THE EVOLVING MEANING OF FIDUCIARY DUTY

Are Boards of Pension Organizations Keeping Up?

By Keith Ambachtsheer

The term "fiduciary duty" has been evolving along three paths over time. On the first path, legislators and regulators rewrite statutes that set out the meaning of the term. On the second path, litigation results in court decisions directly involving alleged breaches of fiduciary duty. On the third path, legal experts participate in ongoing interpretive processes that redefine fiduciary duty in light of changing economic and social circumstances and court judgments that may impact the interpretation of fiduciary duty.

The most visible example of evolution on the first path is the current effort by the U.S. Department of Labor (DOL) to cast a wider net over those it believes should be held to a fiduciary standard in the provision of retirement and investment advice under ERISA. Given that powerful interest groups oppose the DOL's New Fiduciary Rule proposal, the initiative's ultimate impact remains to be seen. Also, given that actual court cases directly involving litigation related to allegations of breaches of fiduciary duty are few and far between, the second path is an unlikely venue for evolution. In my view it is the third path, the ongoing interpretation by legal experts, that is the most likely route for change. I also believe this third path is the most constructive route to impacting the thinking of boards of pension organizations about their obligation to act as fiduciaries.

Five Inflection Points for Reinterpretation

One of the most important (and possibly most underappreciated) research projects funded by the Rotman International Centre for Pension Management over the past five years was on the evolving meaning of "fiduciary duty" for boards of pension organizations in the 21st century. This work was conducted by legal experts James Hawley, Keith Johnson, Douglas Sarro, and Edward Waitzer and led to Hawley et al. (2011) and Waitzer and Sarro (2014). This article summarizes the conclusions reached by these experts and sets out a work plan for pension boards that want to keep up with the evolving meaning of fiduciary duty in the 21st century—rather than having to play a possibly unpleasant game of catch-up in a few years.

The legal experts point out the following four "inflection points" as developments that open the door for boards of pension organizations to be proactive now rather than reactive later:

Growth of pension funds. The global pension fund sector has become a major financial force, with assets of $30 trillion–$40 trillion. The growing sovereign wealth and foundation/endowment fund sectors add materially to this amount. These massive asset pools represent the multi-generational financial interests of hundreds of millions if not billions of beneficiaries. Collectively, the investment decisions of these pools directly impact both how the global financial markets work and how the global real economy works. This enormous scale, and the long-term perspective necessary to understand and meet retirement income needs, should motivate pension organizations to ensure that they understand, and are in fact fulfilling, their fiduciary duty.

Emphasis on the short-term; influence of agents. Investment policy documents of pension organizations tend to emphasize the long term, but actual practices continue to reflect the short-term mind-set in many cases. This dichotomy is reinforced through multiple channels: media, performance measurement, incentive compensation, and the presence of multiple intermediary agents (e.g., consultants, money managers). There is no natural alignment between the financial interests of these agents and those of trust beneficiaries. In such an increasingly complex world, fiduciaries are seriously challenged to articulate the best short- and long-term interests of current and future beneficiaries, and to demonstrate that they are actually serving these interests in a balanced manner through their investment policies.

Overreliance on simplistic investment theories. Investment theories such as the efficient markets hypothesis (EMH) are elegant, but the assumptions behind them hardly reflect reality. For example, in the case of the EMH, material information about individual investments is not always known by all investors all the time; information that is generally known is not always interpreted identically by all investors and is not always accurately reflected in asset prices; investors are not always rational and risk tolerances are not always stable; and investment returns are not independently and identically distributed. As a result, events such as the global financial crisis cannot happen in an EMH world, but they do happen in the real world. The point is that trying to exercise the fiduciary duties...
of prudence, loyalty, and impartiality while using the assumptions and implications of EMH is indefensible in the 21st century. Boards of trustees have an obligation to understand the world as it is, and not as it is posited, in order to perform their fiduciary duty.

Recent legal responses to financial-system dysfunction. The four legal experts point to a number of recent legal opinions and actions that bear on the evolving meaning of fiduciary duty, such as the following: In a pensions dispute, the U.S. Supreme Court ruled that fiduciary duty requires "trustees to take impartial account of all beneficiaries … both present and future." The Dutch pension act requires fiduciaries to take into account the interests of all plan stakeholders in setting policy and making decisions. The global financial crisis prompted a number of actions against financial institutions and individuals working in these institutions for fiduciary misbehavior. In contrast, the Supreme Court of Canada recently ruled against a class action initiated by a corporation's bond holders against its board of directors, ruling that the board had made reasonable decisions reflecting the interests of the corporation's creditors and shareholders as well as the corporation's broader obligations "as a good corporate citizen." Emerging from these opinions and judgments is a new "reasonable expectations" standard for the exercise of fiduciary duty. This emerging view contrasts sharply with the historical view that attention to fiduciary duty could be demonstrated by engaging in a standard box-checking exercise drawn up by legal counsel.

To these four inflection points, I add the following as a fifth development that arguably should motivate pension boards to develop their sense of fiduciary duty:

Passive acceptance of unsustainable pension designs. I have long been uncomfortable with traditional defined benefit and defined contribution pension designs. In my view, neither fully acknowledges the differing needs of the young and the old today or the financial interests of the young and the old tomorrow. As a result, these traditional designs are problematic in a number of ways (e.g., the one-size-fits-all problem, the fuzzy property rights problem, the fuzzy risk definition and allocation problem). I set out these views in detail in Ambachtsheer (2014). The duty of impartiality requires pension fiduciaries to balance divergent interests—of various classes of beneficiaries and other risk-bearing stakeholders, as well as the intergenerational implications of their decisions. These fiduciaries also have a duty to test the pension designs of the plans they govern for long-term sustainability and fairness regarding all stakeholder groups, present and future.

