Reclaiming Forgotten Fiduciary Duty Fundamentals

21 March 2011 - Public Consultation Draft[1]

Query: Did pension lawyers abandon their role as guardians of fiduciary duty; allowing investors to fixate on the standard of care until it eclipsed the duty of loyalty and facilitated an unprecedented inter-generational transfer of wealth and risk – precisely what the duty of loyalty was designed to prevent?

Overview

This consultation paper describes how evolution of markets and pension funds over the past 35 years, combined with lack of attention to the changing context in which fiduciary duties are being applied, has weakened sustainability of pensions and undermined efficient allocation of capital. The paper explores how rediscovery of the basic principles which underlie the duties of loyalty and impartiality could improve the ability of fiduciaries to meet their legal obligations, while promoting both pension success and economic health.

Comments are requested on both content of the paper and development of Key Performance Indicators (KPIs) to assist pension fiduciaries, advisors and fund participants in modernizing their understanding of and compliance with fiduciary duties. In particular, input is solicited on KPI measures regarding:

- <u>Duty of Impartiality</u> - Achieving balance in promoting, measuring and reporting how pension practices are positioned over both the short and long term to impartially deliver sustainable pension benefits to the different groups of participants in pension schemes (e.g., 25-, 50- and 75 year olds).

- <u>Duty of Loyalty</u> – Effective supervision of service chain conflicts of interest and alignment of influential service providers with the balanced interests of pension fund participant groups.

- <u>Pension Fund Governance</u> – Attention to management of pension board governance practices, including use of trustee time and fund resources.

Changes in the Market Environment

Neither financial markets nor the role played by pension funds in those markets have remained static since emergence of modern pension funds in the mid 20th century. The extent of change, in many respects, has been quite remarkable. For pension fiduciaries, the most important transformations have included:

- <u>Growth of Pension Assets</u> – Assets under the management of pension fiduciaries have grown from being an insignificant part of the economy to a collectively huge pool of capital. Total pension fund assets now exceed national GDP in the Netherlands and Iceland. Across all OECD countries, the average pension assets-to-GDP ratio in 2009

[1] Prepared by Keith L. Johnson for public consultation meetings with the Network for Sustainable Financial Markets (NSFM), as part of a project funded by the Rotman International Centre for Pension Management at the University of Toronto. Mr. Johnson is Co-Chair of the NSFM Fiduciary Duty Working Group.

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was 67 percent. In the UK, it was 73 percent; in Australia, 82 percent.[2] Institutional investors now collectively own 73 percent of stock issued by companies in the Fortune 1000. Pension funds alone hold the largest block, with almost 30 percent of Fortune 1000 stock.[3] Pension investors have clearly become major allocators of capital. Their collective investment practices affect the overall economy.

- <u>Obsession with Short-Term Returns</u> – The average holding period for shares listed on the New York Stock Exchange has gone from over five years in 1970 to less than a year today.[4] High frequency trading is estimated to now account for 73 percent (or more) of all trading volume on US equity exchanges.[5] The CFA Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics did a joint study in 2006, which 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.*"[6]

- <u>Market Complexity</u> – Development of computer technology, the resulting explosion of derivative instruments and creation of new investment strategies has produced a far more complex investment marketplace. Complexity has spawned a vast new industry of expert pension consultants and advisors, without whom pension trustees would not be able to navigate the markets. These service providers heavily influence decisions made by fiduciaries.

- <u>Exposure to Systemic and Extra-Financial Risk</u> – Use of passive investing has skyrocketed from $1 billion in 1980 to over $3 trillion.[7] Seventy five percent or more of the typical pension fund's returns now come from general market exposure (beta) rather than benchmark outperformance (alpha).[8] The recent financial crises produced unexpected global correlation of risk exposures that lopped $5.4 trillion (20 percent) off global pension assets in 2008, accelerated the closure of defined benefit pension plans and ravaged retirement security for millions of plan participants.[9] In this environment, signatories to the United Nations Principles for Responsible Investment grew to over 850 investment organizations from more than 45 countries, with $25 trillion under

