduciary duties and, in turn, promote success in sustainable delivery of promised pension benefits.

**Table 1: Reclaiming Fiduciary Duties – Key Governing Fiduciary Issues**

| Fiduciary Challenges | Fiduciary Issues: Policies and Procedures | Fiduciary Issues: Oversight Responsibilities |
|---|---|---|
| • Changing circumstances and knowledge base<br>• Systemic and long-term risk exposures<br>• Inter-generational equity and pension disparity<br>• Unbalanced short-termism<br>• Conflicts of interest<br>• Pension governance quality<br>• Implementation of *do no harm* principle<br>• Alignment of policies and procedures | • Allocate resources and time to understand challenges<br>• Adopt enterprise risk management approach<br>• Use beneficiary-aligned and impartial measures of success<br>• Understand global best practices<br>• Develop *fit for purpose* governance capabilities<br>• Ensure sustainable plan design<br>• Expand reporting / engagement to address loyalty and impartiality | • Acquire expertise to address fiduciary challenges<br>• RFPs to address fiduciary challenges<br>• Invest in research on long-term issues and fiduciary challenges<br>• Foster collaboration on education and shared resource development<br>• Measure success impartially on achieving beneficiary goals and interests<br>• Identify and measure risks across all beneficiary groups<br>• Align service provider contracts and fees with beneficiary interests<br>• Manage ESG risks and opportunities for sustainability and impartiality |

## Endnotes

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2. In the United Kingdom, 73% of defined benefit plans are now closed to new entrants.

3. See also New York Stock Exchange website, http://www.nyxdata.com/nyse-data/asp/factbook/viewer_edition.asp?mode=table&key=2992&category=3.

4. The long-term value destruction dynamic is illustrated in a study by Bhojraj et al. (2009), who found that companies which use reductions in R&D, advertising, and other discretionary spending to narrowly beat Wall Street quarterly projections experience a short-term stock value increase but go on to underperform over the following three years.

5. See, for example, Montgomery (2011); Kahneman and Tversky (1979); and Devenow and Welch (1996).

6. See, for example, J.P. Morgan Asset Management (2009); and Taleb (2007). A good example of this is the "pack mentality" of hedge funds (correlations of returns) from 2004 to 2010: see, for example, Strasburg and Pulliam (2011).

7. The popularity of index funds had an unpredicted consequence, which illustrates the *fallacy of composition* problem, one manifestation of which is herding. As a result of increase in demand for stocks that are included in a market index, the price of these stocks has been moved to some extent independently from their fundamental values. The indexation paradox has led to undermining the efficacy of the risk metrics essential to calculating risk-adjusted returns, since, paradoxically, a market index is no longer representative of a market; rather, it fluctuates based on the demand of index funds and portfolio managers that attempt to replicate the index. Therefore, performance evaluation based on these indices (both alpha and beta) is subject to inefficiencies, as these indices are not really an "index" of the market.

8. Indeed, Keynes's mid-1930s observation about the dangers of unrealistic economic assumptions is just as relevant today: "Too large a proportion of recent 'mathematical' economics are mere concoctions, as imprecise as the initial assumptions they rest on, which allow the author to lose sight of the complexities and interdependencies of the real world in a maze of pretentious and unhelpful symbols" (Keynes 1936, 298).

9. Different forms of pension organizations, governing structures, and legal regimes may require varying approaches to implementation of an evolving understanding of fiduciary duty. For example, changed regulations or stricter enforcement of existing laws might be appropriate in some civil law jurisdictions, while supervisory authorities or courts might adopt new interpretations of existing legal principles in some common law jurisdictions. Even under common law tradition, pension law is a unique combination of trust and contract principles that is effectively a specialized form of contract law (see Langbein 1997). See also Stewart and Antolin (2008) and Galler (2002) for a discussion of the fundamental pension fund governance issues that are common across various legal structures and jurisdictions.

10. Ironically, some recent regulatory reforms are moving toward a revival of constraints on permissible assets (and asset classes) in response to funds taking outsized risks to remedy their deficits; see, for example, Norgrove (2010).

11. See Restatement of Trusts, Second (1959), §227, Comment (f).

12. See, for example, National Conference of Commissioners on Uniform State Laws (1997a).

13. See, for example, Nelson (1993); Stanley (1984).

14. For a discussion of key fiduciary duty concepts across various jurisdictions see Berry (2011).

15. National Conference of Commissioners on Uniform State Laws (1997a); Restatement of Trusts, Third (1992, §227). Similar principles apply across common law countries (e.g., Canada, the United States, the United Kingdom, Ireland, Australia) and civil law countries (e.g., Italy, Japan, the Netherlands) (Galler 2002).

16. While this paper does not focus on defined contribution (DC) pension plans, the same basic legal responsibilities of trustees (including loyalty and impartiality) apply to selection and monitoring of investment options by the fiduciary, even though participants decide on allocation of their own savings between managers. See *Howell v. Motorola* (2011).

17. "[The] issues with respect to typical trusts … are materially different from those in the corporate-governance discussion, and trust beneficiaries ordinarily have available no close counterpart of the corporate shareholders' opportunities to sell their stock or to influence their company's behavior" (Restatement of Trusts, Third, 1992, §227, Comment (c)). For example, trust law generally precludes fiduciaries from engaging in self-interested transactions, although corporate directors can usually enter into related-party transactions with the company if these are disclosed and approved by disinterested directors as fair to the corporation. See Restatement of Trusts, Third (1992, §8 and §144).

