

Responsible Investment and Fiduciary Duty

Evolving US Fiduciary Duties
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Investment Theory v. Fiduciary Duty

“ERISA’s plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan.”

[2008 US Department of Labor Bulletin]

“A fiduciary shall discharge his duties solely in the interest of the participants.”

[ERISA § 404; emphasis added]



The “Lemming” Fiduciary Standard

- *A fiduciary shall discharge his duties . . .*
“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” [ERISA § 404; enacted 1974]
- Markets have changed since the 1970s
 - Institutional investor asset growth exploded
 - Greater allocation of assets to equities
 - Shorter time horizons; more portfolio turnover
- Investor herding behavior amplifies volatility
 - Pension and economic health are now interdependent

Short-Termism and Risk

“It is shocking that the majority of firms are willing to sacrifice long-term economic value in order to deliver short-run earnings. Companies do this in response to intense pressure from the market to meet expectations.”

Value Destruction and Financial Reporting Decisions, Graham et al., Duke Univ. (2006)

“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.”

CFA Centre for Market Integrity & Business Roundtable Institute for Corp Ethics (2006)



Forgotten Duty of Impartiality

- The ***‘Duty of Impartiality’*** requires that fiduciaries identify and impartially balance conflicting interests of current and future trust fund beneficiaries [*Restatement of Trusts, Third §79*]
- Are young and old beneficiaries served equally well by current risk management practices and prevailing fund investment strategies?
 - Might long-term risks affect the ‘interests’ of a 20-year old fund participant more than an the ‘interests’ of a 70-year old?
 - Are ESG/sustainability issues relevant to a short-term manager?
- Could attention to impartiality reduce short-termism and lemming behaviors?



Upside Down Industry?

- In a survey of European pension professionals:
 - 65% of fund respondents said asset management firms do not understand their fund’s long-term needs
 - Only 15% of asset managers saw that as an issue
- Fee structures based on the value delivered was cited as a priority goal by 67% of fund respondents

“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.”

‘DB & DC Plans: Strengthening Their Delivery,’ Create-Research (2008)



Pension Risk Behavior Survey

Top 2010 Pension Risks Reported by Pension Managers

- Liability Measurement
- Underfunding of Liabilities
- Plan Governance
- Asset Allocation
- Advisor Risk (biggest move upward in ranking from 2009 survey)
- Asset and Liability Mismatch
- Inappropriate Trading
- Ability to Measure Risk
- Fiduciary Risk and Litigation Exposure
- Decision Process Quality

Metlife, *"US Pension Risk Behavior Index: 2nd Annual Study of Risk Management Attitudes & Aptitude,"* February 2010.



Service Provider Risk

“Some plan sponsors feel that they may not be able to - nor want to - rely on their consultants and advisors to the same extent they once did when consulting assignments were more standardized.”

MetLife U.S. Pension Risk Behavior Index (February 2010)

“While plan sponsors are viewing risk more holistically, implementing the management of all these risks is work in progress.”

MetLife U.S. Pension Risk Behavior Index (February 2010)



Mainstreaming of ESG Analysis

“Financial professionals worldwide have a duty to act in the best interests of their clients and ultimate beneficiaries. There is an increasing recognition of the need to include the analysis of ESG (environmental, social and governance) factors in order to more completely fulfill this duty.” CFA Manual for Investors (April 2009)

Investors with \$22 trillion have signed up to the UNPRI

- *Acknowledge effects of ESG risks on long-term investors*

Stewardship codes have been adopted in Britain and South Africa

- *Being developed in several other markets*

Implications for the standard of care applied to fiduciaries?



Evolution of Fiduciary Duty

Management of long-term risks, sustainability, service provider conflicts of interest and impartiality toward the conflicting interests of current and future beneficiaries are matters of fiduciary duty.

Nine out of ten investment professionals surveyed by the Network for Sustainable Financial Markets believe that sustainability issues and prevention of market crises are part of their fiduciary duty.

[<http://www.sustainablefinancialmarkets.net>]