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[2] Organization of Economic Cooperation and Development, "*Pension Markets in Focus,*" Issue 7, July 2010.
[3] The Conference Board, "*The 2010 Institutional Investment Report,*" November 2010.
[4] The Conference Board, *"Commission on Public Trust and Private Enterprise, Part 2 – Corporate Governance,"* January 2003; New York Stock Exchange website at http://www.nyxdata/com/nysedata/asp/factbook.
[5] Robb Iati, *"The Real Story of Trading Software Espionage,"* The TABB Group, July 10, 2009.
[6] CFA Centre for Financial Market Integrity and Business Roundtable Institute for Corporate Ethics, *"Breaking the Short-Term Cycle,"* July 2006. The long-term value destruction dynamic is illustrated in a study by Sanjeev Bhojraj, Paul Hribar, Marc Picconi and John McInnis, *"Making Sense of Cents: An Examination of Firms that Marginally Miss or Beat Analyst Forecasts,"* The Journal of Finance (October 2009), where they 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.
[7] Larry Swedroe, *"Passive Investing Continues to Gain Momentum,"* MoneyWatch.com, 14 September 2009.
[8] Roger Ibbotson, *"The Importance of Asset Allocation,"* Financial Analysts Journal, March/April 2010.
[9] Organization of Economic Cooperation and Development, *"The Impact of the Financial Crisis on Defined Benefit Plans,"* July 2010. In the UK, 73 percent of defined benefit plans are now closed to new entrants.

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management.[10] There is an increasing awareness that broad exposure to the market limits the ability of institutional investors to escape economic shocks.

Interpretation of Fiduciary Duty

While fiduciary duty is an ancient concept, current views of trustee obligations were heavily influenced by the last half of the 20th century, when today's pension trust regulations were being developed.[11] That time period coincided with the global spread of capitalism and acceptance of modern portfolio theory as the dominant investment industry paradigm. A generation of investment professionals have spent their entire careers in this environment.[12] Consequently, there is strong cognitive resistance to viewing fiduciary duty from any perspective other than 20th century investment theory, despite major market meltdowns, intervening changes in the economic environment and surprises not predicted by prevailing models.

(a) Fiduciary Duty is a Flexible Legal Standard

Fiduciary duty is not a static concept, nor is it tied to a single investment theory. It is a flexible set of legal principles that have been subject to varying interpretations over time. For example, in explaining rejection of prior interpretations of the fiduciary standard of care in the early 1990s, The Restatement of Trusts (Third Edition), said:

> "***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***."[13] [Emphasis added.]

Although fundamental principles of fiduciary duty have remained stable over time, our understanding of how to apply them to current circumstances has changed. For example, less than 50 years ago, stock investments were generally viewed as imprudent for trust fiduciaries.[14] Obviously, understanding of fiduciary duty can evolve as knowledge and developments change.

(b) Basic Fiduciary Duties

Fundamental trust law principles require that fiduciaries 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 participants and beneficiaries; (d) with the care, skill and prudence exercised by similar fiduciaries, including as to diversification of

[10] See http://www.unpri.org/signatories. Signatories pledge to integrate environmental, social and governance concerns into their investment processes.
[11] Avisheh Avini, *"The Origins of the Modern English Trust Revisited,"* 70 Tulane L. Rev 1139 (1996). Additional background on the historical development of fiduciary duty will be included in the final paper.
[12] An expanded discussion of the influence of modern portfolio theory will be included in the final paper.
[13] Restatement of Trusts, Third, § 227, Introduction (1992).
[14] See Restatement of Trusts, Second, § 227, Comment f. (1959).

investments; (e) incurring only costs that are appropriate and reasonable; and (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." Though often compared to corporate director fiduciary duties, trustees are held to a higher standard of conduct that has different legal roots.[16]

Much ink has been spilled over the past three decades about application of fiduciary duty to pension trusts, but little has been devoted to the duty of impartiality. In addition, analysis of how changes in the economic environment affect implementation of fiduciary duty has received little attention.

The Duty of Impartiality

The duty of impartiality requires that fiduciaries identify and impartially balance conflicting interests of different trust fund beneficiary groups, including those of current and future retirees.

> *"In what might be called the 'substantive' aspects of impartiality . . . Subsection (1) directs trustees . . . to make diligent and good-faith efforts to identify, respect, and balance the various beneficial interests when carrying out the trustees' fiduciary responsibilities in managing, protecting, and distributing the trust estate, and in other administrative functions."* [17]

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."[18]

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

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[15] National Conference of Commissioners on Uniform State Laws, *"Uniform Management of Public Employee Retirement Systems Act,"* (1997) and Restatement of Trusts, Third, § 227 (1992). Similar principles apply across common law countries (e.g., Canada, US, UK, Ireland, Australia) and civil law countries (e.g., Italy, Japan, the Netherlands), according to Russell Galer, OECD, *"Prudent Person Rule Standard for the Investment of Pension Fund Assets,"* November 2002.