18. It is worth noting that courts have extended pension fiduciary liability. For example, in two related cases, the Ontario Divisional Court imposed a fiduciary liability on the (then) Pension Commission of Ontario for consenting to the withdrawal of surplus funds without giving notice to plan members. See *Re Reevie and Montreal Trust Co. of Canada* (1996) and *Re Collins and Pension Commission of Ontario* (1986).

19. In the United States, pension funds subject to the *Employees' Retirement Income Security Act*, 29 USC §18.1104, must be managed "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."

20. *Merriam-Webster Dictionary* (2011), *s.v.* "prudent."

21. Drucker's focus on "wealth-creating" investment traces its roots to Keynes (1936).

22. The United States Supreme Court, in *Varity v. Howe* (1996), stated that "the common law of trusts [made applicable to ERISA §§404, 409] recognizes the need to preserve assets to satisfy future, as well as present, claims and requires a trustee to take impartial account of the interest of all beneficiaries."

## Endnotes (cont'd)

23. Restatement of Trusts, Third (1992), Comment (c) to §79(1). In the United Kingdom, the 1984 case of *Cowan v. Scargill* turned on impartiality. See also *Withers v. Teachers' Retirement System* (1978, 1257–58). The CFA Institute's Code of Conduct for Members of a Pension Scheme Governing Body advises that an effective trustee will "consider the different types of beneficiaries relevant to each pension scheme" and "engage in a delicate balancing act of taking sufficient risk to generate long-term returns high enough to support real benefit increases for active participants who will become future beneficiaries while avoiding a level of risk that jeopardizes the safety of the payments to existing pensioners" (Schacht and Stokes 2008).

24. Similarly, article 5, paragraph 4, of the Dutch *Pension and Savings Fund Act* (1997) provides that "in performing their duties, the persons who determine or help determine the policy of a pension or savings fund shall act in accordance with the interests of the members, former members and other stakeholders involved in the fund." The legislative history of the Act makes it clear that participants must be represented in a balanced way, with an eye to the possibly divergent interests of the various categories of stakeholder: members, dormant members, pensioners, and other stakeholders (see Maatman 2004).

25. For example, more than 73% of British defined benefit plans are closed to new entrants. In 2009, only 49% of the 200 largest American companies had ongoing defined benefit plans, down from 61% three years earlier (Yermo and Severinson 2010; see also Mercer Consulting 2011).

26. In Europe, article 18, paragraph 1, of the *EU Pensions Directive* (Directive 2003/4 ED) provides that member states must observe the "solely in the interest rule," which requires that assets be invested in the interests of fund members and beneficiaries; in the event of a conflict with other stakeholders, their interests must prevail.

27. There has been a tendency to mistakenly conflate the obligation to manage trust assets in the interest of beneficiaries with the other aspects of the duty of loyalty, which require that assets be managed impartially and for the purpose of providing pension benefits. However, these different aspects of loyalty are distinct obligations. Pension management activities can be designed solely to produce pension benefits yet still violate the duty of impartiality and not be in the interest of all beneficiaries. For example, pursuit of investment activities designed to produce short-term returns while generating long-term risks to pension sustainability may pass the "sole purpose" test but violate the "interest of beneficiaries" and "impartiality" fiduciary duties.

28. For more insight into the critical role of Board leadership see Clark and Urwin (2008a, 2008b).

29. Viewing delegated responsibilities as carrying with them fiduciary obligations might also strengthen the view of such delegation as a fiduciary function.

30. "Viewed from the beneficiaries' perspective, especially that of remainder [long-term] beneficiaries, efforts to prevent or detect actual improprieties can be expected to be inefficient if not ineffective" (Restatement of Trusts, Third, 1992, §78, Comment (b)).

31. See, for example, *CFSIEFF & ORS v. Fox & ORS* (2005). Canadian courts have developed this concept, as well as the "duty to consult," in the context of governments contemplating conduct that might adversely affect the rights of Aboriginal peoples (see, e.g., Lawrence and Macklem 2000).

32. *Free-riding* occurs when a shared resource or benefit is used without users' paying the full cost of it. Over time, this typically leads to overconsumption or exhaustion of the resource or to under-provision of it.

33. The duties to manage pension assets (a) solely in the interest of pension plan participants and beneficiaries, (b) for the exclusive purpose of providing benefits, and (c) with impartiality are separate components of the duty of loyalty. Sustainable investment practices recognize that an investment can be made for the purpose of generating income for benefits yet still not meet fiduciary standards if it does not also qualify as impartial and in the interests of participants and beneficiaries.

34. See also International Organization for Standardization (2010, clause 2.18), which defines *social responsibility* as the "responsibility of an organization for the impacts of its decisions and activities on society and the environment, through transparent and ethical behaviour that (i) contributes to sustainable development, including health and welfare of society, (ii) takes into account the expectations of stakeholders. (iii) is in compliance with international norms of behaviour; and (iv) is integrated throughout the organization and practiced in its relationships."

35. Pension Funds Act, 1956 (South Africa): Amendment of Regulation 28 of the Regulations made under Section 36, preamble and Section 1(b)(viii) (February 23, 2011).

36. With support of a research funding grant from the Rotman International Centre for Pension Management, the authors plan to hold fiduciary roundtables to explore development of key performance indicators and publish the findings in future articles.

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Rotman iCPM International Centre for Pension Management

151 Bloor Street West, Suite 702
Toronto, Ontario Canada M5S 1S4
Tel: 416.925.4153
Fax: 416.925.7377
icpm@rotman.utoronto.ca
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