Now What?

Having established five reasons why now is the time for pension boards to evolve their understanding of fiduciary duty, we turn to the question of what actions should pension boards take to develop this new understanding. In other words, how should pension organizations individually—and collectively, at the national and global pension community levels—respond to these five catalysts? Consider the following:

Responses at the Pension Organization Level

Obviously nothing will happen at the organizational level unless the board of trustees, led by the board chair, is prepared to own the fiduciary duty development project. If that is the case, the following six-point checklist1 will be helpful:

Pension design. Do we have a fair, sustainable, understandable pension formula?

How can we best address this question?

What would we do if our formula doesn't pass a reasonable fair/sustainable/understandable test?

Stakeholder communications. Are we clear about who are our stakeholders? Do we communicate with them effectively about pension design and the value the pension organization is creating for them? How do we know our communication strategies are effective?

Organization design. Do we have a cost-effective organization that produces “value for risk” and “value for money” in its key functions? How can we best address this question? What would we do if our organization doesn't benchmark well in its key functions using credible metrics?

Board effectiveness. How effective are we as a board? Do we have the right mix of skills and experience? Are we seen as trustworthy by our plan stakeholders? Are we public-minded? Do we measure our own effectiveness and improve our own performance?

Risk management. What risks do we need to measure and manage? Do we have the people, protocols, and technology to do this well? If not, what are we going to do about it?

Investment beliefs and policies. Do we have an investment program geared to generate plan-member wealth through long-horizon return compounding? Is it working well? How do we know? Do we have an investment program geared to meeting payment obligations to retirees? Is it working well? How do we know?

Collective Responses at the National and Global Levels

A pension organization that implements the above six-point checklist undoubtedly would net an improving score on an assessment of organizational fiduciary duty. A broader dimension of fiduciary duty, however—one that encompasses expectations and responsibilities—also needs some attention. Waitzer and Sarro (2014) proposed the following four specific initiatives for financial institutions (including pension organizations), lawmakers, and regulators to undertake collectively to strengthen the expectations and responsibilities attached to the fulfillment of fiduciary duty:

Foster win-win collaborations. A single organization needs a clear short-term net benefit to become the first to move on a particular issue that may be of great long-term collective benefit. But the lack of any such benefit results in a conflict between

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safety and social cooperation, i.e., a “trust dilemma.” The solution calls for multiple parties to agree on the importance of the issue and to share the cost of addressing it. Examples of such collaborations are numerous. For example, the Focusing Capital on the Long-Term initiative opens up the prospect of investor/investee collaboration on such issues as fostering long-term perspective in investing and the measurement of organization success.

Create legal mechanisms to protect future generations. Establishing a commissioner or ombudsman to represent the rights of future generations would guard against the short-term mind-set in political decision-making. Such mechanisms already exist in the environmental and human-rights spheres. Additionally, more day-to-day decision-making could be delegated to nonpartisan, independent agencies or to senior administrators with guaranteed term lengths.

Rethink legislation. Financial legislation and regulation since the global financial crisis has spawned “complicated rules breeding complicated systems,” which in turn feed a box-checking “is it legal?” mentality. A far-better approach would be to specify fewer broad, coherent, concise, enforceable rules that focus on core expectations. Courts can play a constructive role here by emphasizing the “reasonable expectations” principle.

Reassert the social utility of the financial sector. The global financial crisis and its aftermath exacerbated the lack of public trust and understanding of the financial system. Many years of hard work will be required to regain that public trust and to enhance public understanding of the vital role the financial sector in general, and the pensions sector in particular, plays in mobilizing capital and pricing and allocating financial risks in a well-functioning economy. The CFA Institute’s Future of Finance initiative is an example of the work already underway to address this challenge.

In the exercise of their fiduciary duty, pension boards of trustees need to be aware of these collective national and global initiatives and to understand the roles their organizations are playing (or should be playing) in moving one or more of these initiatives toward successful implementation.

Doing the Right Thing

In conclusion, Waitzer and Sarro (2014) argue that board governance in the financial sector has focused, and continues to focus too much, on “doing things right”—that is, on technical compliance with whatever rules may exist. They argue that a fundamental mind shift is required. Instead of focusing on “doing things right,” boards must begin to focus on “doing the right thing.” They believe that this increasingly will be the basis on which decisions and actions will be judged, in courts of law and in the court of public opinion.

So “doing the right thing,” based on balancing the financial interests of all relevant stakeholder groups, is the new 21st-century standard for fulfillment of fiduciary duty. Are the boards you know meeting this standard?

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Endnotes

1. The Rotman International Centre for Pension Management (ICPM) is a network of 38 thought-leading pension organizations from 12 countries based at the Rotman School of Management at the University of Toronto.

2. The Rotman ICPM Board Effectiveness Program offers a week-long course for board members of pension organizations. The course offers a deep dive into each of the six effectiveness areas listed above. For more details on this program, visit http://www.rotman.utoronto.ca/ProfessionalDevelopment/ExecutivePrograms/CoursesWorkshops/Programs/PensionManagement.aspx.

3. ICPM has invested significant resources to research in collaboration theory and practices; see Guyatt (2008, 2013). Examples of such collaborations include the following: International Corporate Governance Network, Principles for Responsible Investment, World Economic Forum, ICPM, Council of Institutional Investors, Canadian Coalition for Good Governance, Eumedion, National Association of Pension Funds, Australian Superannuation Funds Association, and Australian Council of Superannuation Investors.


References