[16] *"[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, § 227, Comment c. (1992). Trust law generally precludes fiduciaries from doing self–interested transactions, though corporate directors can usually enter into related party transactions with the company if disclosed and approved by disinterested directors as fair to the corporation. See Restatement of Trusts, Third, §78 and §144 of the Delaware General Corporation Law.

[17] Comment c to §79 (1) of the Restatement of Trusts, Third. In the UK, *Cowan v. Scargill,* [1984] All ER 750, turned on impartiality.

[18] CFA Institute Centre for Financial Market Integrity, " *Code of Conduct for Members of a Pension Scheme Governing Body,"* (2008).

personal favoritism . . . nor is it permissible for a trustee to ignore the interests of some beneficiaries merely as a result of oversight or neglect."[19]

Most importantly, the duty of impartiality imposes "procedural" duties. Not only must actual results reflect due regard for beneficiaries' interests, but the "process of administration itself," including communication with beneficiaries, must be impartial.[20] As a separate fiduciary duty that is distinct from the standard of care, impartiality is not defined with reference to practices of other similar fiduciaries.

(a) Progression of the Duty of Prudence into a '*Lemming Standard*'

The standard of care (described above and also known as the duty of prudence) encourages pension fiduciaries to adhere to practices followed by similar institutional investors.[21] However, changes in the market environment have generated tension between the duty of prudence and duty of impartiality.

Trustees are advised under the duty of prudence to adopt performance benchmarks and investment approaches that are similar to those used by other pension funds. This amplifies natural investor herding behavior but also protects fiduciaries from criticism or exposure to liability for violating the duty of prudence.[22] Unfortunately, in the current environment, excessive herding can generate other fiduciary problems.

With growth in pension assets over the past few decades and increased investor focus on short-term investing, herding can also function like an economic wave generation machine.[23] Collectively, pension fund investors have the ability to create market volatility and undermine sustainable wealth creation when they invest with the same short-term bias and follow each other around the markets.[24] What used to work well as fiduciary guidance for trustees when pension

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[19] Restatement of Trusts, Third, § 79, Comment b. (1992).

[20] Scott and Ascher on Trusts, §17.15 (2010). See also *McNeil v. Bennett*, 792 A.2d 190 (Del. Ch. 2001), where the Court stated, "*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.*"

[21] Russell Galer, OECD, *"Prudent Person Rule Standard for the Investment of Pension Fund Assets,"* November 2002. In the United States, pension funds subject to the Employees' Retirement Security Income Act (ERISA) 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." 29 USC §18.1104.

[22] Indeed, researchers who have studied large public pension funds in the United States found that trustees appear to be primarily motivated by shifting responsibility and avoiding blame. William O'Barr, John Conley and Carolyn Kay Brancato, *"Fortune and Folly: The Wealth and Power of Institutional Investing,"* Arcadia Books.

[23] Frank Jan de Graaf and Keith Johnson, *"Modernizing Pension Fund Legal Standards for the Twenty-First Century,"* Rotman International Journal of Pension Management, Vol. 2, No. 1, 2009.

[24] Pressure on corporate managers to deliver short-term investment results has become so strong that nearly eighty percent of them report they would sacrifice future economic value to manage short term earnings so as to meet investor quarterly earnings expectations. See John Graham, Campbell Harvey and Shivaram Rajgopal, *"Value Destruction and Financial Reporting Decisions,"* (September 6, 2006) at SSRN: http://ssrn.com/abstract=871215. See also Moody's Investors Service, Special Comment, *"Short-Term Shareholder Activists Degrade Creditworthiness of Rated Companies,"* June 2007.

funds were not a major collective force in the economy could perhaps now be better described as a '*900-pound lemming standard of care*.'

This is an historically recent phenomenon. It has increased exposure of pension fund participants to systemic risks, while hampering efficient allocation of capital for creation of sustainable economic wealth.[25] Unfortunately, strict adherence to a lemming standard of behavior also discourages adoption of improved practices that would reduce these effects.

(b) Eclipse of the Duty of Impartiality

Signs of economic malaise and deterioration of pension sustainability have been evident throughout developed markets. The S&P 500 is currently at the same level it was 12 years ago, though intervening periods of volatility decimated pension funding.[26] More than 73 percent of UK defined benefit plans are now closed to new entrants. In 2009, only 49 percent of the 200 largest US companies had ongoing defined benefit plans, down from 61 percent three years earlier. Underfunding of corporate defined benefit plans in OECD countries went from 13 percent at the end of 2007 to 26 percent in 2009.[27]

Sustainability of the pension promise is under stress for major segments of fund participants. Workers nearing retirement have been left with terminated defined benefit plans or decimated defined contribution accounts and must defer retirement, while defined benefit plans are being closed to younger workers who are moved to costlier schemes. For many plan participants pension management results have been grossly unfair, particularly from an inter-generational perspective.

While this is unlikely to present problems under the duty of prudence – common management approaches and poor results have been widely shared – the duty of impartiality presents a more clouded picture. Unquestioning acceptance of highly volatile investment practices, with fluctuations in defined benefit contribution rates and commensurate pressure to grant unsustainable benefit increases during good times, followed by contribution spikes and closure of defined benefit plans during bad times, seems destined to produce uneven pension promise instability. Moreover, it is no surprise that widespread adherence to investment practices focused on producing short-term portfolio earnings at the expense of future capital growth, comes with "*consequences of destroying long-term value, decreasing market efficiency, reducing investment returns, and impeding efforts to strengthen corporate governance,*" as was highlighted five years ago by the CFA Institute and Business Roundtable.[28]

Unfortunately, past preoccupation with the standard of care has come to overshadow the duty of impartiality. Impartiality is of little concern to an investment manager with a market relative

[25] See footnote 6, s*upra,* and the accompanying text.
[26] The S&P 500 first hit 1300 in early 1999, approximately where it sits in early 2011.
[27] Data is from Juan Yermo and Clara Severinson, "*The Impact of the Financial Crisis on Defined Benefit Plans and the Need for Counter-Cyclical Funding Regulations,*" OECD (July 2010) and "*Mercer's Retirement, Risk and Finance Perspective,*" Mercer Consulting (February 10, 2011).
[28] See footnote 6, s*upra,* and the accompanying text.

benchmark. However, it is highly relevant when viewed from the perspective of pension fund participants. That is the perspective required of trustees.

The duty of impartiality mandates use of a balanced process that gives due regard to the interests of different participant groups.[29] It is an extension of the duty of loyalty, not part of the standard of care. When a fiduciary uses an investment process that is inherently biased, deference is not accorded to practices used by other fiduciaries.[30] Fiduciaries must be able to show they made a diligent and good faith effort to identify, respect and balance the various beneficial interests of pension scheme participants.[31] The obligation applies to all pension management responsibilities, but it is not clear that impartiality is widely integrated into fiduciary practices.[32]

Dilution of The Duty of Loyalty

Pension trustees have a *"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."*[33] This duty is often referred to as the strictest standard of conduct in the law.

Uncompromising rigidity of the rule is not just a formality.[34] *"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."*[35]

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[29] See footnote 20, *supra.*

[30] *"The duty of impartiality is an extension of the duty of loyalty to beneficiaries. . ."* Restatement of Trusts, Third, § 79, Comment b. (1992). *"The duty to furnish information and to act impartially are not subspecies of the duty of care but separate duties." McNeil v. Bennett*, 798 A.2d at 509 (Del. Super. 2002).

[31] *"This policy of strict prohibition also provides a reasonable circumstantial assurance . . . that beneficiaries will not be deprived of a trustee's disinterested and objective judgment."* Restatement of Trusts, Third, § 79, Comment b. (1992). *"Asset selection also requires sensitivity to the trust's investment time horizons and to the goals and needs of the trust."* Restatement of Trusts, Third, § 227, Comment k. (1992).

[32] A more balanced approach to investment and risk management would likely cause certain factors to take on greater relevance. For example, plan governance, decision process quality, ability to measure risk, fiduciary litigation exposure and advisor risk are now listed among the top ten pension risks by pension managers. Metlife, *"US Pension Risk Behavior Index: 2nd Annual Study of Risk Management Attitudes & Aptitude,"* February 2010. See also footnote 10, *supra,* and the accompanying text regarding growth of institutional investor consideration of environmental, social and governance factors.

[33] Restatement of Trusts, Third, § 78 and Comment b. (1992).

[34] 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 that require 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 but 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 fail the 'interest of beneficiaries' and 'impartiality' fiduciary duties.

[35] R. Hallgring, *"The Uniform Trustees' Powers Act and the Basic Principles of Fiduciary Responsibility,"* 41 Washington L. Rev. 808 – 811 (1966).

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However, increasing financial market complexity and growth of the pension consulting industry have eroded protections of the duty of loyalty. The US Government Accountability Office recently reported findings that pension consultant conflicts of interest appear to be associated with lower investment returns.[36] In response, the US Department of Labor has proposed new regulations under the Employee Retirement Income Security Act to finally 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."*[37]

A 2008 survey of European pension fund executives and asset managers offers insight into the practical ramifications of these conflicts of interest.[38]
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> "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.

The survey also found that 65 percent of pension fund respondents believe pension consultants do not understand the long-term needs of their clients, while only 15 percent of asset managers identify that as an issue. Development of a fee structure that is aligned with the value delivered was also one of the top concerns cited by funds, with 67 percent noting it as important. Most alarming was the finding that the vast majority of both pension fund executives and their fund managers see current pre- and post-retirement products as woefully inadequate to deliver adequate retirement incomes.[39]

Unfortunately, growth of the pension service provider industry over the past 40 years has coincided with increasing complexity of investment markets and focus on the duty of prudence in a rapidly evolving marketplace. Full appreciation of duty of loyalty principles has taken a back seat in this environment, while the pension industry became the largest allocator of capital in society. One wonders whether economic and pension security developments would have played out differently over the past decade if the duty of loyalty had not been eclipsed by attention to the standard of care.

(a) Management of Service Provider Conflicts

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[36] Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans, GAO 09-503T (March 24, 2009).

[37] Federal Register: October 22, 2010 (Volume 75, Number 204).

[38] Amin Rajan, "DB & DC Plans: Strengthening Their Delivery," Create-Research (2008).

[39] This is particularly troubling given that fiduciary duties run to trust fund participants and beneficiaries as individuals, not to the trust's investment portfolio. *Varity Corp. v. Howe,* 516 U.S. 489 (1996). For example, in the US, the Employees Retirement Income Security Act *"was enacted by Congress in the following context: included directly in the statute are Congressional findings and a declaration of policy stressing the need to protect employee interests. In part, it states 'the continued well-being and security of millions of employees and their dependants are directly affected by these plans." Erisman v. Unum Life Insurance Company of America,* 2006 WL 516752 (W.D. Wash.)

Trustees have a legal obligation to identify and manage conflicts of interest in their service provider chain.[40] Regulatory initiatives are beginning to refocus on this aspect of fiduciary duty, but regulation is not a substitute for effective management of conflicts by fiduciaries.

Attention to development of an effective conflicts management program should include the following components:

- Consideration of behavioral and financial indicators of conflicted interests: The courts have recognized that loyalty is a subtle and subjective concept best addressed by prophylactic measures. *"[The] policy of the trust law is to prefer (as a matter of default law) to remove altogether the occasions of temptation rather than to monitor fiduciary behavior and attempt to uncover and punish abuses . . . The inherent subjectivity and impracticability of second-guessing a trustee's application of business judgment or exercise of fiduciary discretion are aggravated by the opportunities and relative ease of concealing misconduct."*[41] In other words, "just say 'No' to conflicts."

- Use of conflicts screening in selection of service providers: The legal obligation to view conflicts of interest from fund participants' perspectives and focus on avoiding conflicts rather than monitoring them requires selection of service providers without conflicts whenever practicable.[42]

- Alignment of service provider interests with fund participants: Contract mandates and fee structures should be aligned with the duty of impartiality and incent service providers to achieve goals that serve the interests of fund participants in a balanced manner.[43]

- Monitoring of Conflicts and Enforcement of Standards: Particular attention should be paid to ongoing oversight of areas where service providers are likely to have conflicts. For example, there are often situations where providers have competing interests that complicate compliance with the duty of impartiality (e.g., affiliates with business models focused only on generating short-term trading) and where other clients of a provider have conflicting interests (e.g., officers at public companies who hold views on executive compensation in opposition to shareholder interests).

- Reporting to fund participants on management of conflicts: Given the opacity of risks associated with conflicts of interest, transparency of conflicts management practices is particularly important. Research that found conflicts can depress investment returns should put meaningful reporting on duty of loyalty compliance at the same level as reporting of investment returns.[44]

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[40] This applies to defined contribution, hybrid and other pension scheme structures as well as defined benefit plans.
[41] Restatement of Trusts, Third, § 79, Comment b. (1992).
[42] *"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, § 79, Comment b. (1992).
[43] The International Corporate Governance Network is currently undertaking a project to identify best practices for design of asset manager contracts to align interests of the service provider with fund participants.
[44] See footnote 36, *supra*, and accompanying text.

(b) Management of Pension Governing Board Conflicts

Studies on pension fund governance have shown that good governance is associated with increased returns. A report published in the Rotman International Journal of Pension Management found that better governed pension funds outperformed poorly governed funds by 2.4 percent per annum during the four years ending December 2003.[45] The results confirmed a similar 1993 – 1996 study which found a one percent annual good governance performance dividend.

Key factors tying good governance to pension fund success included:

- 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; and
- Clarity of board and staff roles about delegation of management responsibilities.[46]

While some of these factors are beyond control of trustees, most of them are not. If good governance does indeed have the impact that research has identified, pension fund board members have a duty to take reasonable steps to manage and improve their governance practices. Failure to consider pension governance success would place trustee behavioral self-interests in conflict with the interests of pension plan participants. This appears to have duty of loyalty implications, though our understanding of the impact of governance practices is still developing. It could well be an issue tested in the courts and further defined by regulators over the coming decade.

Development of Key Performance Indicators

Re-integration of fundamental fiduciary concepts of loyalty and impartiality into governance and management practices at pension schemes presents a challenge. The extended time period over which those legal duties have been overshadowed by deference to concentration on the standard of care has produced broad misalignment of pension industry business models with participant-oriented measures of success. This consultation paper seeks input from pension attorneys, investment professionals, regulators, pension plan members and fiduciaries on development of

[45] Capelle, Ronald, Lum, Hubert and Ambachtsheer, Keith, *"The Pension Governance Deficit: Still with Us,"* (October 1, 2008). Rotman International Journal of Pension Management, Vol. 1, No. 1, 2008.
[46] For more insight about the crucitical role of board leadership, see Clark, Gordon L., Urwin, Roger, *"Making Pension Boards Work: The Critical Role of Leadership."* Rotman International Journal of Pension Management, Vol. 1, No. 1, 2008, 38- 45; Clark, Gordon L., Urwin, Roger, "*Best-practices pension fund governance,"* Journal of Asset Management, 2008, Vol. 9, 1, 2-21.

Key Performance Indicators (KPIs) for use by all stakeholders to address gaps in implementation of fiduciary duties.[47]

In particular, input is solicited on development of KPIs relating to:

- Implementation of the Duty of Impartiality - Potential discussion items might include:

    - What key factors are associated with identification of success toward impartially delivering sustainable pension benefits to various groups of pension fund participants (e.g., 25-, 50- and 75-year olds?
    - What are key sustainability risks for pension benefits over the short and long term?
    - Are there meaningful ways of measuring and reporting on success toward meeting the pension savings goals of various age groups in a pension scheme?
    - What kinds of expertise should be used by fiduciaries to evaluate pension benefit sustainability over long time periods?

- Compliance with the Duty of Loyalty – Potential discussion items might include:

    - What are the key issues that should be addressed in policies for selection, instruction and monitoring of pension service providers?
    - Are there particular characteristics associated with effective conflict of interest identification and management processes?
    - What asset manager remuneration structures, risk indicators and success measurements would best align service providers with interests of fund participants?
    - What should be reported to participants so they can determine whether conflicts of interest are being effectively managed?

- Adoption of Governance Practices Designed to Achieve Success – Potential discussion items might include:

    - What are the characteristics of an effective pension governance structure?
    - Are there also particular behavioral markers of successful pension governance?
    - How important are trustee use of meeting time and prioritization of information reported to governing boards?
    - What are the best measures of governance quality for reporting to participants?
    - Are particular governance mechanisms needed to ensure impartiality and loyalty?
    - Should KPIs differentiate between defined benefit and defined contribution funds?

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[47] The duties of loyalty and impartiality apply equally to defined benefit, defined contribution and hybrid pension schemes. While often mischaracterized solely as issues of prudence, and inadequately applied, these fundamental legal obligations have begun to receive increased attention. For example, in *Howell v. Motorola*, 2011 WL 183066 (7th Cir. 1/21/11), the 7th Circuit United States Court of Appeals favorably cited a refined Department of Labor interpretation of fiduciary duty in regard to selection of defined contribution plan investment options. The Court said, *"We agree with the position taken by the Secretary of Labor in her amicus curiae brief that the selection of plan investment options and the decision to continue offering a particular investment vehicle are acts to which fiduciary duties attach, and that the safe harbor [from fiduciary liability] is not available for such acts."*